INDIAN FINANCIAL SYSTEM

Tenth Edition

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Preface to the Tenth Edition

We are pleased to place in the hands of the readers this revised edition of our book: **Indian Financial System.** The new edition, like the earlier editions, focuses on presenting to the readers the emerging organisational/structural/institutional and regulatory/policy developments in the financial sector in India. The contents of all the chapters reflect all the major developments since the publication of the earlier edition until end-March 2017. They are too numerous to be listed completely. The notable features of the revision are highlighted below.

Chapter-wise Changes

The chapter-wise changes are listed as under:

- **Chapter 5:** **(i)** Addition of a Section on SEBI Listing Regulations 2015
  (ii) Deletion of Section on Listing Agreement
- **Chapter 7:** **(i)** Inclusion of: **(a)** Conditions and Manner of Providing Exit Opportunity to Dissenting Shareholders, **(b)** Listing on Institutional Trading Platform, **(c)** Listing of Securities on Stock Exchanges
  (ii) Deletion of Listing and Issue of Capital by Small and Medium Enterprises in Institutional Trading Platform without Initial Public Offering.
- **Chapter 11:** **(i)** Scheme for Sustainable Structuring of Stressed Assets
  (ii) Addition of Insolvency and Bankruptcy (IB) Code, 2016
- **Chapter 14:** **(i)** Section 2 on NBFC-D Prudential Directions, completely rewritten
  (ii) Section 3 on NBFC-ND-SI Prudential Directions, completely rewritten
  (iii) Section 4 on NBFC-MFI Direction, deleted
  (iv) RBI CICs Directions, completely rewritten
  (v) Section on IFD NBFC, deleted
- **Chapter 16:** Complete rewriting of **(i)** Registration of Corporate Agents, **(ii)** Appointment of Insurance Agents, **(iii)** Registration of Indian Insurance Companies, and **(iv)** Health Insurance Regulations

- **Chapter 18: (i)** Section on General Condition on FDI, completely rewritten, **(ii)** Section on Sector-specific Conditions on FDI substantially rewritten, **(iii)** Section on FIPB deleted.

Website Material

Additional reading material listed below is available on the book's website:
http://www.mhhe.com/khanifs10e

Appendix	(Chapter)	
4-A	(4)	Disclosures to be Made in the Offer Document
5-A	(5)	Code of Conduct for the Directors on the Governing Board
5-B		Code of Ethics for Directors and Key Management Personnel of Stock Exchange or Clearing Corporation
6-A	(6)	Model Code of Conduct for Prevention of Insider Trading
6-B		Code of Corporate Disclosure Practices for a Prevention of Insider Trading
7-A	(7)	Inter Se Allocation of Responsibilities
7-B		Format of Agreement Between Lead Merchant Banker to the Issue and Issuer/Issuing Company
7-C		Mandatory Collection Centres
7-D		Manner of Submission of Soft Copy of Draft offer Document and Offer Document to SEBI
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7-F		Nature of Updation/Changes in the offer Document and Consequent Steps Therein Regarding Filing of Updated Offer Document
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7-Q		Disclosures in Placement Document
7-R		Disclosures in Prospectus and Abridged Prospectus for Issue of Indian Depository Receipts
10-A	(10)	Short Sale in Government Securities
10-B		When Issued Market–Guidelines
10-C		Investment Portfolio of Banks–Transactions in Securities–Conditions Subject to Which Securities Allotted in the Auctions for Primary Issues can be Sold

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Suggestions for improvements from readers are welcome.

M Y KHAN

Preface to the First Edition

The importance of a diversified, vibrant, mature and efficient industrial financing system in stimulating economic development via capital formation cannot be overstressed. In fact, the process of industrial growth requires, as one of its adjunct structural changes within an economy, the development of a financial mechanism capable of meeting the varied requirements of finance and credit of heterogeneous entrepreneurs. Its structure and organisation, of course, varies from country to country, as well as over a period of time within the same country, depending upon a variety of economic, social and political factors.

The scheme of planned economic development had significantly conditioned the course of financial development in India till the late eighties. Since the early nineties, the industrial financing system is evolving in response to the emerging liberalised/deregulated/globalised economic environment. The transformation is essentially focused on a shift away from the domination of the organisation of the financial sector by state-sponsored and controlled development finance institutions (DFIs) and other monolithic public sector financial institutions to the capital market and related institutions. Indian Financial System attempts to present, against the background of the planned growth of industry till the late eighties and the deregulated economic policy particularly after 1991, a comprehensive account of the main strands in the development of the industrial financing system in India on the basis of information from widely/scattered original sources. The growth of the system is described in terms of the development in the organisation, structure, operating policies, etc., rather than in quantitative terms.

The book would hopefully be found useful by a wide section of readers. Teachers and students of finance, management and commerce would find it of special interest and use. The contents have been classtested with my students in the Department of Financial Studies, Delhi University. To financial and investment managers of corporates and financial institutions and the stock exchange community in general, it would be equally useful.

The book is divided into seven parts. Part One consists of two chapters. The first of these provides a broad view of the relevance of financial systems to economic development. Chapter 2 outlines the evolution of the organisation of the Indian financial system in the context of the planned economic development in India since 1951 and the deregulated economic environment after 1991. Against this background, the subsequent discussions relate to the main elements of the organisation of the Indian financial system.

Four chapters of Part Two of the volume deal with the role of the commercial banks in industrial financing and the emerging money market organisation in India. While Chapter 3 dwells on the changing character of Indian commercial banks is relation to the financing of industry, the financing of corporate working capital by them is discussed in Chapter 4. In the context of the shift in Indian banking from social/mass to prudential, management of their funds requires critical emphasis, the main ingredients of the framework for which are outlined in Chapter 5. The last chapter in this part (Chapter 6) comprehensively describes the money market organisation as an important component of the Indian financial system.

The other component of the financial system, namely, the capital/securities market in India is discussed in detail in four chapters of Part Three of the book. The organisation and functions of the securities markets in general terms is outlined in Chapter 7, while the statutory/regulatory framework of the Indian securities market in terms of company law regulations, Securities and Exchange Board of India (SEBI) and listing requirements is the subject matter of Chapter 8. The organisational developments in the primary and secondary markets in India are covered in Chapters 9 and 10 respectively.

An important constituent of the institutional structure of the capital market is mutual funds. The Unit Trust of India was the pioneer monolithic public sector mutual fund and has emerged as a financial super-house. Its operations are analysed in Chapter 11 of Part Four. The structure of mutual funds industry has been diversified through the establishment of other mutual funds which are examined in Chapter 12.

The development banks/finance institutions (DFIs) constituted the backbone of the Indian financial system. In response to the changing environment, they are emerging as financial conglomerates with capital market-orientation in their operations. Part Five of the volume consisting of four chapters covers the main DFIs, namely, Industrial Finance Corporation of India (Chapter 13), Industrial Credits and Investment Corporation of India (Chapter 14), State Financial Corporation (Chapter 15) and Industrial Development Bank of India (Chapter 16).

Two chapters of Part Six cover the two monolithic public sector insurance organisation—Life Insurance Corporation (Chapter 17) and General Insurance Corporation (Chapter 18).

Finally, Part Seven (Chapter 19) examines the roles of foreign capital/investments in the post-1991 financial system in India.

Suggestions for improvements from readers are welcome.

M Y Khan

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The Background

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Indian Financial System: An Overview

A **system** is a set of interrelated parts working together to achieve some purpose. With reference to financial system, it implies a set of complex and closely-connected or intermixed institutions, agents, practices, markets, claims, and so on in an economy. Conceptually, the term financial system includes a complex of institutions and mechanisms which affect the generation of savings and their transfer to those who will invest. In other words, financial systems may be said to be made up of all those channels through which savings become available for investment. Included in the complex of institutions are: (i) financial institutions/intermediaries like banks, insurance organisations, unit trusts/mutual funds, and so on which collect capital from savers-investors and distribute them to entrepreneurs/productive enterprises; (ii) financial markets comprising of the capital/securities market (i.e. stock exchange and the new issue market), the money market and the foreign exchange (forex) market; and (iii) financial assets/instruments (securities) such as shares, debentures, units, derivatives and so on. Forex markets are, however, beyond the scope of this book. Part One of the book consisting of two chapters is devoted to outlining the functions and structure/organisation of the financial system and the main strands in the evolution of the Indian financial system in the post-Independence and post-liberalisation/deregulation period. While the functions of the financial system and its organisation/structure is described in Chapter 1, the main elements of the growth of a diversified financial mechanism in India in the pre and post-1990 periods are covered in Chapter 2.

CHAPTER 1

Financial Systems: Functions and Structure/Organisation

INTRODUCTION

This Chapter discusses the functions and organisation of the financial system. Sections 1-2 cover respectively their functions and organisation. Concluding observations are given in the last Section.

FUNCTIONS

Financial systems are of crucial significance to capital formation. That adequate capital formation is indispensable to a speedy economic development is universally recognised in academic literature. The main function of financial systems is the collection of savings and their distribution for industrial investment, thereby stimulating the capital formation and, to that extent, accelerating the process of economic growth. The process of capital formation involves three distinct, although inter-related activities:

(i) Savings: The ability by which claims to resources are set aside and become available for other purposes.

(ii) Finance: The activity by which claims to resources are either assembled from those released by domestic savings, obtained from abroad, or specially created usually as bank deposits or notes and then placed in the hands of the investors.

(iii) Investments: The activity by which resources are actually committed to production.

The volume of capital formation depends upon the intensity and efficiency with which these activities are carried on. The effective moblisation of savings, the efficiency of the financial organisation/system and the channelisation of these savings into the most desirable and productive forms of investment are all inter-connected and have a great bearing on the contribution of capital formation to economic development. Their relevance to the saving-investment process is derived from what is called the ***transfer process***.

Transfer Process

The genesis of the financial system is traceable to the divorce between savings defined as the excess of current income over current expenditure, and investments representing expenditure on durable assets. The relationship between savings and investments varies considerably among economic units. Goldsmith[1] has designated the various economic units into three categories: **(i) Saving-surplus units**, that is, those units whose savings are in excess of investments, **(ii)** Economic units whose investments exceed their savings referred to as ***Savings-deficit units*** and **(iii) Neutral units** in whose case savings are equal to investments. If capital formation is to take place, the savings of the savings-surplus units must be transferred to the savings-deficit units. There is, in other words, a need for institutional arrangement to facilitate the transfer of resources. This is precisely what the financial systems do by acting as a link between the savers and the investors, thereby facilitating the flow of savings into industrial investment. They are important in the process of capital formation, because the act of investment is usually confined to a special class of businessmen who command the requisite technical and market information and temperament to use it, while the activity of savings is largely diffused between innumerable individuals who lack the skill, capacity and personal characteristics for active investment. Hence, the transferred process is crucial to facilitate economic growth. Besides, there are geographical and technical limitations that inhibit the process of investment. This gap is filled by the financial systems which promote the process of capital formation by bringing together the supply of savings and the demand for investible funds.

ORGANISATION

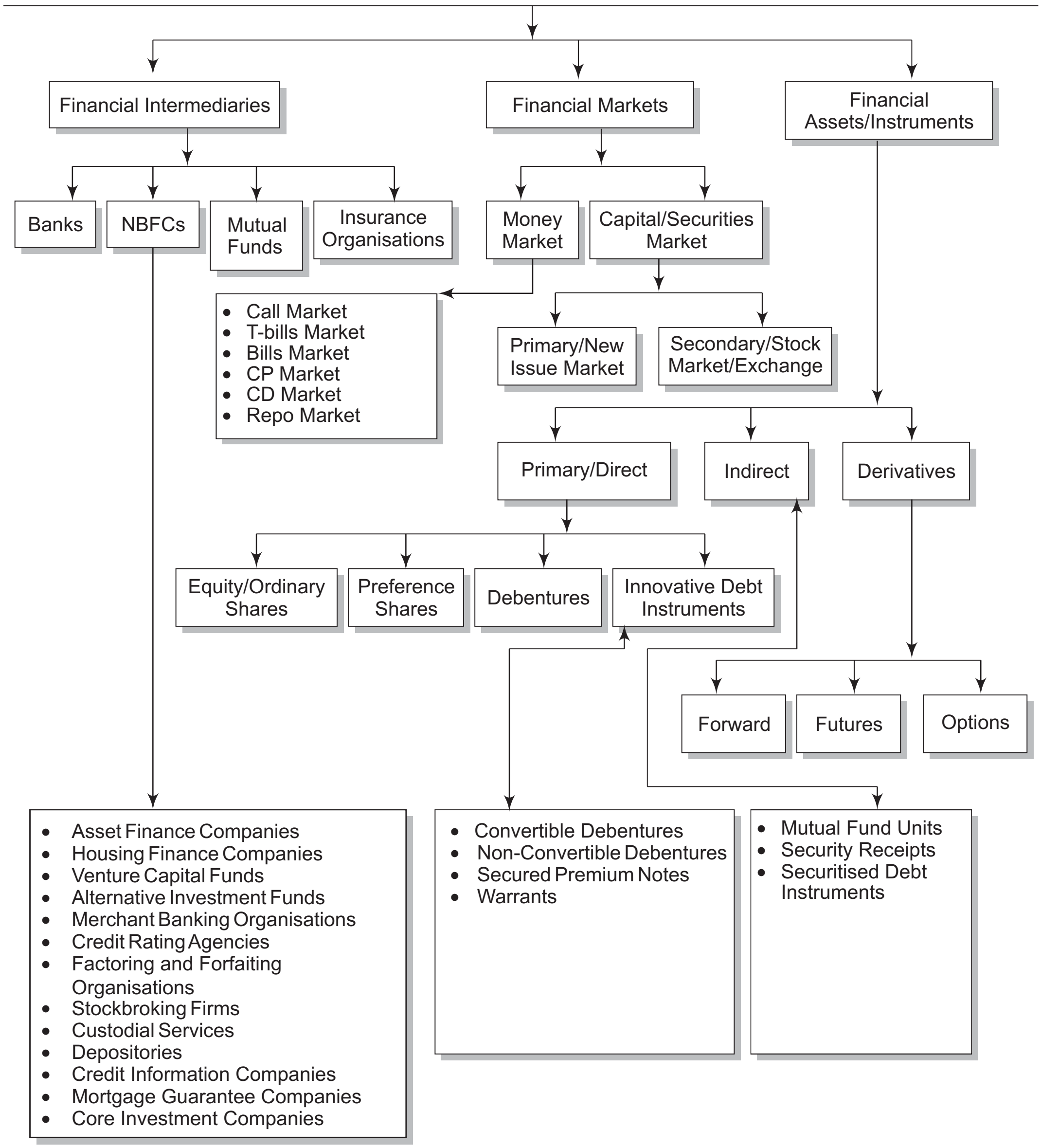
The organisation/structure of the financial system consists of **(i)** financial intermediaries, **(ii)** financial markets and **(iii)** financial assets/instruments. **Exhibit 1.1 portrays the organisation of the financial system.**

Financial Intermediaries

A significant constituent of the organisation of the financial system is an array of financial intermediaries which collect savings from others and issue in return claims against themselves and use the funds thus raised to purchase ownership or debt claims. Financial intermediaries issue to savers claims whose characteristics may be quite different from those that these institutions buy and hold. In other words, financial intermediaries, in the savings-investment process, come in between the ultimate borrowers and ultimate leaders. They represent a very significant change in the whole process of a transfer of choice of investment from an individual saver to an institutional agent.

Financial intermediaries play a vital role in economic development *via* capital formation. Their relevance to the flow of savings is derived from what is called the **transmutation effect**.[2] This term refers to the ability of the financial intermediaries to convert contracts with a given set of characteristics into contracts with very different features. In other words, the financial intermediaries make one type of contract with the lenders and another type with the borrowers. This arrangement permits them to tailor contracts to the preferences of both the borrowers and the lenders. To quote Gurley and Shaw, the principal function of financial intermediaries is "*to purchase primary securities from ultimate borrowers and to issue indirect debt for the portfolio of the ultimate borrowers and to issue indirect debt for the portfolio of the ultimate lenders.*"[3] Thus, they transform direct claims/primary securities into indirect securities. Primary securities are securities issued by non-financial economic units. Indirect securities are financial assets issued by financial intermediaries. In other words, the product of intermediation is indirect financial assets coined

Exhibit 1.1 Organisation of the Financial System



from the underling primary securities and bearing its own utilities.[4] There are notable differences in the utilities provided by indirect financial asses. As Goldsmith has aptly remarked, "*Financial intermediaries transform funds in such a way as to make them more attractive*".[5] They are attractive because they are better suited to the requirements particularly of small investors. Likewise, indirect securities are equally attractive to borrowers in the sense that they will be able to sell their securities to financial intermediaries on more satisfactory terms than selling them directly to ultimate lenders. The main consideration underlying the attractiveness of indirect securities is that the pooling of funds by the intermediary financial institutions leads to a number of direct and derived benefits that add greatly to the efficiency and effectiveness of this type of financial marketing. Some of these are benefits that arise from division of labour and efficiencies of size and scale, as similar to those observed in many other economic processes. But, another type of benefit is uniquely financial and is largely statistical in nature. This relates to the variety of services and economies that are provided by financial intermediaries in the mobilisation of savings as well as their channelisation, thereby making transformation of claims attractive.

Services The services/economies provided by the financial intermediaries that tailor financial assets to the desires of savers-investors are: **(i)** Convenience, **(ii)** Lower risk, **(iii)** Expert management and **(iv)** Economies of scale.

Convenience Financial intermediaries convert securities into more *convenient* vehicle for the mobilisation of savings, particularly of small savers. This convenience to the savers has two dimensions. One is ***divisibility***. They adjust the denomination of the securities to suit the requirements of individual savers by offering securities of varying sizes. They divide primary securities of higher denomination into indirect securities of lower denomination so that even savings can be tapped from small pockets for ultimate investment in real assets. For examples, the minimum threshold investment in new (primary/direct) issues in India presently in rupees 5 – 7 thousands. In the case of mutual funds, the minimum investment requirement is rupees one thousand only. Borrowers too achieve *flexibility* in dealing with a financial intermediary as compared to dealing with a large number of lenders. They are able to obtain terms suiting their needs more readily.

The other convenience of indirect securities is their ability to transform a primary security of a certain ***maturity*** into an indirect security of a different maturity. Financial intermediaries, in fact, manufacture liquidity[6]. They create claims, which are more liquid than the securities they buy, and issue them to savers. The redemption facility available to unitholders of open-ended mutual funds can be cited in support of this argument. To the extent that mutual funds agree to buy their own units, investors are spared the inconvenience of stock exchange dealings. As a result, maturities on indirect securities may conform more with the desires of ultimate borrowers and lenders than those on primary securities.

Lower Risk Indirect securities also have the merit of exposing investors to lower risk as compared to primary securities. This is mainly because of the benefits of '**diversification**' that becomes available to even small investors. Financial intermediaries enable investors, through a single commitment, to diversify investments widely, thereby reducing the risk of capital depreciation and poor dividends. Since diversification is a function of the size of investible funds as well as market information and supervision facilities available to investors, relatively small investors with limited capital can obtain better diversification by purchasing indirect securities than what they could do by direct purchase of securities in the securities market. Thus, financial intermediaries extend the same facilities - of diversification and reduction in the risk - as are available to an investment portfolio of large institutional investors. In effect, a mutual fund transforms the relatively small investors in matters of diversification of investment, into large institutional investors, as they share proportionate beneficiary interest in the total portfolio.

Expert Management Indirect securities give, both large and small investors, the benefits of trained, experienced and specialised management together with continuous supervision, neither of which the investor is, as a rule, qualified to supply himself. The importance of this service provided by financial intermediaries should be viewed in the context of the complexities involved in the selection and supervision of securities, namely, specialised knowledge, training, ability, aptitude, time, and inclination. Large investors can set right these deficiencies by engaging experts. But small investors cannot avail of these facilities due to financial limitations. With their specialised knowledge and facilities, the professional managers of financial intermediaries can demonstrate a superior performance to that of the individual investors. Thus, in effect, financial intermediaries place the small investors in the same position in the mater of expert management as large institutional investors.

Economies of Scale Indirect securities provide economies of scale. As financial intermediaries are continually in the business of purchasing/selling primary securities, the economies of scale not available to a borrower or to an individual saver, are available to them. They exploit economies of scale in lending and borrowing. Its one implication is that they are able to channel funds from the ultimate lenders to the ultimate borrowers at a lower cost.

In brief, the financial intermediaries play a notable role in the task of mobilisation of savings for economic development. By forming separate pools of borrowers and lenders, they give borrowers appropriate contact terms, and at the same time give lenders the much sought after liquidity and safety. They tailor the denomination and type of indirect securities to suit the desires of savers. They channel funds from the ultimate borrowers at a lower cost, or with more convenience, or both, than is possible through a direct purchase of primary securities by the ultimate lenders. Thus, financial intermediaries tend to make the financial systems/organisations more efficient. By transforming primary securities, they lower the cost to the borrower and provide a security better suited to the lender. A variegated structure of financial intermediaries can appeal to the security, motivation and other such aspects of savers, and attract more savings by the creation of an array of financial assets. in developing countries, in particular, savings are *institution-elastic*. The volume of savings as well as its direction is considerably influenced by the structure of financial intermediaries.

Types A brief account of the main financial intermediaries is given in what follows.

Commercial Banks These collect savings primarily in the form of deposits and traditionally finance working capital requirements of corporates. The traditional practice of banks supplying mainly short-term funds for financing the working capital needs of industry is based on the theory of deposit banking. According to the orthodox view of the theory of deposit banking, given the liability characteristic of banks to be always able to repay their deposits on demand, banks should confine their investments to outlets of self-liquidating nature defined as those which in the normal course of business generate resources automatically available for the repayment of borrowed funds. However, in tune with the emerging needs of the economic and financial system, banks have also entered into **(i)** term-lending business particularly in the infrastructure sector, **(ii)** capital market directly/indirectly, **(iii)** retail finance such as housing finance, consumer finance and so on. For the same reason, they have also enlarged their geographical and functional coverage in terms of rural/agricultural and other priority sector financing, namely, exports, medium and small enterprises and so on. Inspite of the diversification into new forms of financing and diversity in geographical and functional coverage, the primary focus-area of commercial banks continues to be working capital financing.

Non-Banking Financial Companies (NBFCs) They provide a variety of fund/asset-based and non-fund based/advisory services. Most of their funds are raised in the form of public deposits ranging between one year to seven years of maturity. Depending on the nature and type of service provided, they are categorised, *inter-alia*, into:

- Asset finance companies
- Core investment companies
- Housing finance companies
- Mortgage guarantee companies
- Venture capital funds
- Alternative investment funds
- Merchant banking organisations
- Credit rating agencies
- Factoring and forfaiting organisations
- Stock broking firms
- Depositories

Mutual Funds A mutual fund is a special type of investment institution which acts as an investment conduit. It pools the savings of relatively small investors them in a well-diversified portfolio of sound investment. Mutual funds issue securities (known as units) to the investors (known as unit-holders) in accordance with the quantum of money invested by them. The profit (or losses) are shared by the investors in proportion to their investments. A mutual fund is set up in the form of a trust which has **(i)** a sponsor, **(ii)** trustees, **(iii)** asset management company (AMC) and **(iv)** custodian. The trust is established by the sponsor who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unitholders. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of the SEBI regulations by the mutual fund. The AMC manages the funds by making investment in various types of securities. The custodian holds the securities of the various schemes of the mutual fund in its safe custody. As an investment intermediary, mutual funds offer a variety of services/advantages to the relatively small investors who, on their own, cannot successfully construct and manage an investment portfolio mainly due to the small size of their funds, lack of expertise/experience and so on. These, *inter-alia*, include convenience in terms of lower denomination of investment and liquidity, lower risk through diversification, expert management and reduced transaction cost due to economies of scale.

Insurance Organisations Insurance organisations/companies essentially invest the savings of their policyholders (insurance premium) and in exchange promise them and/or beneficiaries a specified sum at a later stage (on maturity of the insurance policy) or upon the happening of a certain event (i.e. death of the policyholder). They differ from mutual funds in that while the main business of mutual funds and, in fact, the only reason for the existence, is investment in securities, such investments are only incidental to the main business of insurance organisations to provide protection against risk. The operational implications of this feature of insurance organisation is that they are guided by the consideration of protecting the interest of policyholders whose money they hold in trust for which reason their investments are closely regulated with reference to the eligible investments for their portfolios in terms of investment norms and exposure norms.

Insurance organisations universally occupy a crucial position among all the savings institutions. This is mainly because they are able to collect the small savings of innumerable individuals. Insurance appeals to the savers due to a number of reasons. Savings being *institutions-elastic*, insurance companies are ideally suited in terms of their ability to create in people at a desire to save. The desire to save forms an important element of the savings process and is affected by a variety of motives such as **(i)** to assist the individual in the creation of an emergency fund to guard his family against financial misfortune, **(ii)** to build-up a potential family estate, should be current earning power of the head of the family be removed by death and **(iii)** to assist in the accumulation of a fund by the time of retirement from active work.

The contractual nature of insurance also contributes to the mobilisation of savings as it tends to commit the policyholders, particularly after the first few years, to continue even more firmly in their resolution to save. Insurance through the contractual payment of premium controls an individual's impulses and fosters saving habit in him.

The principal virtue of insurance is its peculiar combination of savings and family protection. When the necessity of insurance is once recognised, it becomes an integral part of the family budget and the household and personal expenses are adjusted to the necessity of paying the premium. Regular premium payments strengthen an individual's ability to save in a systematic manner.

In brief, besides income, the persuasive efforts of thrift/savings institutions are an important contributory factor in determining the volume and form of savings in an economy. In this connection, insurance with its contractual nature and its combination of protection and savings creates the desire in people to save, thereby exercising a positive influence on the volume and form of savings. By virtue of control over measure funds, insurance organisations emerge as a dominant financial intermediary in the financial systems.

Financial Markets

Another significant component of the organisation of the financial system comprises of financial markets which perform a crucial function in the savings-investment process as **facilitating organisations**. They are not sources of finance but they are a link between the savers and investors, both individual as well as institutional. Based on the nature of funds which are their stock-in-trade, the financial markets are classified into **(i)** Money market and **(ii)** Capital/securities market.

Money Market Money market is a market for dealing in monetary assets of short-term nature, generally less than one year. It refers to that segment of the financial market which enables the raising up of short-term funds for meeting temporary shortages of cash and obligations and the temporary deployment of excess funds for earning returns. The major participants in the money market are the RBI and commercial banks. The broad objectives of the money market are to provide:

- An equilibrating mechanism for evening out short-term surpluses and deficiencies,
- A focal point of RBI (central bank) intervention for influencing liquidity in the economy, and
- A reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable/price/cost.

Money market organisation/structure comprises of a number of interrelated sub-markets, that is, Call market, Treasury-bills market, Commercial bills market, Commercial papers (CPs) market, Certificate of deposits (CDs) market, Money market mutual funds (MMMFs) and Repo (repurchase) market and so on.

Capital Market It is a market for long-term funds. Its focus is on financing of fixed investment in contrast to money market which is the institutional source of working capital finance. The main participants in the capital market are mutual funds, insurance organisations, foreign institutional investors, corporates and individuals. The capital/securities market has two segments: **(i)** Primary/new issue market and **(ii)** Secondary market/stock exchange(s)/market(s).

New Issue Market (NIM)/Primary Market The NIM deals in new securities, that is, securities which were not previously available and are offered to the investors for the first time. Capital formation occurs in the NIM as it supplies additional funds to the corporates *directly*. It does not have any organisational setup located in any particular place and is recognised only by the specialist institutional services that it tenders to the lenders/borrowers (buyers/sellers) of capital funds at the time of any particular operation. It performs ***triple-service/function***, namely: **(i) origination**, that is, investigation and analysis and processing of new issue proposals; **(ii) underwriting** in terms of guarantee that the issue would be sold irrespective of public response and **(iii) distribution** of securities to the investors.

Secondary Stock Market/Exchange (SE) The SE is a market for old/existing securities, that is, those already issued and granted SE quotation/listing. It plays only an *indirect* role in industrial financing by providing liquidity to investments already made. It has a physical existence and is located in a particular geographical area. The SE discharges three vital functions in the orderly growth of capital formation: **(i)** Nexus between savings and investments; **(ii)** Liquidity to investors by offering a place of transaction in securities and **(iii)** Continuous price formation.

The behaviour of SEs as reflected in the prices of listed securities has a significant bearing on the level of activity in the NIM in terms of its response to issues of capital. Similarly, the prices of new issues are generally influenced by the price movements in the stock markets.

Financial Assets/Instruments (Securities)

The third component of the organisation of the financial system is financial assets/instruments (securities). They represent claims on a stream of income and/or assets of another economic unit and are held as a store of value and for the return that is expected. The maturity and sophistication of the financial system, indeed, depends on the prevalence of a variety of securities/financial assets to suit the investment requirements of heterogeneous investors. In a way, they represent financial product innovation. The financial system also promotes financial product innovation. The financial assets fall into three broad categories: **(i)** Direct/primary, **(ii)** Indirect and **(iii)** Derivatives.

Primary/Direct Securities A primary security is a security issued by non-financial economic units. The main types of primary securities are **(i)** ordinary/equity shares, **(ii)** preference shares and **(iii)** debentures/bonds including innovative debt instruments.

Equity/Ordinary Shares They are ownership securities and represent risk capital. The owners of such securities bear the risk, are residual claimants on the income and assets and participate in management of the company.

Debentures A debenture is a creditorship security. Their holders are entitled to a prespecified interest and first claim on the assets of the entity. They have no right to vote in the meetings of the company. A company can issue perpetual or redeemable debentures. Debentures can be either bearer/negotiable/transferable by delivery or registered which are payable to the registered holders only. They can be secured or unsecured/naked. Debentures can be nonconvertible or convertible into equity shares.

Preference Shares A preference share is a hybrid security and partakes the features of both equity and debentures. It combines both ownership and creditorship privileges. The holders of such securities have preference/prior rights over the equityholders in respect of fixed dividend as well as return of capital. All preference shares are redeemable within 10 years. Companies also issue *cumulative convertible preference shares* which embrace the features of both equity preference shares. They can be converted into equity shares.

Innovative Debt Instruments A variety of debt innovative instruments emerge with the growth of the financial system. New features are embedded in the debt instruments to make them more attractive to investors. An illustrative list of such instruments is given below.

Participating Debentures The participate in the excess profits of the company after the payment of equity dividend.

Convertible Debentures with Options They are a derivative of convertible debentures with an embedded option. The coupon rate on the debentures is specified at the time of the issue. Both the company and the debentureholder can exit from the term of the issue.

Third Party Convertible Debentures These include a warrant which entitles the holder to subscribe to the equity of another firm at a preferential (lower than market) price. Due to conversion option, the coupon rate of interest on such debentures is lower *vis-à-vis* pure debentures.

Convertible Debentures Redeemable at Premium They are issued at the face value with a put option which entitles the holders to sell the debentures at a premium.

Debt Equity Swaps These are offers to swap debentures for equity.

Zero Coupon Convertible Notes They can be converted into shares. On exercise of choice, all accrued/unpaid interest is to be foregone. They are quite sensitive to changes in interest rates.

Secured Premium Notes (SPNs) With Detachable Warrants They are redeemable after a lock-in period, while the warrants entitle the holders to receive shares after the SPN is fully paid. No interest is payable during the lock-in period. The holder has an option to sell back the SPN to the company at par value after the lock-in period. On the exercise of this option, no interest/premium is payable on redemption. In case of redemption after the expiry of the term of the SPN, the holders have the right to receive principal plus additional interest (premium) in predetermined instalments. The detachables are to be converted into shares within the specified time period.

Non-Convertible Debentures (NCDCs) With Detachable Equity Warrants These give an option to buy a specified number of shares at a specified price within a specified time. After a stated lock-in period, holders of such debentures have to exercise their option to apply for equities.

Zero Interest Fully Convertible Debentures (FCDs) They carry no coupon rate of interest. The FCDs are automatically converted into shares after the lock-in period.

Secured Zero Interest Partly Convertible Debentures (PCDs) With Detachable and Separately Tradeable Warrants Such debentures have two parts: A and B. Part A is convertible into shares at a fixed amount on the date of allotment. Part B, however, is nonconvertible and is redeemable at par after a specified period from the date of allotment. It carries a detachable and separately tradeable warrant with entitlement to (option of) equity shares at a price to be determined by the issuing company.

Fully Convertible Debentures (FCDs) With Interest (Optional) They do not yield any interest for a short period (say, six months) after which the holder has an option to apply for equities at premium, without paying for the premium. However, a specified rate of interest is payable on FCDs from the date of first conversion to the date of second/final conversion, in lieu of which shares are issued.

Warrants These are also referred to as *sweeteners*. A warrant is a security which entitles the holders to purchase a specified number of shares at a stated price before a stated date/period. They are issued with either debentures or equity shares.

Indirect Securities/Financial Assets Indirect securities are financial assets issued by financial intermediaries, such as units of mutual funds, policies of insurance companies, deposits of banks, security receipts issued by securitisation and asset reconstruction companies, securitised debt instruments issued by special purpose vehicles (SPVs) and so on. The indirect financial assets are coined from the underlying primary security and bearing their own utilities. They are better suited to the requirements of investors, particularly small investors. They are equally attractive to borrowers in that they can sell their primary securities to financial intermediaries on more satisfactory terms than selling them directly to ultimate lenders (investors). The main consideration underlying the attractiveness of indirect securities is that the pooling of funds by a financial intermediary leads to a number of indirect and derived benefits that add greatly to the efficiency and effectiveness of this type of financial marketing. Some of these are benefits that arise from division of labour and efficiencies of size and scale as similar to those observed in many other economic processes. But another type of benefit is uniquely financial and is largely statistical in nature. This relates to the variety of services and economics that are provided by the financial intermediaries, namely, convenience, lower risk and expert management. These were elaborated in the preceding Section.

Derivatives/Derivative Instruments Financial markets, by their very nature, are marked by a very high degree of volatility arising out of fluctuation in prices of financial assets/securities. Through the use of derivative instruments, it is possible to partially/fully transfer price risks by locking-in asset prices. As instruments of risk management, these generally do not influence fluctuation in underlying asset prices. However, by locking-in asset prices, they minimise the impact of fluctuations in asset prices on the profitability and cash flow situation of investors averse to risk. ***Derivative*** is a product whose value is derived from the value of one/more basic variables called base (underlying asset/index/reference rate), in a contractual manner. The underlying asset can be equity/forex/any other assets. The price of the derivative is driven by the post price of the asset price which is "undelrying". The Securities Contracts (Regulation) Act defines derivatives to include **(1)** a security derived from debt instrument/share/secured or unsecured loan/risk instrument/contract for differences/any other form of security, **(2)** a contract which derives its value from the prices/index of prices of underlying securities. The most commonly used derivative contracts are forwards, futures and options.

Forward Contract A forward contract is an agreement to exchange an asset, for cash, at a predetermined future date specified today. At the end of the contract, one can enter into an offsetting transaction by paying the difference in the price (payoffs). Forward contracts are private bilateral contracts to settle them at some future date. They are exposed to a default risk by a counterparty. Each forward contract is unique in terms of contract size, expiration date and the asset type/quality. The contract price is not transparent as it is not publicly disclosed. Since the forward contract is not typically tradeable, it has to be settled by delivery of the asset on the expiration date.

Futures/Future Contracts Future contracts are transferable specific delivery forward contracts. They are agreement between two counterparties to fix the terms of an exchange/lock-in the price today of an exchange that will take place between them at some fixed future date. As highly standardised contracts between sellers (writers/shorts) and buyers (longs), they obligate the former to deliver and the latter to receive the given assets in the specified quantities of specified grades, at a fixed time in the future, at the contracted prices. The period of contract (deferment) may vary between 3 to 21 months. Depending on the underlying assets, they could be commodity/financial futures and stock index futures (interest rate/currency). While stock index futures are traded on the basis of different share price indices rather than on any individual share, interest rates futures are written on the basis of interest rate/price indices of fixed interest securities such as T-bills/bonds/debentures/commercial papers/certificate of deposits/mortgage loans. Future contracts are transferable legal agreements and their terms cannot be changed during the life of the contract. Although futures provide for the delivery of the contracted assets, in practice, only a small portion, not offset by corresponding opposite contracts, are settled by actual delivery. In fact, there is simply no deliverable asset in the case of bond/equity index futures; the value of the contract in such cases is some multiple of the value of the index and the settlement of such contracts has to be in cash.

In contrast to forward contracts, future contracts are standardised tradeable contracts. They are standardised in terms of size, expiration date and all other features. They are liquid and transparent. Their market prices and trading volumes are regularly reported. The future trading system has effective safeguards against defaults in the form of clearing corporation guarantees for trades and the daily cash adjustment (mark to market) to the accounts of trading members, based on daily price change. Futures are far more cost efficient than forward contracts for hedging.

Options Options are contracts that give the holder the right (but not the obligation) to buy (call option) or sell (put option) securities at a pre-determined price (strike/exercise price) within/at the end of a specified period (expiration period). For the holders of call and put options, the exercise of the right would be worthwhile only if the price of the underlying securities, of the respective option, rise/falls above/below the exercise price. There can be options on commodities, currencies, securities, stock index, individual stocks and even on futures. In order to acquire the right of option, the option buyer pays the option seller (option writer) an option premium, which is the price paid for the right. The buyer of an option can lose no more than the option premium paid but his possible gain is unlimited. The option writers' possible loss is unlimited but his maximum gain is restricted to the option premium charged by him to the holder. The most critical aspect of option contract is the evaluation of the fairness of option premium, that is, option pricing. The availability of both financial futures and options would provide the users with a wider choice of hedging instruments. At issue time, to make hedging possible, the market should have speculators who are prepared to be counterparties to hedgers. A derivative market wholly/mostly consisting of speculators is unlikely to be a sound economic institution. A sound derivative market requires the presence of both hedgers and speculators.

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CONCLUDING OBSERVATIONS

- The main function of a financial system is the collection of savings and their distribution for investment, thereby stimulating capital formation and, to that extent, accelerating the process of economic growth. The financial system is a link between the savers (savings-surplus economic units) and the investors (saving-deficit economic units). It is made up of all those channels through which savings become available for investment.
- The organisation of the financial system comprises of three inter-related components, namely, financial intermediaries, financial markets and financial assets/instruments (securities).
- Financial intermediaries (FIs) represent a significant change in the whole process of a transfer of choice of investment from an individual saver to an institutional agent. They convert primary securities with a given set of characteristics, into indirect securities with very different features. A primary security is a security issued by a non-financial economic unit. A security issued by a financial intermediary is an indirect security. The ability of FIs to transform a primary security into an indirect security makes it more attractive to both the borrowers and the lenders. The pooling of funds by an FI leads to a number of indirect and derived benefits that add greatly to the effectiveness and efficiency of the savings-investment process. The benefits/services associated with the tailoring of financial assets according to the desires of the savers and investors are: **(i)** convenience in terms of denomination and liquidity, **(ii)** lower risk due to diversification of the portfolio, **(iii)** expert management of the portfolio and **(iv)** lower cost resulting from economies of scale. A diversified structure of FIs in a matured and sophisticated financial system consists of banks, NBFCs, mutual funds, insurance organisations and so on. With a variegated structure, these are able to mobilise savings from the widest section of the investing public and channelise them to a cross-section of economic/industrial enterprises.
- Financial markets are a significant component of the financial system. They are not a source of funds, but they act as a facilitating organisation and link the savers and investors, both individual as well as institutional. As facilitating organisations, financial markets provide a wide variety of specialist institutional facilities. Based on the nature of funds which are their stock-in-trade, they are classified into: **(i)** money markets and **(ii)** capital/securities markets.
- Money market is a market for dealing in monetary/financial assets of a short-term nature, generally less than one year. Its broad objectives are to provide **(i)** an equilibrating mechanism for evening out short-term surpluses and deficiencies in the financial system, **(ii)** a focal point of central bank (RBI) intervention for influencing liquidity in the economy through a variety of instruments, and (iii) a reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable price/cost. The money market organisation comprises

of a number of interrelated sub-markets such as call market, T-bills market, commercial bills market, CP market, CD market, repo market and so on.

- Capital/securities market is a market for long-term funds. It has two segments: primary/new issue market and secondary stock exchange market. The primary market deals in new securities, offered to the investors for the first time. It performs a **triple-service function,** at the different stages of the issue, namely, **origination**, that is, investigation, analysis and processing of new issue proposals; **underwriting,** and **distribution** of securities to the investors. The stock exchange is a market for existing securities. It discharges three vital functions: it acts as a nexus between savings and investment, it provides liquidity to investors by offering a place for transaction in securities and it helps in continuous price formation.
- A financial asset/instrument/security is a claim on a stream of income and/or assets of another economic unit and is held as a store of value and for the expected return. There are three types of financial assets: primary/direct, indirect and derivatives.
- A primary security is a security issued by a non-financial economic unit, such as ordinary/preference shares, debentures/bonds and innovative debt instruments including participating, convertibles, warrants and so on.
- An indirect security is a security issued by an FI such as **(i)** units of mutual funds, **(ii)** security receipts of securitisation/asset reconstruction companies and **(iii)** securitised debt instruments of SPVs. It is based on an underlying primary security. The pooling of funds by an FI and converting a primary security into an indirect security is associated with a number of benefits, namely, convenience, diversification, expert management and lower cost.
- A derivative instrument includes: **(i)** a security derived from a debt instrument, share, secured or unsecured loan, risk instrument, contract for differences or any other form of security and **(ii)** a contract which derives its value from the prices/index of prices of the underlying securities. It is an instrument of risk management. The most commonly used derivative contracts are forwards, futures and options.
- A forward contract is an agreement to exchange an asset for cash, at a predetermined future date specified today. At the end of the contract, one can enter into an offsetting transaction by paying in the difference in the price. It is settled by the delivery of the asset on the expiration date.
- Future contracts are transferable specified delivery forward contracts. They are agreements between two counterparties to fix forward the term of an exchange/lock-in the price today, of an exchange that will take place between them at some fixed future date, ranging between 3 to 21 months. Depending on the underlying asset, future contracts could be stock futures or index futures.
- Options give the holder the right (but not the obligation) to buy (call option) or sell (put option) securities at a predetermined price (strike/exercise price) within/at the end of a specified period. In order to acquire the right of option, the buyer pays to the seller, an option premium as the price for the right. He can lose no more than the option premium paid but his possible gain is unlimited. The sellers' possible loss is unlimited but his maximum gain is restricted to the option premium charged by him.

CHAPTER 2

Indian Financial System: An Overview

INTRODUCTION

An efficient, articulate and developed financial system is indispensable for the rapid economic growth of any country/economy. The process of economic development is invariably accompanied by a corresponding and parallel growth of financial organisations. However, their institutional structure, operating policies, regulatory/legal framework differ widely, and are largely influenced by the prevailing politico-economic environment. Planned economic development in India had greatly influenced the course of financial development. The liberalisation/deregulation/globalisation of the Indian economy since the early nineties has had important implications for the future course of development of the financial system/sector. The present Chapter sketches the main strands in the evolution of the Indian financial system against the background of the development planning and economic liberalisation. The focus of description of the emerging trend is organisational/structural/institutional and not quantitative data. The evolution of the Indian financial system falls, from the viewpoint of exposition, into three distinct phases:

(i) Up to 1951, corresponding to the post-independence scenario, on the eve of the initiation of planned economic development,

(ii) Between 1951 and the mid-eighties reflecting the imperatives of planned economic growth and

(iii) After the early nineties responding to the requirements of liberalised/deregulated/globalised economic environment.

Accordingly, the chapter is divided into three parts corresponding to the three phases. The principal features of the organisation of the Indian financial system before 1951 are outlined in Section 1. The main elements of the system during the second phase are presented in Section 2. Section 3 is devoted to delineating the emerging scenario in the post-1990 period. The last Section contains concluding observations.

PHASE I: PRE-1951 ORGANISATION

The organisation of the Indian financial system before 1951 had a close resemblance with the theoretical model of a financial organisation in a traditional economy, as formulated by R.L.

Bennett.[1] A traditional economy, according to him, "is one in which the per capital output is low and constant."[2] The principal features of the pre-1951 financial systems were aptly described by L.C. Gupta as: "*The principal features of the pre-Independence industrial financing organisations are the closed-circle character of industrial entrepreneurship; a semi-organised and narrow industrial securities market, devoid of issuing institutions and the virtual absence of participation by intermediary financial institutions in the long-term financing of the industry.*"[3] As a result, the industry had very restricted access to outside savings. The fact that the industry had no easy access to the outside savings is another way of saying that the financial system was not responsive to opportunities for industrial investment. Such a financial system was clearly incapable of sustaining a high rate of industrial growth, particularly the growth of new and innovating enterprises.

PHASE II: 1951 TO MID-EIGHTIES ORGANISATION

In sharp contrast to the position around 1951, when the organisation of the financial system left much to be desired, the ability of the system to supply finance and credit to varied enterprises in diverse forms was greatly strengthened during the second phase. The organisation of the Indian financial system during the post-1951 period evolved in response to the imperatives of planned economic development. In pursuance of the broad economic and social aims of the State to secure economic growth with social justice as enshrined in the Indian Constitution, under the Directive Principles of State policy, the scheme of planned economic development was initiated in 1951. The introduction of planning had important implications for the financial system. With the adoption of mixed economy as the pattern of industrial development, in which a complementary role was conceived for the public and private sectors, there was a need for an alignment of the financial mechanism with the priorities laid down by the Government's economic policy. In other words, planning signified the distribution of resources by the financial system to be in conformity with the priorities of the five-year plans. The requirement to allocate funds in keeping with the corresponding pattern implied Governmental control over distribution of credit and finance. The main elements of the financial organisation in planned economic development could be categorised into four broad groups:

(i) Public/Government ownership of financial institutions,
(ii) Fortification of the institutional structure,
(iii) Protection to investors and
(iv) Participation of financial institutions in corporate management.

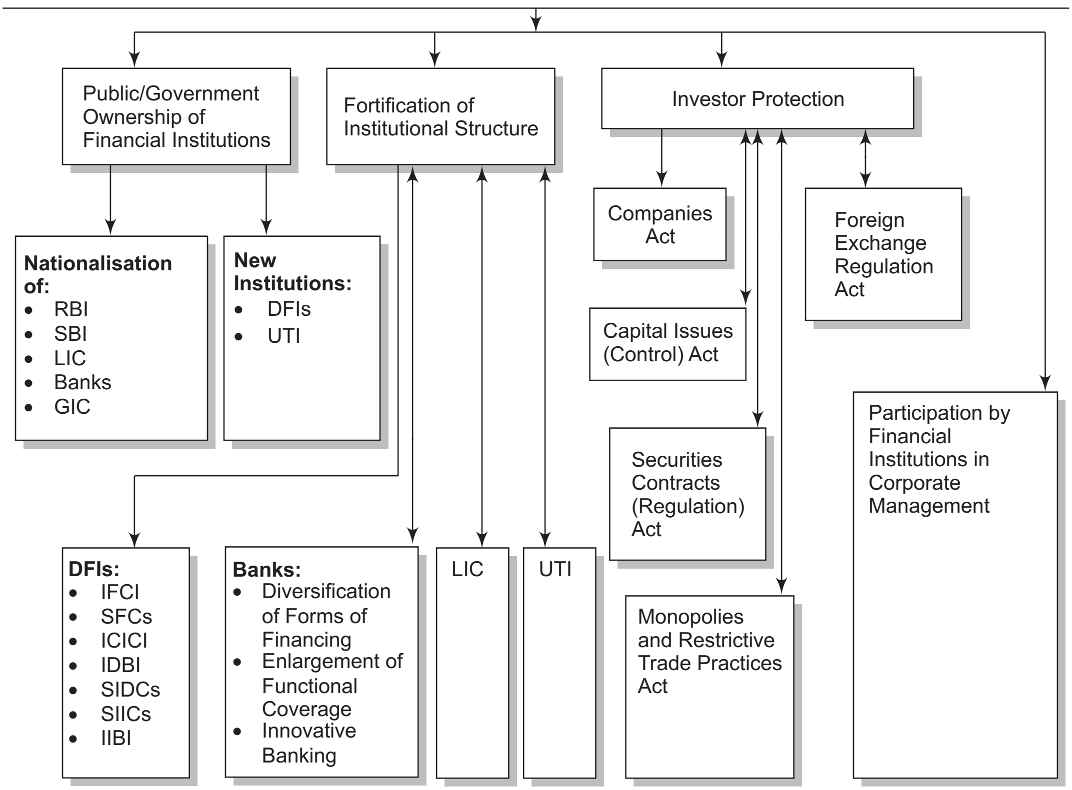
The phase II organisation of the Indian financial system is depicted in Exhibit 2.1.

Public Ownership of Financial Institutions

One aspect of the evolution of the financial system in India during this phase was the progressive transfer of its important constituents from private ownership to public control. Important segments of the financial mechanism were assigned to the direct control of public authorities through nationalisation measures, as well as through the creation of entirely new institutions in the public sector.

Nationalisation The nationalisation of the Reserve Bank of India (RBI) in 1948 marked the beginning of the transfer of important financial intermediaries to Governmental control. This was followed in 1956 by the setting up of the State Bank of India by taking over the then Imperial Bank of India.

Exhibit 2.1 Phase II Organisation of Indian Financial System



In the same year, 245 life insurance companies were nationalised and merged into the state-owned monolithic Life Insurance Corporation of India (LIC). The year 1969 was a landmark in the history of public control of the private financial institutions, when fourteen major commercial banks were brought under the direct ownership of the Government of India. Yet another measure, which deserves mention in this connection, was the setting up of the General Insurance Corporation (GIC) in 1972, as a result of the nationalisation of general insurance companies. Finally, six more commercial banks were brought under the public ownership in 1980.

New Institutions In addition to nationalisation, the control of public authorities on the sources of credit and finance led to the creation of a battery of new institutions in the public sector. In the first place, a number of powerful special-purpose financial institutions designated as development banks/development finance institutions/term-lending institutions were set up. A wide[4] range of such institutions came into being, some of which were national/all India, while others were regional/state-level institutions and between them they covered the whole range of industry and provided finance in diverse forms. Another step of considerable significance was the creation of an investment trust organisation – the Unit Trust of India – in the public sector. The only other important pool of savings, namely, pension and provident funds, were for all purposes under the control of the Government, in terms of the regulations governing their investments. Thus, the public sector occupied a commanding position in the industrial financing system in India, that is, virtually the entire institutional structure was owned and controlled by the Government.

Fortification of Institutional Structure

The relevance of the financial organisation in the stimulation of capital formation rests on a broad-based and diversified pattern to the extent that capital formation is *institution-elastic*. The most significant element in the emergence of a fairly well-developed financial system in India during the second phase was the strengthening of its institutional structure. The fortification of the institutional structure of the Indian financial system was partly the result of modification in the structure and policies of the existing financial institutions, but mainly due to the addition of newer institutions as detailed in the discussions that follow.

Development Banks The setting up of a variegated structure of development banking/finance/term-lending institutions was the most *outstanding* development in this sphere. This was because in *quantitative terms*, they grew into a massive source of industrial finance, and as the most important supplier of capital during the period under reference, they could be appropriately designated as the *backbone* of the system of industrial financing in India. Their role, however, was not merely quantitative. Their relevance had an overwhelmingly *qualitative* dimension also in terms of the accent on *promotional* functions in their operations. This refers to their role as instruments of state policy, of directing capital into chosen areas of industry in conformity with planning priorities, and of generally securing the development of private industry along the desired path, to facilitate effective public control of private enterprise. They were, in addition, the agency through which specific socio-economic objectives of state policy such as encouragement to new entrepreneurs and small enterprises, and the development of backward regions in order to broad-base the growth industry were being realised.

The structure of development banking consisted of both all India as well as state-level institutions. The setting up of the Industrial Finance Corporation of India (IFCI) in 1948 marked the beginning of the era of development banking in India. The full potentialities of these institutions were realised only after some experience in planning, which began in 1951. The IFCI was established to give medium and long-term credit to industrial enterprises in circumstances where normal banking accommodation was inappropriate, or recourse to the capital issue method impracticable, thus envisaging the role of a *gap-filler*. Under the State Financial Corporations Act, 1951, as counterpart of the IFCI at the state level, regional institutions, State Financial Corporations (SFCs), were organised to assist the small/medium enterprises. These institutions, however, functioned purely as industrial mortgage banks, being organised on most orthodox lines. Their policies were characterised by excessive caution; their procedures were dilatory; they concentrated on traditional industries and laid more emphasis on *security* rather than on prospects. Therefore, they failed to make an impact on the availability of long-term finance to industry and, consequently, could not fulfil the expectation of solving the problem of chronic shortage of industrial capital.

There was, therefore, the need for a more dynamic approach on the part of the development banks, if the requirements of the private corporate sector were to be met effectively. This found expression in the fact that emphasis shifted from *finance* to *development*, so that the new institutions in this sphere could assume the role of a developmental agency. In pursuance of this changed perspective, the National Industrial Development Corporation (NIDC) was the first attempt towards this reorientation, being established in 1954, to provide both finance and entrepreneurship. Although ambitious in conception, it ultimately degenerated into a financing agency for the modernisation of cotton and jute textiles. Subsequently, it was converted into a consultancy organisation and had no concern with the financing of the private industry.

The establishment of the Industrial Credit and Investment Corporation of India (ICICI) Ltd, in 1955 represented a *landmark* in the diversification of development banking in India, as it was a pioneer in many respects like underwriting of issues of capital, channelisation of foreign currency loans from the World Bank to private industry and so on.

Consequently upon the initiation of the Second Five Year Plan, there was a need for further sophistication of the financing system to cater to the needs of different types of enterprises. The Government of India, as a follow-up, set up the Refinance Corporation of Industry (RCI) Ltd in 1958 to provide refinance to the banks against term loans granted by them to medium/ small enterprises. This facility was later extended to the State Financial Corporations. The RCI subsequently merged with the Industrial Development Bank of India (IDBI) in 1964.

The most important event in the sphere of development banking in India took place in 1964, when the IDBI was established as a subsidiary of the Reserve Bank of India. It represented a step towards evolving an integrated structure of financing institutions in India. As an apex institution, it had an important role in the task of planned economic development. Accordingly, it not only provided finance but also coordinated the activities of all the financing institutions. It was delinked from the Reserve Bank of India in 1976 and was converted into a holding company. It was elevated, in a sense, to the same position among the long-term institutional suppliers of industrial capital in India as is occupied by the Reserve Bank of India in the monetary and credit sphere.

At the state level, the machinery of the State Industrial Development Corporations (SIDCs)/ State Industrial Investment Corporations (SIICs) were geared up to meet the financial needs, in terms of the requirements of the Third Five Year Plan. In 1971, with the functional reorientation of the development banks, the Industrial Reconstruction Corporation of India (IRCI) Ltd was jointly set up by the IDBI, banks and LIC to look after the rehabilitation of sick mills. It was renamed as the Industrial Reconstruction Bank of India (IRBI) in 1984. It was converted into a full-fledged public financial institution (PFI) and was renamed as the Industrial Investment Bank of India (IIBI) in 1997.

The Technical Consultancy Organisations (TCOs) added a new dimension to the diversification of development banking in India, as a result of joint sponsorship/participation by the IDBI, IFCI and ICICI. Their setting up in the different states of the country was a vital element in the scheme of fortifying the institutional structure of the Indian financial system at the regional level.

Finally, another institutional innovation was the setting up of the Small Industrial Development Bank of India (SIDBI) as a subsidiary of the IDBI, for fostering the development of small and medium enterprises.

In brief, as an integral part of the broad strategy of planned economic development, several development banks came into being in India so that, with a variegated structure they would be able to provide finance to industry in diverse forms. From a modest beginning in 1948 the machinery was strengthened and diversified, by the addition of newer institutions with more flexible structures, and by enlarging the resources and the scope of functions of the existing institutions.

Life Insurance Corporation of India Another development in the direction of fortifying the structure of the industrial financing organisation in India during this phase was the coming into being of the Life Insurance Corporation (LIC) in 1956, as a result of the amalgamation of 245 life insurance companies into a single monolithic state-owned institution. The setting up of the LIC, as a part of the deliberate and conscious attempt to remould the financial system to the requirements of planned development, was a notable feature in the evolution of the post-1951 organisation of industrial financing in India. This was so, not only because it transferred an important savings institution from private to public ownership, but also because it brought about a massive concentration of long-term funds in the hands of the LIC. The LIC emerged as the single largest reservoir of long-term savings in India. Reflecting its control over such huge investible resources, it emerged as a very influential factor in the industrial securities market in India. It played a truly dominant role in the capital market dealing with corporate financing, through underwriting as well as the direct purchase of industrial securities. The LIC emerged as a leading underwriter of corporate issues of capital and a shareholder of massive and pervasive importance. Its importance in the investment market in India, however, was not reflected simply in the amount provided in various forms, such as purchase of shares and bonds of the special industrial financing institutions, direct lending to industry, underwriting of issues of capital by corporate enterprises and purchase of securities from the secondary markets. Its operations had a beneficial effect on the functioning of the financial system. In particular, its purchases of corporate securities imparted a price-stabilising effect on the stock market, particularly during the *downswing* of the market, and strengthened the influence of investment considerations in the determination of share market prices. Finally, the presence of such a large institutional shareholder as the LIC, had the effect of promoting greater discipline among corporate management and added a new dimension to public control of private enterprises.[5]

With the entry of the Unit Trust of India in 1964, however, the capital market activity of the LIC witnessed a sharp decline in terms of purchases of securities since the early seventies. This was mainly due to the changes in the regulation governing the investment of such funds, coupled with the traditional conservatism of life insurance companies which was reinformed in the case of the LIC by the Mundhra episode of 1957.

Unit Trust of India The establishment of the Unit Trust of India (UTI) in 1964 was the culmination of a long overdue need of the capital market in India and reflected the efforts of the Government of India to popularise unit trusts/mutual funds to encourage indirect holding of securities by the public. The phenomenal growth achieved by similar institutions in countries like the USA and Japan was an eloquent testimony of their wide acceptance, as a suitable vehicle for mobilisation of savings by a substantial section of the saving populace of the country. The objective of setting up the UTI was to enable the small investors to share in industrial prosperity, through indirect holding of equities, and to mobilise the savings of the relatively small investors who numerically formed the major section of the saving populace. As a versatile savings institution, the UTI introduced new forms of financial assets through various ~: unit schemes to suit different classes of investors. In order to popularise it, the Government extended various types of concessions including exemption from payment of taxes to the UTI and its unitholders, subsidy in administrative expenses, and initial capital contribution by various financial institutions, and so on.

Over the years, the UTI made rapid strides and emerged as an important constituent of the institutional arrangement supplying industrial capital to corporate enterprises in India. Before its establishment, the LIC was the most dominant buyer of industrial securities in India, as well as the single most important institutional underwriter of issues of capital. The UTI emerged as the largest buyer of industrial securities since the mid-seventies, the LIC was relegated to the second place. After the entry of the UTI in the market, LIC progressively withdrew, presumably to concentrate more on the financing of housing and other schemes of state governments, statutory authorities, co-operatives, electricity boards 1 and other infrastructures. Thus, the UTI relieved the LIC of the responsibility of supporting the industrial securities market.

Commercial Banks Along with the establishment of various new institutions, efforts were made to mould the structure and policies of the existing institutions in favour of industrial financing. The commercial banks in India, wedded to the orthodox view of the theory of deposit banking, were mostly confining themselves to the supply of short-term funds for financing trade and commerce. Industrial financing accounted for a small fraction of the total bank credit. With a unified and compact banking system, there arose a need to integrate the banking operations and policies with planning priorities. A beginning was made with the modification in the monetary and credit policies of the RBI in the form of instruments such as selective credit controls, moral suasion and other such macro-type controls to encourage the banks to reorient their operational policies to the finance for industry. With the initiation of planning which emphasied repaid industrialisation, there was on upsurge in bank financing of industry and consequent sharp decline in financing of trade and commerce.

Diversification in Forms of Financing Since the mid-sixties, the commercial banks in India were officially encouraged to enter new forms of financing of which two deserve specific mention: **(i)** Term-lending and **(ii)** Underwriting of new issues of corporate securities by industrial enterprises. The introduction of formal term loans by commercial banks in India represented a radical departure from their traditional role of suppliers of short-term credit. The modification in the existing practice was necessitated by the enlarged programmes of industrial development in the Second Five Year Plan (1956-61). There was also the need for expanding institutional credit facilities for the small and medium-sized enterprises. In view of these considerations, the Government encouraged the banks to engage in term-lending to industry and formulated a specific scheme for this purpose in 1958. Under the scheme, the lending banks were provided refinancing facilities against approved term loans from the Refinance Corporation of India (RCI) Ltd specially created for the purpose. The RCI was merged with the Industrial Development Bank of India on September 1, 1964. The flow of bank credit in the form of refinance-based term loans was, thus, encouraged as being in conformity with the policy of industrialisation.

Another innovation during this phase was the entry of commercial banks in the field of underwriting of new corporate issues. The participation of banks in such underwriting was suggested by the Indian Central Banking Enquiry Committee as early as 1931. This was repeated by the Shroff Committee appointed by the RBI in 1953. It recommended the formation of joint underwriting consortium of banks and insurance companies. Although the idea of forming the consortium was finally dropped, some banks, on individual initiative, started participating in underwriting activity. Their interest was presumably stimulated by the tacit support of the central banking authorities.

Apart from term loans and underwriting of issue of capital, the banks also widened their range of financial assistance to the industry partly through direct subscription to the shares and debentures of corporate enterprises and partly through their lending against such securities.

Enlargement of Functional Coverage The commercial banks were further directed to channelise their resources to small-scale industries, exports and agriculture, that is, the neglected (later priority and now directed) sectors of the Indian economy. Notwithstanding their importance in the economy, these sectors received very little credit from the banks previously. The flow of credit into these desired channels further symbolised the attempts to secure the alignment to bank credit with planning priorities. The policy and institutional measures to stimulate bank credit to these sectors are described below.

Small-Scale Industries Three measures were taken in the sphere of channelisation of bank funds to the small-scale enterprises. In the first place, a systematic study of the problems involved was made and small-scale industrialists and bankers were brought together at a seminar on "Financing of Small-scale Industries" organised by the RBI at Hyderabad in 1959 with an aim to finding their solutions. Secondly, in pursuance of the suggestions made at the Hyderabad Seminar, the Government formulated a Credit Guarantee Scheme (CGS) in consultation with the RBI in July 1960 to guarantee the major part of the advances given by banks to the small-scale industries. The CGS was administered by the RBI. The guarantee was given by the Government on the payment of a small fee related to the amount of advance. A working group set up by the RBI in April 1969 examined the provisions of the CGS in detail and suggested modifications which were incorporated in a scheme that came into effect from 1 February 1970. It stated that the guarantee was to be made available to all eligible advances on an automatic basis subject, however, to each approved institutions entering into an agreement with the Credit Guarantee Organisation (CGO). These institutions were required to submit a quarterly statement containing the particulars of all eligible loans and advances which formed the basis of charging the guarantee fee. The CGO made a surprise inspection of these institutions on a sample basis to verify the accuracy of the submitted quarterly statements. The CGS covered all credit facilities allowed to small units (excepting the performance guarantee issued on behalf of the constituents) and the guarantee cover was upto 75 per cent of the amount defaulted or the amount guaranteed, whichever was lower. Moreover, a maximum amount recoverable from the CGO was ₹7.5 lakh in respect of working capital advances, and a further sum of ₹2.5 lakh in respect of the term loans per borrower. These features of the CGS helped the banks in taking on more responsibilities in the financing of small-scale enterprises.

Finally, in its credit policy, the RBI incorporated devices so as to stimulate bank credit to this sector. Thus, in 1962, the RBI introduced a policy of granting additional rights to the banks to borrow from it at concessional rates in case they increased the quantum of lending to the small industries. These concessions continued through in different forms, for example, by providing refinance at the bank rate irrespective of the net liquidity ratio in regard to the increase in short-term lending to small-scale industries over a specified base period, and the rediscounting of bills under the new bill market scheme. As a result of these measures, there was a rapid rise in the quantum of credit extended to this sector by the banks.

Exports An important measure taken to facilitate credit for exports was the setting up of the Export Risk Insurance Corporation in 1957 to offer insurance to exporters against exchange controls or multiple currency practices, and the lack of adequate information regarding the creditworthiness of importers. In 1964, it was renamed as the Export Credit and Guarantee Corporation (ECGC) Ltd and in that capacity it extended guarantees to the banks for the various types of finance given by them to the exporters, in addition to providing insurance cover to exporters. Apart from this institutional measure, the RBI also endeavoured to exempt such credit from the purview of its measures to regulate the total volume of bank credit. Furthermore, since 1968, the concessional rates of interest were fixed for export credit by the banks. To compensate the banks for the difference between this rate and the rate that they wold normally have obtained, the Government of India paid them a subsidy at the rate of 1.5 per cent per annum on their outstanding amount of export credit.

Agricultural Finance The Agricultural Refinance Corporation Ltd was set up as a subsidiary of the RBI in 1963 for providing medium and long-term finance to eligible financial institutions, including banks, for promoting the development of agriculture and allied activities by way of refinance. It financed those agricultural development projects which could not be financed by the existing credit agencies either on account of the large outlay involved, or because the terms and conditions of repayment were such that they could not be brought within the normal rules of business under which these agencies functioned.

In brief, the growing need of integrating the banking operations and policies with the five year plans led the banks to extend the range of their financial assistance to industry by entering into new areas of underwriting and refinance-based term-lending. They had also oriented their operational policies by directing funds to priority sectors - the small-scale industries, export credit and agriculture. These measures indicated a greater readiness of the banks in India to meet the financial requirements of industry in diverse forms. The magnitude of such financing, however, in quantitative terms, was not large. The bulk of bank assistance was still in the form of short-term loans mainly to the large borrowers in the organised sector of industry. Thus, none of the new initiatives could alter the basic structure of Indian banking till the mid-1960s.

Innovative Banking The period after the mid-sixties to the early nineties may be aptly described as the phase of *innovative banking* or *revolutionary* phase or the beginning of the *big change*. After 1964, there was a significant shift in the tenor of politics in India. In fact, the period 1964-67 witnessed the 'ascendancy of radicalist ideology' at the political front, and there was an increasing concern about the problem of concentration of economic power in few hands and the widening economic disparities. Several official reports investigated into these problems. These formed the basis of significant policy changes in Indian banking. In operational terms, an equitable distribution of bank credit among the various classes of borrower, became the *central issue* of an acrimonious debate. It was argued that large-scale industries, large borrowers and the big and established business houses had almost monopolised bank credit, while the priority sectors such as the small-scale industries, agriculture, exports and small borrowers were not receiving their due share. This provided a broad setting for the revolutionary changes in the structure, operations, policies and practices of commercial banks in India during this phase. However, it may be noted that the argument for greater bank financing of the priority sector was not entirely ideological. Such enterprises had no access to the capital market either and their need for funds could be met only through bank credit. The main features of this phase were: **(i)** social control, **(ii)** Nationalisation and **(iii)** Bank credit to priority sectors.

Social Control The Indian banking structure had grown in strength and stability in the preceding phase mainly as a result of the rigorous control enforced by the RBI. Yet, the system continued to suffer in terms of coverage and credit gaps. The network of branches covered only a limited segment of the population, mostly in the big cities, almost completely excluding the rural areas and the smaller towns. Moreover, there were substantial credit gaps to sectors such as agriculture, and small industries, despite steps to improve the credit flow to these sectors as also to artisans, other self-employed persons, retail traders, and so on, who did not enjoy the facility of institutional credit at all. The control of major banks by the leading business houses was yet another weak element of the banking system. It was in response to these persistent deficiencies of the banking system that the **Scheme of Social Control** was introduced at the end of 1967.

The basic postulate of this scheme was that the bank credit was an instrument for the attainment of the socio-economic objectives of state policy. Its main objective was "achieving a wider spread of bank credit, preventing its misuse, directing large volume of credit flow to priority sectors and making it a more effective instrument of development." It sought to remove the control of the business houses over banks without removing the private ownership of banks. This was sought to be achieved by reforming their management and making them receptive to the changing concepts an goals of banking. The elements of social control were **(i)** Organisational changes, **(ii)** National Credit Council and **(iii)** Agriculture Finance Corporation Ltd.

Organisational Changes The first step under the scheme of social control was the introduction of organisational changes through the reconstitution of the Board of Directors of banks, by introducing persons who had specialised knowledge or practical experience of agriculture and rural economy, small scale industries, cooperation and banking, finance, economics and business administration.

National Credit Council The second important step was the creation of the National Credit Council (NCC) in February 1968. It symbolised the role of credit planning in development with a view to providing a forum for assessing credit priorities on an all-India basis. The main functions of the NCC were:

(i) To asses the demand for bank credit from the various sectors of the economy;

(ii) To determine the priorities for the grant of loans and advances, or for investment, according to the availability of resources and the requirements of the priority sectors, particularly, agriculture and small enterprises; and

(iii) To coordinate the lending and investing policies of the commercial banks, cooperative banks and spceialised agencies to ensure the optimum utilisation of resources.

Agriculture Finance Corporation Ltd The Agriculture Finance Corporation Ltd was set up as a joint venture by the leading banks for financing priority agricultural projects as well as to help the banks to participate actively in developing the agricultural sector.

The banks were also advised to adopt the area/project approach by selecting specific areas/projects in consultation with the State Governments for expanding agricultural credit in order to maximise the benefit accruing to agricultural through supplies of inputs, or those engaged in marketing or processing the produce including the Government procurement operations, storage and transportation.

Nationalisation Although the banking system had taken several measures for achieving the objectives of social control, there were still serious reservations amongst a sizeable section of the political leadership about the effectiveness of the social control measures without abolishing the framework of the profit-oriented private-ownership of banks. To satisfy this radical ideology. 14 major banks with individual deposits exceeding ₹50 crore were nationalised on 19 July 1969. The broad aims of nationalisation were:

> "*To control the heights of the economy and meet progressively and serve better the needs of development of the economy in conformity with national policy and objectives.*"[7]

At the time of the nationalisation of these banks, the share of the public sector in Indian banking in terms of branch offices, deposits and assets was 79.7 per cent, 82.7 per cent and 83.7 per cent respectively. Nationalisation was viusalised to provide a great impetus to changes and also give a new orientation to the banking system. For instance:

> *It was expected that the nationalised banks would endeavour to ensure that the needs of productive efforts of diverse kinds, irrespective of size and social status of the borrowers and in particular those of farmers, small-scale industries and self-employed professional groups,*

are met in an increasing measure and to create fresh opportunities for backward areas in the different parts of the country… A number of changes in bank's attitude and methods of operations were called for. It was necessary to reorient the concept of security for loans; to pay special attention to growth potential and development and term financing. Also, it was necessary to ensure that large borrowers did not have more access to resources of the banks than was actually required for productive use and to prevent the use of credit for speculative and other unproductive purposes. Simultaneously, they were required to intensify their efforts, through a coordinated branch expansion programme, for deposit mobilisation in all the parts of the country and from all sections of the people."

Expectedly, the post-nationalism period yielded significant changes in the operational policies and practices of the banks. The development which are of paramount significance were the introduction of the Tandon Committee Report, 1974 and the Chore Committee Report, 1980. These reports provided a framework of bank lending to industry.

Tandon Committee Report The report of the study group to Frame Guidelines for Follow-up of Bank Credit (Tandon Panel), 1974, was a revolutionary development as far as the evolution of a scientific system of rationing bank credit was concerned. There was an urgent need to accommodate the rising claims of funds by the new claimants who had been granted the status of a **'priority sector'** by the Government since 1968. There was also a need to contain bank credit within safe limits to avoid inflationary pressure on the Indian economy. Bank credit, in other words, had become an extremely scarce commodity. If the legitimate credit requirements of all the sectors were to be met, it was of utmost urgency that bank credit was strictly rationed, particularly to the large sector of the industry which was overrelying on the bank finance, having almost pre-empted most of it, while other sectors were not getting even their due share. The 'credit ration' of industrial units had to be fixed on the basis of some principles or criterion. The general aim was that the credit made available through the banking system was related to the production requirements. The method and criterion adopted for fixing credit ration needed to be standardised, so that there is a minimum scope for laxity and misuse on the part of the credit-users. The Tandon Committee was concerned exactly with this problem. Its reports laid down as to how the 'credit ration' of individual borrowers could be fixed, and imposed certain obligations on them for the efficient use of the credit made available.

Chore Committee Yet another notable development in the sphere of working capital controls by banks was the report of the working group to review the system of cash credit. (Chore Committee) in the light of the implementation of the Tandon Committee's framework of lending.

Bank Credit to Priority Sector The flow of bank credit to the priority sector was considerably accelerated following the nationalisation of major banks. As a result of the conscious efforts to increase the flow of credit to the priority sectors, their advances to agriculture, small-scale industries, small borrowers and other weaker sections of the community showed a notable rise.

In brief, significant policy changes occurred in the structure and operations of the banks during the innovative phase of Indian banking. The lack of geographical and functional coverage led to the scheme of social control. This was followed by the nationalisation of the major commercial banks which restored the public sector to commanding heights in Indian banking. In terms of the structural reorientation, the banks were assigned the role of instruments of development. In pursuance of the changed perspective of Indian banking, the flow of bank credit to the priority sectors was considerably accelerated during the post-nationalisation period. Attempts were also made, simultaneously, to regulate and ration bank credit available to the large industry by implementing the recommendations of the Tandon and Chore Committees. As a result, the share of the large and medium industries steadily declined.

Protection to Investors

The extent to which savings can be mobilised for industrial investment depends, apart from the development of specific financial facilities, on the confidence of the investing public in industrial securities which, in turn, is dependent on the safeguards and protection available to them. Recognising the importance of this requirement, along with the measures to strengthen and diversify the institutional structure, extensive legal reforms were carried out to provide protections to the investors.

Industrial securities, as a form of savings, were not popular in India before 1951, an important reason being the general distrust of the public of private business. Neither corporate laws nor the organisation of the industrial securities market afforded adequate protection to the holders of industrial securities against the mechination of market operators and company promoters. So rampant were corporate frauds and abuses that the public had lost all its faith in the corporate securities. Gross mismanagement of companies had undermined the confidence of the investors, and drastic reforms were carried out to restore the investors' confidence. To name a few, the remodelling of the legal and administrative apparatus of the companies and stock exchanges; tightening of the listing requirements of the stock exchanges, the control of capital issues and industrial licensing, monopolies and restrictive trade practices and the ban on forward trading since 1969, abolition of the oligarchic managing agency system in all its ramifications, and, above all, the active participation of the public financial institutions in the management of the private industry. These developments toned up the quality of corporate management in the interest of the shareholders. The important elements of the elaborate legislative code adopted by the Government are briefly recapitulated below.

Companies Act The enactment of the Companies Act, 1956 represented an important stage in the development of corporate enterprises in India. It intended to weave an integrated pattern of relationship as between promoters, investors and management. The Act also made considerable changes in the matter of prospectus, allotment of shares, terms and conditions on which companies were floated, and the capital structure of companies. The underlying objective was the protection of the interests of prospective shareholders. The law was further tightened from time to time to plug the emerging loopholes.

Capital Issues (Control) Act The second element in the scheme of providing protection to the investing public was the Capital Issues (Control) Act, 1947. The control aimed at fostering a rational and healthy growth of the corporate sector by ensuring that the investment did not go into channels which were wasteful and not in accordance with the objectives of the plans; and that companies had a capital structure which was sound and conducive to the public interest. Also, that there was no undue congestion of offers for public subscription during any part of the year. The Act was a potent tool in the hands of the Government to prevent investment in non-essential activities. It regulated the capital structure of companies with a view to discouraging undesirable practices; and aimed at protecting the investors of new enterprises, by examining the terms of new issues of capital. It scrutinised the various reorganisation plans including the merger and amalgamations, for the benefit of the shareholders and the creditors of the companies. It also regulated foreign investment including the terms and conditions of such capital, which participated with Indian capital. The Act was implemented through the Controller of Capital Issues (CCI) in the Ministry of Finance.

Securities Contracts (Regulation) Act The Securities Contracts (Regulation) Act, 1956 provided for reforms in stock exchange trading methods and practices which were the subjects of controversy in the past. The main objective of this Act was to have a healthy and strong investment market in which the public could invest their savings with full confidence. It provided for general apparatus relating to control without detailed or meticulous regulatory provisions relating to any specific matter. This Act, in conjunction with the Companies Act, was envisaged to create those basic conditions on which the edifice of a sound and revitalised private sector could be built up. The scheme of regulation included the provision that only recognised stock exchanges were permitted to function and that the Government was empowered to withdraw the recognition in the interest of trade or in public interest. It also contained important provisions in respect of listing of securities on the stock exchanges. To enforce the Act, a Directorate of Stock Exchanges (DSE) was set up in the Ministry of Finance.

Monopolies and Restrictive Trade Practices Act The Monopolies and Restrictive Trade Practices Act came into force from June 1, 1970 with the following objectives: **(a)** To ensure that the functioning of the economic system did not result in concentration of economic power and **(b)** To control such monopolistic and restrictive trade practices that were injurious to the public welfare. The Act certainly contributed to restoring public confidence in the corporate sector.

Foreign Exchange Regulation Act The Foreign Exchange Regulations Act (FERA), 1973, regulated foreign investment with the aim of diluting the equity holding in foreign companies. It was also a step in the direction of engendering confidence among the investing public in industrial securities.

Finally, the G.S.Patel Committee on stock exchanges reforms was appointed in 1984 and several of its recommendations were implemented. The setting up of the Securities and Exchanges Board of India (SEBI) in 1988 to oversee the entire gamut of the securities market in India, was a revolutionary development as far as investor protection was concerned. It was, however, not given statutory status till 1992.

To conclude, an elaborate legislative code had been adopted by the Government. It could reasonably be claimed that these reforms were thoroughgoing and effectively eliminated the major abuses and malpractices associated with the corporate management and stock exchange dealings. There is no doubt that it was a notable contributory factor in restoring public confidence in industrial investment, and an important element in the emergence of a vibrant financial system in India in the pre-1990 period.

Participation in Corporate Management

A development of considerable significance in the Indian financial system in this phase of its evolution was the participation of the financial institutions in the management of the assisted concerns. The role of institutional finance for industry shifted its focus from the problems of supply of finance to the impact of the institutional operations on the corporate power structure in India. Till the mid-seventies, the size of institutional shareholding aroused interest mainly from the viewpoint of the *supply of finance.* A new dimension to the problem, during the eighties, was the potential control of the public financial institutions over private industrial enterprises through their shareholding. The participation of the institutional investors in the management and control of private industry had serious implications for the financial system, because of the accumulation of voting strength in their hands. There were numerous cases where the institutional equityholding had become so large that the management's tenure in office became dependent on their direct and indirect support. In several large companies, these institutions, particularly the LIC and the UTI, were able to exercise considerable pressure on the management by virtue of the voting powers they had, to secure board representation for themselves, and initiate other changes in the composition of the Board of Directors and in the appointment of the Chief Executive. Even when the percentage of equity held by these institutions was relatively small, they could make their influence felt on the company management due to several reasons. Firstly, they could campaign against erring managements. Secondly, most companies needed to approach one or more financial institutions for underwriting or loan and, therefore, they liked to maintain their general goodwill. Finally, they also advanced term loans and it was usual for them to reserve, under the loan covenants, the power to appoint one or more of their nominees on the Board of Directors and to require the company to get their prior approval for certain important managerial decisions. These powers, arising from contractual obligations/arrangements, reinforced the power arising from the voting strength based on shareholding.[6]

This change in the approach of the public financial institutions could be ascribed to *three* factors. The first, and foremost, was the Government's policy decision that the public financial institutions were to actively participate in the control and management of the enterprise financed by them. This policy decision of the Government was based on the recommendation of the Industrial Licensing Policy Inquiry (Dutt) Committee Report, 1969, which argued vehemently in favour of a shift in policy and had even suggested the conversion of loans into equity by the development banks.

The second factor having a bearing on the attitude of the public financial institutions, was the structure of the industrial securities market itself. Financial institutions, as a general rule, stick to the time-honoured tradition of not getting involved in the control and management of enterprises.[7] In India also, the institutional investors were being guided by a similar consideration. A radical change, however, took place in their attitude beginning with 1970-71. The traditional attitude was based on the premise that if a financial institution was not satisfied with the performance of a particular company, it could always switch its holding to some other company. With the size that institutional shareholding had attained in India, this kind of switching was extremely difficult, often impossible. The unloading of any large block of securities raised practical difficulties. Hence, the option to sell away the holdings was not always available to the institutional shareholders. Therefore, they had to exercise effective control over the performance of these companies to safeguard their investment.

A related fact was the deep involvement of the development banks in the fortunes of companies through their lending operations. Thus, the old institutional attitude of keeping aloof from management became illogical.[8]

To sum up the emerging trends in the organisation of the Indian financial system between 1951 and the mid-eighties, the financial system in India was immature initially, a broad-based and diversified organisation gradually came into being. In the first place, an institutional structure with considerable strength and repute capable of supplying industrial capital to various enterprises in diverse forms was gradually built up. With the fortification of the structure by moulding the operational policies of the existing institutions, and by the setting up of a variety of newer institutions, the whole financial system had come under the ownership and control of public authorities so that the public sector occupied a commanding position in the distribution of credit and finance to private industrial enterprises in India. Such a control was viewed as an integral part of the strategy of planned economic development. Also, an elaborate legislative code was designed to provide a framework within which a private enterprise was to operate and progressively develop. Another development of considerable significance in this respect was the participation of the financial institutions in the management and control of the companies to which finance was provided. Thus, the problem of industrial financing in India was, until the fifties, the lack of a broad-based, efficient and responsive distributive mechanism. The task of creating such a mechanism was accomplished during the sixties to the eighties.

Organisational Deficiencies

Certain weaknesses still persisted in the pre-1990 organisation of the Indian financial system. These pertained to: **(i)** institutional structure, **(ii)** problem of small and new enterprises and **(iii)** new issue market organisation.

Institutional Structure An aspect of weakness in the organisation of the industrial financing system in India related to the institutional structure. It consisted of two categories of financial institutions:

(i) Commercial banks, LIC, GIC, and *UTI* which were normal constituents of the institutional financing mechanism and obtained their resources by mobilising savings from saving-surplus economic units, and

(ii) Development finance institutions, namely, IDBI, IFCI, ICICI, SFCs, and so on, which were like artificial limbs, created to compensate *for* the lack of growth of normal channels, and derived most of their funds from their sponsors like the RBI, and the Government.

The structure of the Indian financial system was heavily dominated by the second category of financial institutions. The prevailing structure sharply contrasted with those in the industrially advanced countries of the West, where the rise of institutional finance to industry was the result of the *institutionalisation of personal savings* and, therefore, the normal channels played a dominant role, while the development finance institutions played only a supplementary role as 'gap-fillers.' It, undoubtedly, redounded to the credit of the development finance institutions that they were instrumental in channelising substantial funds into the productive system despite unfavourable conditions in the investment market. Their participation in the financing of the companies carried an implicit guarantee to the investing public of the soundness of the proposition. The rigorous, exacting and detailed appraisal by them toned up the quality of projects and ensured the use of available resources *for* developmental purposes. Moreover, the evaluation of projects by them was objective and impersonal. This led to the availability of funds to varied types of enterprises in diverse forms, especially to relatively new firms and industries. Further, the relevance of development banks in the system of industrial financing had a *qualitative dimension*, in terms of promotional functions, so that industrial development could subserve the basic economic objectives of balanced regional development, growth of new entrepreneurial talents and small enterprises, and development of indigenous industrial technology, thus, contributing to the emergence of a diversified and egalitarian structure *for* industrial growth.

Distributive Mechanism The domination of the Indian financial system by the development banks and the massive reliance of industry on them for funds had, however, serious implications for their ability to cope with the future requirements of the accelerated programmes of industrial growth. Development finance institutions were primarily the distributors of finance and credit to industrial enterprises, which was made available to them by the agencies sponsoring them, such as the Government and the RBI. They did not autonomously mobilise savings from the saving-surplus economic units. Thus, while the relevance of the financial system to development is based both on the mobilisation of savings as well as their channelisation to saving-deficit units, the Indian financial system so overwhelmingly dominated by the development finance institutions, was practically divorced from the pool of savings in the economy. It was playing a limited role as a distributive mechanism only. Such a system was clearly incapable of growing *pari passu* with the growing requirements of the expanding industrial sector.

Forms of Financing A related deficiency of the Indian financial system was the prevalence of financial practices of questionable prudence in terms of the form of financing of industrial enterprises. Since the development banks provided most of the funds in the form of term loans, there was a preponderance of debt in the financial structure of industrial enterprises and the share of equity/risk capital was both low and declining. The financial structure of corporate enterprises practically approximated to *equityless* structure. It is true that term-loans, as a form of financing, reduced the dependence of investment on the 'erratic' stock exchanges and the detailed scrutiny of the loan applications, the accompanying covenants in the loan agreement promoted greater financial discipline among the borrowers, on the one hand, and more effective public control of private enterprise, on the other. But the overwhelming position of debt had rendered the capital structure of the borrowing concerns lopsided and, on consideration of the orthodox canons of corporate financing, highly imprudent. The sympathetic and flexible attitude of the developmental banks did permit, in case of defaults, a greater use of debt than was warranted by the traditional concept of sound capital structure, but it did not justify the unlimited use of borrowed funds without jeopardising the future of the concern itself. Moreover, liberalised finance available from development banks in terms of very high permissible debt-equity ratio implied natural reluctance on the part of the promoters of industrial enterprises to bring in large amounts of capital. Under some pretext or the other, the development banks were to acquiesce in the pleas of the promoters for a lower share capital base. It was not surprising, therefore, that while they were set up to provide supplementary finance, in actual practice, they became normal suppliers of finance and credit. The reduced equity requirements also resulted in higher debt burden to the concerns/units and consequently, they defaulted on their part in the 'payment of interest as well as the return of the principal. This was reflected in the serious problems of recovery/over dues/default experience of the development finance institutions after the mid-seventies which got accentuated in the eighties. The problem of default by borrowers assumed such alarming proportions, especially in the case of state-level institutions, that the financial viability of the development banks themselves was adversely affected. The development banks focussed mainly on large scale sanction of assistance but practically ignored the supervision of the proper use of credit. Apart from wasting massive amounts of public money, it also impaired the ability of these institutions and consequently of the financial system, to sustain their financing operations to the level of the requirements of the emerging industrial economy.

The crying need of the Indian financial system after the mid-eighties was the integration of the distributive mechanism with the ultimate pool of savings of the community. This could be achieved through encouragement to the growth of institutions like mutual funds which were organically linked with the source of savings, as well as modification in the regulation governing the investment of funds of insurance organisations, (LIC, GIC), pension, provident and other trust funds which pre-empted their investments in the Government approved investments. This ensured the availability of institutionalised personal savings for industrial investments. It was also necessary to promote diversification in the form of financing of industrial enterprises with greater focus on equity/risk capital to reflect larger stake to promoters, and the implicit financial discipline. Yet another requirement was the injection of norms of: financial prudence in their financing operations, and the observance of internationally accepted accounting standards relating to capital adequacy, asset classification, provisioning and income recognition, by the development financial institutions.

Problems of Small and New Enterprises Another weakness in the organisation of the Indian financial system was its inability to meet the financing needs of small and new enterprises. This was partly attributable to the institutional structure of the market in which the two monolithic institutions, namely, the LIC and the UTI dominated the scene. In general, the holdings in small enterprises, because of the difficulty of administration and the lack of marketability, did not fit into their investment requirements. Apart from *institutional obstacles*, such enterprises also faced *operational obstacles* in terms of the prohibitively high cost of raising capital. The solution to the problem of supply of equity capital to such enterprises required the creation of institutional demand for their securities, as well as the development of institutional facilities for placement of their securities.

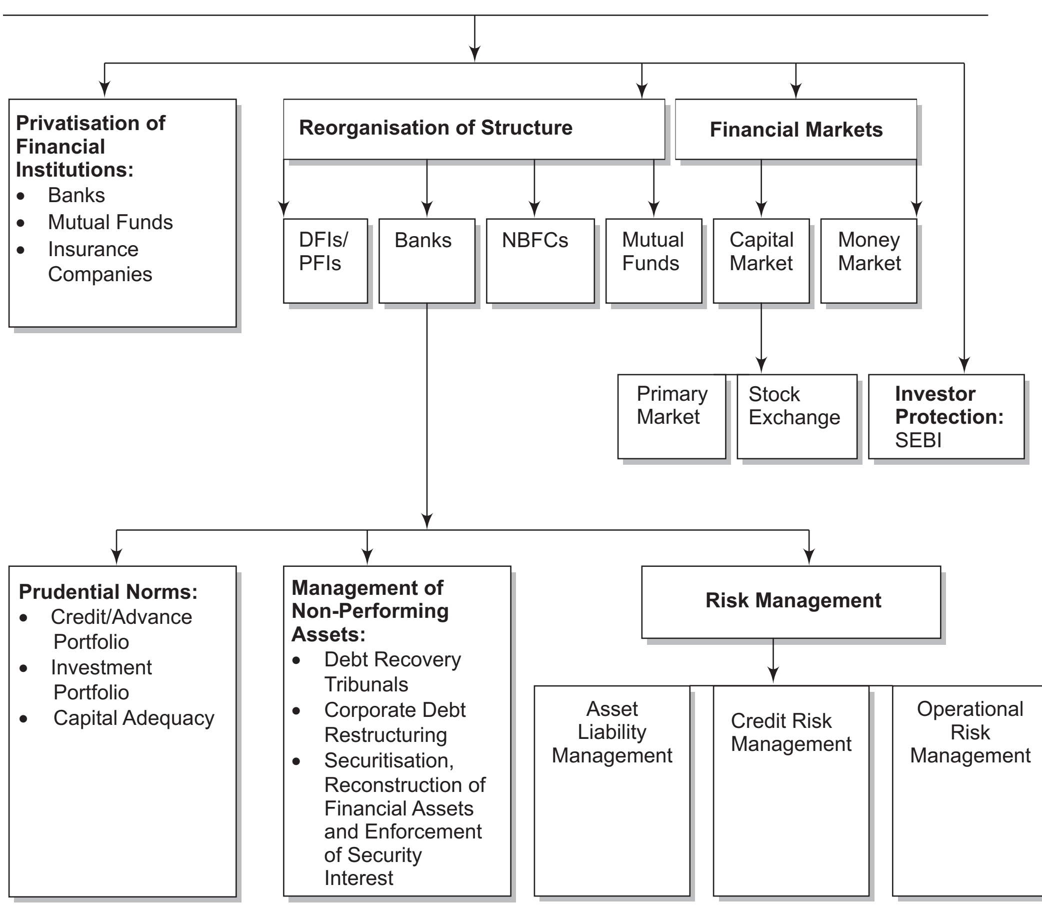
New Issue Market Organisation The new issue market in India also suffered from serious institutional lacunae. For one, there was practically no institutional arrangement for the origination of issues of capital. The importance of adequate provision for such facilities in the process of flotation of capital lies in the fact that, on the thoroughness of investigation and soundness of judgement of the sponsoring institutions (originator of an issue proposal) depends, to a large extent, on the quality of new issues, the success of an issue of capital and the standard and allocative efficiency of the market. The chief answer to the problem lay in the setting up of merchant banking institutions to provide the necessary skill and expertise.

Moreover, the underwriting facility to issues of capital, though fairly pervasive, was. of limited complexion in the sense that it was synonymous with an amount of money which each underwriter was prepared to guarantee in case of unsatisfactory public response. Apart from being inconvenient, time-consuming and expensive to the issuers of capital, there was no in-built provision for the distribution of securities to the investing public in this type of underwriting arrangement. What was required was an arrangement for a unified and comprehensive package of service, a greater integration in the underwriting organisation and closer cooperation among the underwriting agencies. This could be ensured by the development of merchant banking institutions which could assume the role of the sponsors of the issue or the leader of the group, on the pattern of similar institutions in the USA and the UK.

PHASE III: POST-NINETIES ORGANISATION

The organisation of the Indian financial system, since the mid-eighties in general, and the launching of the new economic policy in 1991 in particular, has been characterised by profound transformation. The fundamental philosophy of the development process in India shifted to free market economics and the consequent liberalisation/deregulation/ globalisation of the economy. Major economic policy changes such as macro-economic stabilisation, delicensing of industries, trade liberalisation, currency reforms, reduction in subsidies, financial sector/capital market/ banking reforms, privatisation/disinvestments in public sector units, tax reforms, and company law reforms in terms of simplifications and debureaucratisation were gradually implemented, and they have had far-reaching impact on the structure of the corporate industrial sector in India. In such an emerging economic scenario, the role of the Government in economic management did obviously shrink, and with greater momentum in the process of economic liberalisation/globalisation, the relative importance of the Government in this sphere will decline further. As a logical corollary, the role of the Government in the distribution of finance and credit is marked by a considerable decline and the organisation of the Indian financial system, dominated until the mid-eighties by state control, is witnessing capital market-oriented developments/reforms. The capital market is emerging as the main agency for the allocation of resources and all segments of the Indian economy like the public sector, private sector, and state governments are competing to raise resources in the capital market. The essence of these developments is the fact that the Indian financial system is poised for an integration with the savings pool in the domestic economy and abroad. The notable developments in the organisation of the Indian financial system during this phase are briefly outlined below with reference to **(i)** privatisation of financial institutions, **(ii)** reorganisation of institutional structure and **(iii)** investor protection. **The phase III organisation of the Indian financial system is portrayed in Exhibit 2.2.**

Exhibit 2.2 Post-1991 Phase Organisation of the Indian Financial System



Privatisation of Financial Institutions

While practically the entire financial system was under the state ownership and control till the mid-eighties, steps were initiated during this phase to privatise important financial institutions. An outstanding development in this sphere was the conversion of the Industrial Finance Corporation of India – the pioneer development finance institution in the country – into a public company (IFCI Ltd). The IDBI and IFCI Ltd offered their equity to private investors. Private mutual funds have been set up under the guidelines prescribed by the SEBI. A number of private banks under the RBI guidelines have also come into existence. With the setting up of the Insurance Regulatory and Development Authority (IRDA) as a sequel to the implementation of the R.N.Malhotra Committee's scheme of reorganisation of the insurance sector and the enactment of Insurance Regulatory and Development Authority Act, 1999, private insurance companies sponsored by both domestic and foreign promoters have re-emerged on the Indian financial scene. With the establishment of Pension Fund Regulation and Development Authority (PRDA) private entities are poised to enter pension business. Thus, the state monopoly over financial institutions in India till the early nineties, has been dismantled in a phased manner mainly through the establishment of private financial institutions such as banks, mutual funds and insurance companies. This is, indeed, a revolutionary change in the organisation of the Indian financial system.

Reorganisation of Institutional Structure

Apart from the entry of private financial institutions, the institutional structure of the Indian financial system has undergone an outstanding transformation to reflect the capital market-orientation in its evolution. This is illustrated with reference to the emerging changes in the role, organisation, operating policies, sponsorship of the institutions by development finance institutions/development banks/term-lending institutions, commercial banks, mutual funds, securities/capital market, money market, and so on. The main elements of the reorganisation of the institutional structure are briefly outlined below.

Development/Public Financial Institutions (DFIs/PFIs) Although the DFIs/PFIs constituted the backbone of the Indian financial system and despite the fact that they still played a dominant role until 2000, their relative significance in the emerging financing scenario had been declining, indicating a shift in corporate financing in India, in terms of greater reliance of industry on non-institutional sources of finance and greater recourse to the capital market. Secondly, in addition to the financing of industry by these institutions in the traditional form of rupee/foreign currency term loans for project finance, underwriting, direct description, lease financing, and so on, they also started providing core working capital to industry. Another pointer to the capital market-orientation in the operations of the term-lending institutions was the growing focus on non-fund based financial activities/services such as merchant banking and project counseling, portfolio management services, credit syndication, new issue management, mergers and acquisition, corporate advisory services, debenture trusteeship, registrar/transfer agents, sponsoring mutual funds and so on. Further, the pattern of financing of the development banks, which consisted predominantly of funds from the Government and the RBI, was progressively geared to accessing the capital market through issue of capital to the public, issue of innovative floating interest rate bonds, and other types of bonds without Government guarantee. Similarly, these institutions introduced floating rates of interest on term-loans. The bonds issued by the DFIs were no longer eligible as SLR assets for banks. They were meeting almost their entire requirements of funds at market-related interest rates. Concesssional assistance from the RBI is now available only to SIDBI out of repayment being made by IDBI. Government guaranteed bond facility is now available only to the IIBI Ltd and SIDBI besides NABARD and National Housing Bank (NHB).

Another significant indicator of the change in the structure of the DFIs, in tune with capital market, was the nature of institutions sponsored by them. When the focus was on development finance, the infrastructural institutions sponsored by them consisted of the Technical Consultancy Organisations (TCOs), Management Development Institute (MDI) and the Institute for Financial Management and Research (IFMR), whose major objective was the promotion of entrepreneurship. The focus shifted to promoting institutional infrastructure, geared to capital market development. These included three credit rating agencies, that is, Credit Rating Information Services of India Ltd (CRISIL), Investment Information and Credit Rating Agency Ltd (ICRA) and Credit Analysis and Research Ltd (CARE), and also two stock exchanges, namely, Over-The Counter Stock Exchange of India (OTCE) Ltd and the National Stock Exchange (NSE) Ltd. The other organiastions/institutions sponsored by the in conformity with the requirements of the growing capital/securities market are the Stockholding Corporation of India (SHCI) Ltd, Investor Services of India (ISIL) Ltd, ICICI-Securities and Finance Ltd (I-SEC), IFCI Financial Services Ltd, IFCI Investors Services Ltd and IFCI Custodian Services Ltd and so on. Thus, the development banks had assumed the character of financial conglomerate/super market in contrast to their earlier limited role as term-lending institutions.

The RBI guidelines stipulated the application of prudential norms in accounting for income, asset classification, provisioning and capital adequacy on the pattern of the commercial banks as envisaged by the Narasimham Committee I, 1991. The extension of the internationally-accepted accounting standards to the term-lending institutions in India resulted in their operations shifting from quantitative sanctions/disbursements of assistance to financial viability, accountability and improving the bottomline of these organisations. Obviously, a new type of development banking emerged in India.

In brief, the development banking institutions had a dual function to perform: to act as a substitute for the capital market when it was not developed, cater to the needs of the growing industrial sector, and at the same time foster the growth of the capital market. They had, by the mid-eighties, emerged as a substitute for the capital market in India but in the recent years, they geared up to play the traditional role to supplement and not supplant the capital market. With the conversion of the ICICI Ltd and the IDBI into banks coupled with the proposed reorganisation of the IFCI Ltd, and the winding up of the IIBI Ltd, the DFIs/PFIs/term lending institutions have disappeared from the Indian financial scene. This is, indeed, indicative of a truly profound transformation of the organisation of the Indian financial system in this phase.

Commercial Banks In the context of the changed perspective in terms of the deregulated/liberalised/globalised economic environment, the post-1991 era of Indian banking is characterised by prudential/viable/profitable banking. By the mid-nineties, a geographically wide and functionally diverse banking system had emerged as reflected in the phenomenal branch expansion especially in the rural and semi-urban and unbanked areas, phenomenal growth in deposits, and increase in the share of the priority sector in total bank lending. The impressive progress of Indian banking in achieving social goals (social banking) as reflected in the geographical reach and functional spread had, indeed, been a major developmental input. However, serious weaknesses developed in the form of decline in productivity and efficiency of the banking system and consequently a serious erosion of its profitability with implication for its viability itself. Gross profits progressively declined. In case of some banks, the incremental cost of operation per rupee of working funds was more than the incremental income per rupee of working funds. "*The erosion of profitability adversely affected the ability of the banking system to expand its range of service,s in the context of assisting in the creation of competitive vitality and efficiency in the rural economy*." The factors which had adversely affected the profitability of the banking system were partly external in terms of macropolicy environment and partly internal in terms of organisation, staffing and branch spread.

Macro Aspects of Economic Environment There is no inherent contradiction between social obligations and profitable banking. Social banking cannot be said to have depressed potential income and been a factor in declining profitability. The major elements constraining the operational flexibility of banks and depressing the banks' income earnings were identified to the following.

- System of directed investments in terms of the minimum statutory liquidity ratio (SLR) and the variable cash reserve ratio (CRR) pre-empted 63.5 per cent at the margin of the net demand and time liabilities (NDTL) comprising SLR, 38.5 per cent and CRR, 15 per cent plus 10 per cent incremental ratio. Essentially conceived as prudential safeguards, under the Banking Regulation Act, as instrument of credit control, SLR degenerated into a major instrument for financing the public sector/Government current expenditure. The return to banks on such funds was pitiably low. The income of banks was adversely affected both by the quantum of, and interest on, SLR investments. Similarly, the rates on the impounded CRR (in excess of the basics minimum of 3 per cent) were low and the loss on potential income as a result of the ***reserve requirement tax*** adversely affected profitability.
- System of directed credit programmes (credit to the priority sector) over the years resulted in deterioration in the quality of loan portfolio, growth of overdues and consequence erosion of profitability.
- Political and administrative interference in credit decision contributed, by far the most to the decline in the portfolio quality. *The intended socially-oriented credit generated into irresponsible banking*. The forced extension of bank credit to sick units was another dimension to the contamination of the portfolio of banks. Moreover, concessional lending rates on priority sector credit has had adverse implication for the profitability of banks. The erosion of earnings' and profitability of banks was, thus, the result of both depression in interest incomes as well as the deterioration in the quality of the loan portfolio to both the priority and traditional sectors.
- Escalation in cost/expenditure partly due to a steady increase in the interest cost of deposits as a result of higher rates as well as shifts in the maturity pattern of deposits towards the larger term deposits but mainly due to the impact of the phenomenal expansion of branch banking especially in the rural and semi-urban areas.

Internal Factors Factors in terms of organisation, staffing and so on also affected the efficiency, operational flexibility and productivity of the banking system. In the first place, the system could not cope with the load of servicing more branches as the operational methods and procedure remained largely unchanged. Extensive geographical spread and lines of command and control weakened central office supervision without necessarily leading to grater delegation and accountability; there had been significant deterioration in "housekeeping" in the areas of balancing of books and reconciliation of entries; submission of internal control returns by branches to head office had been unsatisfactory; and there had been weakening of internal inspection and audit and increase in unreconciled inter-branch and inter-bank entries.

Secondly, the rapid growth in the numbers of staff and accelerated promotions diluted the quality of manpower. There was a perceptible decline in the quality of supervisory and managerial staff; there had been overmaning at various levels of organisational system; discipline and work culture were badly affected due to militant trade unionism; and technology of banks remained obsolete. All these affected the productivity and efficiency of the system and efficient customer service.

Thirdly, accounting practices in terms of income recognition, asset classification, provisioning and capital adequacy were not transparent and in conformity with international norms and practices.

Finally, the banking system did not have operational flexibility and internal autonomy in decision making either in respect of credit sanctions or all aspects of internal management. Directed investments and credit programmes inhibited operational flexibility; excessive political and administrative interference in credit decision seriously abridged their autonomy. The lack of autonomy and operational flexibility seriously eroded professionalism in banking operation.

Narsimham Committee (NCI) It is in the context of the foregoing features of the Indian banking in the post-nationalisation period that the Narsimham Committee I (Committee on Financial Sector, 1991) suggested a comprehensive framework for the reorganisation/reform of the system. With the implementation of several recommendations of Narsimham Committee I, there had been far-reaching changes in the practices, policies and structure of the banking system. They are briefly summarised below.

Directed Investments The SLR had been brought down in a phased manner and stands at 25 per cent. Similarly, the average CR was brought down in stages to 4.5 per cent.

Directed Credit Programme The existing level of priority sector lending continued to be at the earlier level (40 per cent). However, the scope of priority sector lending had been enlarged to include finance to State Industrial Development Corporations (SDICs)/State Financial Corporations (SFCs), refinance to Regional Rural Banks (RRBs) by sponsor banks, investments in bonds issued by certain specified institution such as Small Industries Development Bank of India (SIDBI).

Interest Rate Structure Except lending to small borrowers and a part of export finance, all lending rates of interest have been deregulated. Interest rates on deposits are now free except for prescription in respect of saving deposits. The interest rate on Government borrowings also is now market related/determined. Concessional interest rates in lending has been phased out to a large extent. The Bank Rate (BR) has been reactivated after April 1997 by linking to it refinance from the RBI, penal interest on shortfall in reserve requirements, and so on. A system of PLR has been put in place since October 1994 which is the minimum lending rate for non-concessional lending, that is, credit limits above ₹2 lakh. The relationship between the BR, the Government borrowing rate, bank deposits rates and the PLRs of banks are determined by market forces and developments in the economy such as expected inflation, and so on.

Capital Adequacy Norms These norms (capital to risk weighted assets ratio) were implemented in stages. It stands at 9 per cent now.

Income Recognition, Asset Classification and Provisioning Norms These norms have been introduced since 1992 in phases. Income recognition is based on actual receipt. A Non-Performing Asset (NPA) is defined now as a credit facility in respect of which interest has remained *due* for a period of two quarters. The four-fold classification of assets into standard, substandard, doubtful and loss has been applied. Provisioning norms are also in place in respect of various classes of assets.

Transparency of Financial Statements The RBI modified the format of the balance sheet with a view to increasing greater transparency and disclosures. The banks were required to disclose the capital adequacy ratios. More significant disclosures were prescribed, namely, a break-up of the provisions made during the year and percentage of net NPAs to net advances and investments on gross and net basis. Banks were directed to disclose seven critical ratios relating to productivity and profitability.

Tax Treatment of Provisions Provisions made by the banks against classified assets are considered tax-deductible if the amount is written-off. As regards the general provisions, the limit of admissible deductions has been enhanced to 5 per cent of income and 10 per cent of average aggregate advances of rural branches.

Debt Recovery Tribunals Under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, eight debt recovery tribunals (special tribunals) have been set up covering 20 states and four union territories. An Appellate Tribunal has also been established in Mumbai.

Regional Rural Banks The approach has been to strengthen and restructure RRBs on a *stand-alone* basis.

Entry of Private Sector Banks About 10 new banks have commenced business under the RBI framework of start-up capital and prudential norms.

Branch Licensing While branch licensing policy has not been abolished, greater operational freedom has been given to banks to open specialised (industrial/small-scale industries/agricultural) branches, off-site ATMs and other non-branch offices. They have also been given freedom to close branches to convert rural branches into satellite offices. Since 1994, banks fulfilling certain specified criteria have been permitted to open branches: net owned funds, ₹100 crore, three-year track record of net profits, capital adequacy ratio, 8 per cent and percentage of NPAs to total advances, not exceeding 15 per cent.

Foreign Banks The RBI has allowed the entry of foreign banks as branches subject to reciprocity and other prudential considerations. Foreign banks/companies have also been permitted to invest up to 20 per cent as a technical collaborator (within overall 40 per cent ceiling) in a new private sector bank, subject to Government approval, provided they do not have presence in India. Foreign equity in new Indian private banks are allowed in accordance with the foreign investment policy. Since 1992, 19 new foreign banks with 47 branches have been allowed. It is mandatory for the foreign banks to achieve the minimum target of 32 per cent to priority sector lending, with two subtargets: small-scale sector, minimum 10 per cent and exports, 12 per cent. They are exempted from targeted credit in respect of agricultural advances.

Recruitment and Creation of Posts Banks fulfilling the undermentioned criteria are allowed to recruit specialised officers and also undertake campus recruitment for partly meeting the requirements of probationary officers: Capital adequacy, more than 8 per cent; Net profit during the last three years; NPA level, below 9 per cent; Minimum net owned funds, ₹100 crore.

The Boards of Directors of banks have been given powers to decide their own policy in respect of creation, abolition, upgradation/modification of posts up to the level of Deputy General Managers (DGMs).

Supervisory Authority A Board of Financial Supervision (BFS) under the aegis of the RBI with four members drawn from the RBI Board and serviced by a separate Department of Banking Supervision has been constituted. An Expert Advisory Council has been set up to advise the BFS on various policy matters.

Appointment of CMDs/CEOs and Board Members To depoliticise appointments, an Appointments Board has been set up for board level appointments. It consists of Governor, RBI (chairman), Finance Secretary, Deputy Governor, RBI, a management expert and a banking expert, Special/Additional Secretary, Banking (member-secretary). The selection by the board is based on professional experience and expertise in the relevant fields.

Overall Assessment The reform/reorganisation process was started in 1991 and implemented in phases/stages. Nonetheless, some positive developments can be discerned in the banking/financial system.

- A significant area of improvement is reflected in the greater accuracy and transparency in respect of financial statements. They became more credible and transparent with the introduction of internationally accepted accounting norms together with fuller disclosure on the sensitive aspects of operations. The refinement of accounting practices and disclosures requirements to bring them fully in line with internationally accepted norms in this regard has, however, to be an ongoing process.
- All but two or three public sector and four private sector banks have fully complied with the minimum capital adequacy ratios.
- Prudential norms on income recognition, stricter definition of NPAs and the revived format for classification of assets and related provisioning are fully in place. Initially, some banks showed losses and erosion in net worth. The profitability of the banking system had also shown an improvement. Yet efficiency and productivity still left much to be desired. To enable the public sector banks to meet competitive challenges from private and foreign banks, cost economies, need to be focused.

Narsimham Committee II The scheme of reform outlined by the Narsimham Committee II (Committee on Baking, 1998) should be viewed in the context of:

- Ongoing form of the Indian banking system since 1992 as a follow-up to the recommendations of NC I, 1991; and
- Major changes that had taken place in the domestic and institutional scene, coinciding with the movement towards global integration in financial services. These developments have reinforced the importance of building a strong and efficient financial system.

The Narsimham Committee II had examined the second generation of reforms in terms of three broad interrelated issues: **(i)** Action that should be taken to strengthen the foundation of the banking system, **(ii)** Streamlining procedures, upgrading technology and human resource development, and **(iii)** Structural changes in the system. These cover the aspects of banking policy, institutional, supervisory and legislative dimensions.

While a persistent and unexpected downturn in the real economy creates difficult problems for the financial sector, a fragile financial sector can deepen the real economy crisis and impose heavy social costs. As part of the economic reforms, since the early nineties, the capital adequacy and other prudential norms of banks have been strengthened and currently are close to the international standards. The quality and standards of supervision have also been upgraded substantially under the direction of a separate Board of Financial Supervision (BFS) under the aegis of the RBI. Barring the performance of a few weak banks, whose problems are being addressed separately, the improvement in the banking sector as a whole is impressive. In terms of inherent robustness, Indian banking system's exposure to real estate/shares is negligible. Their off-balance sheet liabilities are also very small due to regulatory restrictions, and a relatively large part of banking system's assets are in the secure investment particularly in the Government and approved securities. These features of banking system are important and contribute to their long-term financial viability.

Thus, while the focus of reforms until 1997 was on arresting the qualitative deterioration in its functioning, it shifted to making the banking system internationally competitive. The second generation of reforms have consequently addressed to the internal financial management of banks in contrast to the regulatory compliances until then. The implementation of the Basel II framework effective April 2008 has added new dimensions to the prudential management of bank funds in line with the international best practices. The main components of the internal financial management practices of banks in India presently are the following: **(1)** rigorous prudential accounting norms relating to their **(i)** advances/credit portfolio, **(ii)** investment portfolio; and **(iii)** capital adequacy; **(2)** management of non-performing assets to ensure speedy/effective recovery in terms of **(i)** debt recovery tribunals, corporate debt restructuring and securitisation/reconstruction of financial assets and enforcement of security interest and **(3)** management of risks to which banks are exposed, namely, asset liability management, credit risk and operational risk. These are elaborated to subsequent Chapters 10 through 13.

Non-Banking Financial Companies (NBFCs) The NBFCs constitute a significant element of the organisation of the financial system. They broaden the range of financial services. These are partly fee-based and partly fund-based. The important fund/asset based activities of NBFCs are equipment leasing, hire-purchase, bills discounting, loans/investments, venture capital, housing finance, factoring and forfaiting, stock broking, merchant banking and so on. Their fee based/advisory services include issue management, portfolio management, corporate counseling, loan/lease syndication, merger and acquisition and so on.

Reflecting the imperatives of the evolution of a vibrant, competitive and dynamic financial system, the NBFC sector in India has recorded marked growth in the recent years in terms of number, deposits and so on. A regulatory framework for their operations has evolved over the years on the basis of the recommendations of a number of committees in the context of the contemporary financial scenario. Based on their recommendations, the main elements of the regulation currently in force are: **(i)** Chapter III-B of the RBI Act amended in 1998, **(ii)** RBI Acceptance of Deposits Regulations, 1998, **(iii)** NBFCs Prudential Norms (RBI) Directions, 1998 and **(iv)** NBFCs Auditor Reports (RBI) Directions 1998. With a view to giving sharper focus to supervision over the NBFCs, the RBI has set up a separate Department of Non-Banking Supervision which undertakes both on-site and off-site surveillance over the institutions. They now operate within the rigorous framework of RBI's directions relating to **(a)** acceptance of public deposits, **(b)** prudential norms and **(c)** auditors reports.

Mutual Funds A remarkable development in the reorientation of the Indian financial system in the post-1991 years is reflected in the structural growth of mutual funds industry. In contrast to the position around the mid-eighties which consisted primarily of the monolithic Unit Trust of India, the structure has been considerably strengthened by the emergence of a broad-based pattern. The present structure comprises of domestic mutual funds sponsored by the UTI, bank subsidiaries, insurance organisations, private sector with foreign collaboration and foreign institutional investors/merchant banks. In addition, there are several off-shore/overseas/country funds sponsored by Indian financial institutions as well as foreign institutional investors. Between them, they offer a wide variety of schemes focusing on income, growth, tax savings, insurance-linkage and special categories like children and senior citizens, sector-specific, money market mutuals to suit the investment requirements of the heterogeneous category of investors.

Mutual funds are emerging as the backbone of the Indian capital market and as the vehicle for institutionalisation of security investments for the relatively small investors. They are conceived as the preferred route for equity investments in terms of:

(i) Increase in the threshold/minimum limit in direct primary market investment from ₹1,000 to ₹5,000.
(ii) Introduction of the scheme of firm allotment to financial institutions including 20 per cent of the issues of capital to mutual funds.
(iii) Proportional allotment in case of over-subscription to issues of capital.
(iv) The treatment of the units of mutual funds as long-term capital assets if held for 12 months, as against 36 months earlier, for purposes of capital gains tax, and
(v) Complete tax exemption to unitholders on income from mutual funds.
(vi) Reservation of 5 per cent share for mutual funds in the allotment to QIBs under book building.

Thus, mutual funds are being encouraged and have, in fact, emerged as the most preferred form of investment by the investors. They operate within the rigorous and comprehensive framework prescribed by SEBI to promote the sound and healthy growth of the mutual fund industry, consistent with the investors requirements. The reorganisation of the UTI recently, has added a new dimension to the growing significance of mutual funds as a highly vibrant component of the Indian financial system. UTI is now a fully SEBI-compliant mutual fund.

Securities/Capital Market A segment of the Indian financial system that has witnessed the most profound transformation is the securities market. Historically, India's capital market was dormant till the mid-1980s. The long-term needs of the corporate sector were by and large, met by the DFIs as well as other investment institutions, namely, LIC and UTI. Activities in the capital market were limited mainly due to the administered structure of interest rates and easy availability of credit loans from banks and FIs. From being a marginal institution in the mid-eighties, the securities market has emerged as the most important mechanism for allocating resources in the economy. The emerging significance of the security markets is eloquently borne out by the rapid expansion in the quantum of funds raised and the number of investors in the primary market, as also by the increase in the number of stock exchanges and listed stocks, speedy rise in market capitalisation and the volume of trade and entry of sophisticated investors like the foreign institutional investors and the mutual funds. India's capital market has been transfomed into one of the dynamic capital markets of the world. The structure of both the segments of the market – primary/new and secondary/stock exchange – has witnessed significant changes.

Primary Market The primary market organisation, which suffered from some serious lacunae till the mid-1980s, has truly been comprehensively transformed/reformed. **The major reforms that have taken place in the primary market are given in Exhibit 2.3.**

One component of the organisation, namely, the market intermediaries, comprise of specialist merchant banks/lead managers, underwriters, bankers to an issue, registrars to an issue and share transfer agents, portfolio managers, brokers depositories, FIIs, custodians, rating agencies, venture capital funds, mutual funds and so on. They offer specialist institutional services in the market within the rigorous SEBI guidelines. Similarly, the pre - as well as post-issue procedures

Exhibit 2.3 Major Reforms in the Primary Market

- Merit based regime to disclosure based regime.
- Disclosure and Investor Protection (DIP) Guidelines issued.
- Pricing of public issues determined by the market.
- A system of proportional allotment of shares introduced.
- Banks, FIs and pSUs allowed to raise funds from the primary market.
- Accounting standards are close to the international standard.
- Corporate Governance Guidelines issued.
- Discretionary allotment system to QIBs withdrawn.
- FIIs allowed to invest in primary issues within the sectoral limits (including G-Sec).
- Mutual funds are encouraged, both in public and private sectors, and they have been
- Guidelines for private placements of debt issued.
- SEBI promoted Self-Regulatory Organisation, (SROs).
- Allocation to retail investors increased from 25 per cent to 35 per cent.
- Separate allocation of 5 per cent to domestic mutual funds within the QIB category.
- Freedom to fix face value of shares below ₹10 per share only in cases where the issue price is ₹50 or more.
- Shares allotted on a preferential basis as well as the pre-allotment holding are subject to a lock-in period of six months to prevent sale of shares.

and activities have been streamlined and geared for a rigorous compliance to SEBI - prescribed norms/requirements to ensure investor protection. The reforms relating to the intermediaries as well as the issue procedures and activities are indeed thorough going, as a consequence of which the primary market organisation has assumed a highly developed, character capable of catering to the requirements of a sophisticated and articulate securities market.

Secondary Market The secondary market, which represented an institutional mechanism that was inadequate, non-transparent, hardly regulated and rarely geared to investor protection till the early nineties, has also witnessed notable developments. A few stock exchanges, dominated by the Bombay Stock Exchange (BSE Ltd. now) provided the trading platforms for the secondary market transactions, under an open outcry system. **Major reforms in the secondary markets/ stock exchanges are given in Exhibit 2.4.**

The screen-based trading system is a landmark achievement of the Indian capital market. The NSE introduced screen-based trading at its inception in 1992, and was followed by other stock exchanges. Screen-based trading makes possible on-line, electronic, anonymous and order-driven transactions, with the help of over 10,000 terminals, spread over 400 cities in India and abroad. Order matching is done strictly on price/time priority. Screen-based trading is transparent and provides equal access to all investors, irrespective of their geographical locations. Screen-based trading has significantly improved the depth and liquidity of the market.

The Depositories Act, 1996 was another landmark development in the history of India's capital market. Thereafter, two depositories, namely, Central Depository Services Limited (CDSL) and National Securities Depository Limited (NSDL) were set up. The NSDL and CDSL have been successful in the dematerialistaion of securities to the extent of 99 per cent of the total market capitalisation. Currently, the transfer of ownership is mostly done through book-entry form. This has tremendously improved the speed, accuracy and security of the settlement system. About 99.9 per cent of trades are currently settled through delivery, which has been possible only due to dematerialisation of scrips by the two Depositories.

Exhibit 2.4 Major Reforms in the Secondary Market

- Mandatory rgistration of market intermediaries.
- Capital adequacy norms specified for the brokers, sub-brokers of stock exchanges.
- Guidelines issued on listing agreement between stock exchanges and corporates.
- Shortening of settlement cycle to T + 2.
- Regular inspection of stock exchanges and other intermediaries including mutual funds put in place.
- Regulation of Substantial Acquisition of Shares and Takeovers.
- FIIs allowed to invest in Indian capital since, 1992.
- Order driven, fully automatic, anonymous, screen based trading introduced.
- Depositories Act enacted.
- Guidelines on Corporate Governance issued
- SEBI has prohibited fraudulent and unfair trade practices, including insider trading.
- Straight Through Processing Introduced and made mandatory for institutional trades.
- Margin trading, short selling and securities lending and borrowing schemes introduced.
- Separate, trading platform, namely, Indonext, for SME sector launched.
- Corporatisation and demutualisation of stock exchanges notified.
- Settlement and Trade Guarantee Fund/Investor Protection Fund set up.
- Comprehensive risk management system (capital adequacy, trading and exposure limit, margin requirement, index-based market-wide circuit breaker, on-line position monitoring, automatic disablement of terminals) put in place.
- Comprehensive surveillance system
- Securities Appellate Tribunal (SAT) set up.
- Mutal funds and FIIs to enter the Unique Client Code, (UCC) pertaining to the parent entity, at the order entry level, and enter the UCCs for the individual schemes/sub-accounts on the post-closing session.
- Introduction of exchange traded derivatives.

Another notable achievement has been the shortening of the settlement cycle and adoption of the rolling settlement. The settlement cycle was as high as 14 days for specified scrips and 30 days for others. The settlement risk was very high as many things could happen between the transaction and the settlement. Initially, the settlement cycle was reduced to a week. Thereafter, rolling settlement was introduced on a T+5 basis, in July 2001. From December 2001, all scrips which had established connectivity with both the Depositories, were moved to rolling settlement. The settlement cycle was further reduced to T+3 in April 2002 and to T+2 in April 2003.

The setting up of the Clearing Houses/Clearing Corporations (CCs) has been a critical institutional arrangement to improve the market microstructure of the Indian stock market. The NSE has a dedicated subsidiary, namely, the National Securities Clearing Corporation Limited (NSCCL), which performs the role of a central counterparty. The CCs provide full novation with multilateral netting. Trade and Settlement Guarantee Funds have been set up to guarantee settlement in case of default by the brokers. There is also a system of security lending and borrowing to obviate settlement risk. As CCs provide guaranteed settlement, there is no counterparty risk. Moreover, full-fledged Straight Through Processing (STP) has been made mandatory for all institutional trades.

The introduction of securities related derivatives in India is another milestone which provides an important avenue to the investors, mainly for hedging. Derivative trading began in India with the launch of index futures in June 2000, followed by index options, single stock options and single stock futures in 2001. Interest rate futures were introduced in June 2003. The derivative products have a monthly maturity cycle. From September 13, 2004, the weekly stock and index option was launched on the derivative segment of the BSE. Two premier stock exchanges, namely BSE and NSE, provide trading platforms for derivative transactions. The bulk of the derivative trading is done in the NSE. The combined turnover in derivatives on the BSE and NSE surpassed the combined turnover in the cash segments since early 2004. During 2004-05, the turnover in the derivative segments of the NSE was 223 per cent of its cash segment turnover. Single stock futures emerged as the most popular derivative product, followed by index futures, stock options and index options.

The Foreign Institutional Investors (FIIs) were allowed to invest in India in 1992, under the portfolio investment scheme. They have also been allowed to participate in the public issues of debt and equities within the sectoral limits set for equities and the overall limit fixed for the debt instruments by the Government. Strong macro-economic fundamentals, favourable tax treatment, attractive valuation of shares and encouraging corporate results have been cited as underlying causes of large portfolio investments by the FIIs in India.

The SEBI has put in place a comprehensive risk management system. The major features of the dynamic risk management system include, *inter alia*, capital adequacy norms, trading and exposure limits, margin requirement based on mark-to-market and VaR-based margining, index-based market-wide circuit filters, on-line position monitoring and automatic disablement of brokers' terminals. The T+2 trading cycle, settlement guarantee funds, guaranteed settlement by CCs, together with the risk management system, have significantly reduced the risk perception of the Indian stock market.

The SEBI has allowed the member brokers to provide margin trading facility to their clients in the cash segment, since April 1, 2004. Securities with mean impact cost of less than or equal to one and traded at least on 80 per cent of the days during the previous 18 months, would be eligible for margin trading. Only corporate brokers with a net-worth of at least ₹3 crore are eligible to offer this facility, after obtaining prior permission from the exchanges.

Money Market Till the early nineties, the money market in India had a narrow base and a limited number of participants, which was restricted to the banks and the LIC and UTI. There were no participants who would alternate between lending and borrowing to develop an active market. Moreover, there was a paucity of instruments in the market, the only instruments being call/notice money, inter-bank deposits/loans, commercial bills and 91-day T-bills. The interest rates were controlled by the RBI directly or by a voluntary agreement between the participants (banks) through the Indian Bank Association (IBA). Low-risk, highly-liquid and short-term instruments, deregulated interest rates, existence of a number of participants including market makers, and a flexibility of transactional procedures are the pre-requisites for a versatile money market.

In the post-1990 period and particularly in the context of a deregulated economic environment, a sophisticated and articulate money market has emerged in the country. A notable development has been the emergence of specialised institutions, namely, Primary Dealers (PDs), and money market mutual funds (MMMFs). Alongside activating the existing instruments through a modification in the procedures, deregulation of interest rates and enlargement of participants, a number of new instruments have been introduced. The organisation of the Indian money market consists of a number of inter-related sub-markets, namely, Call/notice market, Commercial bills market, T-bills market, Commercial papers (CPs) market, Certificates of deposits (CDs) market, and Repo market. There are also indications of a trend towards an integration of the forex and the money market. The RBI is now using the open market operations, bank rate, cash reserve ratio and repos as active instruments of monetary policy.

Protection to Investors: Securities and Exchange Board of India (SEBI)

The securities market which emerged from the periphery to enter the mainstream of the financial market in India, has been one of the most significant institutional developments since the mid-eighties, especially since the beginning of the nineties. It has witnessed a spectacular growth, both in terms of its ability to mobilise resources and to allocate it with some efficiency. The corporate sector has come to rely on the securities market increasingly, to finance its long-term requirements of funds, in contrast to a decade earlier when the DFIs were the sole purveyors of long-term funds. As a logical corollary, there has also been a growth in the awareness and interest in the investment opportunities available in the securities market among investors. To help sustain this growth and crystallise the awareness and interest into a committed, discerning and growing pool of investors, the investors' right must be fully protected, trading malpractices must be prevented and structural inadequacies of the market must be removed.

Although a fairly comprehensive legislative code had been put in place in the pre-1990 phase, the focus was on control. The framework was fragmented, both in terms of the laws/acts under which the regulatory functions fell and the agencies and Government departments that administered them. For example, the Capital Issue (Control) Act was administered by the Controller of Capital Issues (CCI) in the Ministry of Finance. The scheme of control under the Act required all the companies to obtain prior consent for issues of capital to the public. Under this arrangement, the pricing as well as the features of the capital structure, such as debt-equity ratios, were controlled by the Government. Likewise, the Securities Contracts (Regulation) Act was administered by the Directorate of Stock Exchanges, also in the Ministry of Finance. Its aim was to prevent undesirable transactions in the securities. It empowered the Government to recognise/derecognise stock exchanges, stipulate rules and bye-laws for their functioning, compel listing of securities by public companies, and so on. Such a system of regulation/control was inadequate in the context of the liberalised economic scenario. In such a milieu, regulation of a different kind was called for.

The need of the growing securities market in India was a focussed/integrated regulatory framework and its administration by an independent/autonomous body. The Capital Issues (Control) Act was repealed in 1992 and the Office of the Controller of Capital Issues (CCIs) was abolished. The Securities and Exchange Board of India (SEBI) was set up in April 1988 by an administrative order and acquired a statutory status in 1992. It has emerged as an autonomous and independent statutory body with a definite mandate which requires it to: **(i)** protect the interest of the investors in securities; **(ii)** promote the development of the securities market; and **(iii)** regulate the securities market. In order to achieve these objectives, SEBI exercises powers under: **(a)** the SEBI Act, **(b)** the Securities Contracts (Regulation) Act, **(c)** the Depositories Act and **(d)** the delegated powers under the Companies Act. **The SEBI regulates and supervises the securities markets through (1) regulations, (2) guidelines, (3) schemes, (4) rules and (5) orders (listed in Exhibit 2.5).**

The SEBI prohibits fraudulent and unfair trade practices, including insider trading. It also regulates substantial acquisition of shares and takeovers. In order to ensure investor protection

Exhibit 2.5 SEBI Securities Markets Regulations, Guidelines and Schemes in Force

Regulations

- SEBI (Alternative Investment Funds) Regulations
- SEBI (Bankers to an Issue) Regulations
- SEBI (Buy-back of Securities) Regulations
- SEBI (Central Database of Market Participants) Regulations
- SEBI (Certification of Associated Persons in the Securities Markets) Regulations
- SEBI (Collective Investment Schemes) Regulations
- SEBI (Credit Rating Agencies) Regulations
- SEBI (Custodian of Securities) Regulations
- SEBI (Debenture Trustees) Regulations
- SEBI (Delisting of Equity Shares) Regulations
- SEBI (Foreign Portfolio Investors) Regulations
- SEBI (Infrastructure Investment Trusts) Regulations
- SEBI (Intermediaries) Regulations
- SEBI (Investment Advisers) Regulations
- SEBI (Investor Protection and Education Fund) Regulation
- SEBI (Issue and Listing of Debt Securities) Regulations
- SEBI (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations
- SEBI (Issue of Capital and Disclosure Requirements) Regulations
- SEBI (Issue of Sweat Equity) Regulations
- SEBI [KYC (Know Your Client) Registration Agency] Regulations
- SEBI (Listing of Specified Securities on Institutional Trading Platform) Regulations
- SEBI (Merchant Bankers) Regulations
- SEBI (Mutual Funds) Regulations
- SEBI (Ombudsman) Regulations
- SEBI (Portfolio Managers) Regulations
- SEBI (Procedure for Board Meetings) Regulations
- SEBI (Procedure for Search and Seizure) Regulations
- SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulation
- SEBI (Prohibition of Insider Trading) Regulations
- SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations
- SEBI (Real Estate Investment Trusts) Regulations
- SEBI (Registrars to an Issue and Share Transfer Agents) Regulations
- SEBI (Regulatory Fee on Stock Exchange) Regulations
- SEBI (Research Analysts) Regulations
- SEBI (Self Regulatory Organisation) Regulations
- SEBI (Settlement of Administrative and Civil Proceedings) Regulations
- SEBI (Share Based Employee Benefits) Regulations
- SEBI (Stock Brokers and Sub-Brokers) Regulations
- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations
- SEBI (Underwritten) Regulations
- Securities Contract (Regulation) (Manner of Increasing and Maintaining Public Shareholding in Recognised Stock Exchanges) Regulations
- Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations
- SEBI Listing Regulations

Schemes

- Depository Receipts Scheme
- Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Schemme
- Issue of Foreign Currency Exchangeable Bond Scheme
- SEBI (Informal Guidance) Scheme
- SEBI (Interest Liability Regularisation) Scheme

Guidelines
- SEBI (Aid for Legal Proceedings) Guidelines

Rules
- Companies (Issue of Global Depository Receipts) Rules
- Companies (Prospectus and Allotment of Securities) Rules
- Companies (Share Capital and Debenture) Rules
- Depositories (Appeal to Securities Appellate Tribunal) Rules
- Depositories (Appeal to Central Government) Rules
- Depositories (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules
- SEBI (Annual Report) Rules
- SEBI (Appeal to Central Government) Rules
- SEBI (Form of Annual Statement of Accounts) and Records) Rules
- SEBI (Procedures for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules
- SEBI (Terms and Conditions of Service of Chairman and Members) Rules
- Securities Appellate Tribunal (Procedure) Rules
- Securities Appellate Tribunal (Salaries, Allowances and other Terms and Conditions of Presiding Officer and Other Members) Rules
- Securities Appellate Tribunal (Salaries and Allowances and other Conditions of Service of the Officers and Employees) Rules
- Securities Contract (Reference to the Company Law Board) Rules
- Securities Contract (Regulation) (Appeal to Securities Appellate Tribunal) Rules
- Securities Contract (Regulation) (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules
- Securities Contracts (Regulation) Rules
- Securities Transaction Tax Rules

Orders
- SEBI (Framework for Rejection of Draft Offer Documents) Order
- SEBI Issuing Observations on Draft Offer Documents Pending Regulatory Actions) Order

and to safeguard the integrity of the markets, there is a comprehensive surveillance system. Stock exchanges are the front line regulators for detection of market manipulation, price rigging and other regulatory breaches regarding capital market functioning. This is accomplished through surveillance cells in the stock exchanges. The SEBI keeps a constant vigil on the activities of the surveillance system. Although stock exchanges are vested with the primary responsibilities of taking timely and effective surveillance measures, SEBI, on its own, also initiates surveillance actions. News and rumours appearing in the media are discussed in the weekly surveillance meetings with the representatives of the stock exchanges. In exceptional circumstances, SEBI initiates special investigations on the basis of reports received from various sources.

In order to make the surveillance system more effective, the SEBI has signed an agreement with a consortium of HCL Technologies Limited and Securities Markets Automated Research, Training and Surveillance Limited, Australia, to put in place an Integrated Market Surveillance System (IMSS) by March 2006. The proposed IMSS solution is expected to generate alerts that will help SEBI identify and detect serious market manipulations, insider trading and other types of fraudulent activities.

With growing sophistication of the financial system, quite a few financial conglomerates have emerged in India, which provide a variety of financial services under a single window. These financial conglomerates are in fact, under the control of the multiple regulators. In addition, there are regulatory overlaps in the financial markets. In order to resolve the inter-regulatory issues, there is a High Level Co-ordiantion Committee (HLCC), under the chairmanship of the Governor, RBI, which meets on regular intervals. There are Standing Technical Committees for RBI regulated, SEBI regulated and IRDA regulated entities, which deliberate on the issues of an inter-regulatory nature and provide input to the HLCC meetings.

Enforcement of the regulations is done through investigations and adjudications. After a preliminary investigation, if it is found necessary, the case are taken up for formal investigation. In case of a formal investigation, the SEBI Act provides for the calling of information, compelling production of documents and examination of witnesses, and so on. There is an elaborate procedure which is followed for the adjudication and prosecution of persons/agencies responsible for a violation of the regulations. The Chairman and the Whole Time Members of the SEBI are vested with statutory power to impose penalties, issue directions, suspend/cancel a registration and so on. Moreover, a set of adjudicating officers work independently for this purpose and pass orders. These orders are posted on the SEBI website for the purpose of wider dissemination.

There is a Securities Appellate Tribunal (SAT) which functions independently, to hear cases that are filed by the parties against the adjudication orders passed by the SEBI. The SAT is an integral part of India's judicial system, with power equivalent to that of a High Court and which is designed to hear cases relating to securities market.

'Reforms' is a continuous process. Although commendable progress has been made in various areas of the capital market, there are quite a few items which are in the priority list of the SEBI.

Investors' confidence depends largely on the corporate governance standard. Based on the Narayana Murthy Committee Report, revised corporate governance standards have been prescribed. Corporates have to comply with the revised guidelines on corporate governance by December 31, 2005, under Clause 49 of the Listing agreement. Moreover, SEBI has been encouraging the credit rating agencies to evolve a suitable corporate governance indeed as a measure of wealth creation by the corporates. A premier credit rating agency, namely CRISIL, has developed a yardstick in the form of 'Governance and Value Creation' (GVC) rating for the corporates. SEBI would continue its endeavour to further improve corporate governance in India.

Investor education assumes importance in the context of very low level of household participation in the Indian capital market. 'An educated investor is a protected investor'. A number of initiatives have been taken in this direction. A comprehensive Securities Market Awareness Campaign (SMAC) was launched in January 2003, which used workshops, media-prints, advertisements and so on. Besides the SMAC, SEBI has a comprehensive investor grievances redressal mechanism. The Office of Investor Assistance and Education (OIAE) is the single window interface of SEBI with the investors, which takes up complaints with the concerned entities either directly or through the Investor Complaint Cell of the concerned department.

In order to segregate the management function from the ownership and trading rights, there is a need for a demutualisation of stock exchanges. Moreover, stock exchanges should function as a body corporate, similar to any other 'for-profit' corporate entity. In India, the BSE is a corporate entity, while the NSE and the OTCEI are demutualised from their inception. The corporatisation and demutualisation of stock exchanges is a priority item in the SEBI agenda. The oldest stock exchange of the country, namely, the Bombay Stock Exchange became a limited company on August 9, 2005 and the demutualisation process has been initiated. Demutulisation and corporatisation of the other stock exchanges have been notified.

References

1. For details, refer to Bennet, R.L. op.cit., pp.22-24. In this connection, see also Rosen, G., *Some Aspects of Industrial Finance in India*, Asia, Bombay, 1962, Chapter I.
2. Ibid., p. 22.
3. Gupta, L.C., *Changing Structure of Industrial Finance in India*, Oxford University Press, New Delhi, p.9.
4. A detailed account is available in the next section of this Chapter.
5. This aspect is further elaborated in another section of this Chapter dealing with participation of financial institutions in the management and control of private industry.
6. Gupta, L.C., *Corporate Management and Accountability: Towards Joint Sector*, IFMR, Madras, 1974, p. 34.
7. Clayton, G. and Osborn, W.T., 'Insurance Companies and Finance of Industry', *Oxford Economic Papers* (New Series), Vol. X, p.95. Also see Miller, N.C., 'Concentration in Industrial Common Stock Portfolios', *Journal of Finance*, Vol. XVI, p.49.
8. Gupta, L.C., op.cit., p. 34.

CONCLUDING OBSERVATIONS

- An efficient, articulate and developed financial system is indispenabale for rapid economic growth. The process of economic development is invariably accompanied by a corresponding and parallel growth of financial systems/organisations. However, their institutional structure, operational policies and regulatory framework differ widely and are largely influenced by the prevailing politico-economic environment. Planned economic development in India had greatly influenced the course of financial development till the early nineties. In the post-1990s, the financial system has emerged in response to the imperatives of a liberalised/globalised/deregulated economic phase/era.
- The main features of the pre-1951 organisation of the Indian financial system (IFS) were: closed-circle character of industrial entrepreneurship; a semi-organised and narrow industrial securities market devoid of issuing institutions; and the virtual absence of participation by intermediary financial institutions in the long-term finance of industry. Such a system was naturally not responsive to opportunities for industrial investment.
- The organisation of the IFS during the post-1951 period evolved in response to the imperatives of planned economic development. Planning signified the distribution of credit and finance in conformity with the planning priorities, which, in turn, implied Governmental control over the financial system. The main elements of the IFS were: public/government ownership of financial institutions; fortification of the institutional structure; protection to investors; and participation of financial institutions (FIs) in corporate management.
- Public ownership of FIs was brought about partly through nationalisation of existing institutions [e.g. State Bank of India (1956), LIC (1956), Commercial banks (1969) and GIC (1972)] but mainly through the creation in the public sector, of new institutions, namely, special-purpose term-lending institutions/development banks and UTI.
- The fortification of the institutional structure of the IFS was partly the result of modification in the structure and policies of the existing FIs, but mainly due to the addition of new institutions. The banking policies and practices were moulded so as to be in tune with the planning practices. Banks were encouraged to reorient their operational policies towards the financing of

industry, as against commerce and trade. They were also encouraged to enter into new forms of industrial financing, namely, underwriting and term-lending. The banks also enlarged their functional coverage in terms of financing of small scale industries, exports and agriculture. To remedy the coverage and credit gaps to the priority sector, a scheme of social control was introduced, followed by a nationalisation of the banks to control the heights of the economy and meet progressively and serve better the needs of development of the economy in conformity with national policies and objectives. The post-nationalisation period yielded significant changes in operational policies and practices of banks. This resulted in an acceleration of credit availability to the priority sector and a consequent decline in the share of large industry in the total bank credit, due to regulation and credit rationing.

- The backbone of the institutional structure of the IFS was the variegated structure of development banks, namely, IDBI, IFCI, ICICI, SFCs, SIDCs, SIICs and so on. They were conceived as instruments of the state policy of directing capital into a chosen area of industry, in conformity with the planning priorities, and of generally securing the development of private industry along the desired path, to facilitate effective public control of private enterprise. They were also the agency through which specific socio-economic objectives of state policy, such as encouragement to new entrepreneurs and small enterprises and the development of backward regions in order to broadbase the growth of industry, were being realised.
- The setting up of the LIC, as a result of an amalgamation of 245 life insurance companies into a single monolithic state-owned institution, was a part of the deliberate and conscious attempt to mould the IFS according to the requirements of planned development. It not only transferred an important saving institution from private to public ownership, but also brought about a massive concentration of long-term funds in the hands of LIC, which emerged as the largest reservoir of long-term savings in the country. Similarly, the setting up of the UTI was the culmination of a long overdue need of the IFS to encourage indirect holding of securities by the public.
- Alongwith the measures being taken to strengthen and diversify the institutional structure of the IFS, extensive legal reforms were carried out to provide protection to investors so as to restore their confidence in industrial securities. The main elements of the elaborate legislative code adopted by the Government were: Companies Act; Capital Issues (Control) Act (now repealed and replaced by the SEBI Act); Securities Contracts (Regulation) Act; MRTP Act (now replaced by Competition Act) and; Foreign Exchange Regulation Act (now replaced by Foreign Exchange Management Act).
- A significant feature of the IFS was the participation by the FIs, in the management and control of companies to which finance was provided, in marked contrast to the time-honoured tradition of not getting involved in the control and management of assisted companies. This change in approach of the FIs could be ascribed to three factors: Government policy; structure of the industrial securities itself; and the deep involvement of the FIs in the fortune of the companies through lending operations.
- A serious lacuna in the organisation of the IFS during the pre-1990 period, related to its institutional structure, which was dominated by the development banks, which depended for resources on their sponsors (RBI, Government). The IFS did not have the ability to autonomously mobilise savings and had degenerated into a distributive mechanism. It had also resulted in a lop-sided capital structure of corporates with a heavy component of borrowed capital. The crying need of the IFS around the early nineties was the integration of the distributive mechanism with the savings pool of the community.
- In the post-1991 period, with a decline in the role of the Government in economic management and, as a logical corollary, in the distribution of finance and credit, the capital market has

emerged as the main agency for the allocation of resources for all the sectors of the economy. The IFS has naturally undergone major transformation. The notable developments contributing to this transformation are: privatisation of FIs; reorganisation of the institutional structure; and introduction of an investor protection framework.

- Beginning with the conversion of the IFCI into a company and the offer of equity shares to private investors by the IDBI, steps were initiated to privatise important financial institutions. The private sector financial institutions that had come into being are the new generation of banks under the RBI guidelines; mutual funds under SEBI regulations, sponsored by FIs, FIIs, banks and insurance organisations; and insurance companies sponsored by both domestic and foreign promoters, under IRDA guidelines. Pension funds are poised to be opened for private entities with the setting up of the PRDA.
- The institutional structure of the IFS has undergone an outstanding transformation in its evolution to reflect its capital market-orientation. The components which witnessed the transformation are the development banks/term-lending FIs/public financial institutions, commercial banks, insurance companies, mutual funds, NBFCs and securities/capital market and money market.
- With the impending reorganisation/liquidation of the IFCI Ltd. and the IIBI Ltd. and the conversion of the ICICI and the IDBI into banks, the development banks which constituted the backbone of the organisation of the IFS, have virtually disappeared from the Indian financial scene, the only surviving institution being the SFCs.
- Indian banking is characterised by prudential/viable banking. By the early nineties, a geographically wide and functionally diverse banking system had emerged, as reflected in the phenomenal branch expansion, especially in the rural and semi-urban and unbanked areas, the phenomenal growth in deposits and the increase in the share of priority sector in total bank lending. This impressive progress of Indian banking in achieving social goals had indeed been a major developmental input. However, serious weaknesses developed in the form of decline in the efficiency of the banking system and consequently, a serious erosion of its profitability, with adverse implications for its viability itself.
- The first generation of reforms, as a follow-up to the Narsimham Committee I recommendations, focused on arresting the qualitative deterioration in the functioning of the banking system in terms of directed investments; directed credit programmes; the interest rate structure; capital adequacy norms; income recognition, asset classification and provisioning norms and so on.
- The second generation of reforms, as a follow-up to the Narsimham Committee II recommendations, addressed the issue of making the banking system internationally competitive. The focus shifted to internal financial management of banks, in contrast to the regulatory compliances until then. The major components of internal financial management are: rigorous prudential norms relating to credit/investment portfolio and capital adequacy; debt recovery tribunals, corporate debt restructuring, and securitisation, asset reconstruction and enforcement of security interest to ensure speedy/effective NPA recovery/ management; asset-liability management; credit risk management; and operational risk management.
- With the entry of private insurance companies, the monopoly of the public sector LIC and GIC has been dismantled.
- Mutual funds have emerged as the most preferred route of institutionalisation of security investments for the relatively small investors.
- NBFCs broaden the range of financial services, both fund-based and free-based. They operate within the rigorous framework of RBI's directions relating to acceptance of public deposits, prudential norms and auditors, reports.

- The securities/capital market has witnessed the most profound transformation. From being a marginal institution in the mid-eighties, it has come to occupy the centreage in the IFS. The structure of both the primary and the secondary market is characterised by significant changes. The reforms of the intermediaries as well as the pre and post-issue procedure and activities, are indeed thorough going, as a consequence of which the primary market organisation has assumed, highly developed character, capable of catering to the requirements of the sophisticated and articulate securities market. The secondary market, which represented an institutional mechanism that was inadequate, non-transparent, hardly regulated and rarely geared to investor protection, has been truly transformed. The notable developments relate to intermediaries, reorganisation of stock exchanges, trading and so on.
- The money market in India, had a narrow base and a limited number of participants; there were no participants who would alternate between lending and borrowing to develop an active market; there was a paucity of instruments in the market; and interest rates were regulated. A sophisticated and articulate money market has now emerged. Along with deregulation of interest rates and enlargement of participants, there are a number of inter-related sub-markets: call market, T-bills market, commercial bills market, CPs market, CDs market, repo and so on. The money market intermediaries are PDs and MFs.
- Although a fairly comprehensive legislative code had been built up earlier, the focus was on control. The framework was fragmented, both in terms of the laws/acts under which the regulatory function fell and the agencies/government departments that administered them. The need for a focused/integrated regulatory framework, administered by an independent/autonomous body, found expression in the establishment of the SEBI. Its main function is to protect the interest of the investors in securities and to promote the development and regulation of the securities market. The SEBI exercises power under the SEBI Act, SCRA, Depositories Act and delegated powers under the Companies Act. It regulates and supervises the securities market through a number of regulations/guidelines and schemes.

Part 2

Financial Markets

A significant component of the Indian financial system is the financial markets. They function as facilitating organisations in the savings-investment process. The financial markets comprise capital/securities market and money market.

The capital/securities market segment of the financial markets/system represents the institutional source of long-term funds. From a peripheral/marginal role in the early eighties, the capital market now occupies the centre-stage in the Indian financial system. The structure of the securities market consists of the primary/new issue market and the secondary/stock markets/exchanges. The theoretical aspect of the securities market in terms of functions/organisation is described in Chapter 3. Its operations are largely conditioned by the basic regulatory framework which is briefly outlined in Chapters 4 and 5. The organisational developments in the primary market in the post-1985 period are covered in Chapters 6 and 7, devoted respectively to intermediaries and activities/procedures. The emerging stock markets organisational scenario is examined in Chapters 8. The focus of discussions is on institutional/ organisational/ structural developments and not on quantitative figures.

The money market also forms an important constituent of the financial markets/system and is a source of short-term funds. It also facilitates the adjustment of liquidity amongst the participants in the market. The major institutional players in the money market are the commercial banks, the Reserve Bank of India, which acts as the nerve centre of the monetary and credit system in the country and non-banking entities. The organisation of the money market in India is discussed in Chapter 9.

CHAPTER 3

Functions and Organisation

INTRODUCTION

This chapter describes the functions, organisation and structure of industrial securities market in general. In Section 1, we discuss the relationship between the two parts of the securities market, namely, primary market/new issues market (NIM) and secondary markets/stock exchanges. Section 2 describes the functions of stock exchanges/secondary markets /stock markets. The functions of the new issue/primary market and the issue mechanism/methods of flotation of new issues are outlined in Sections 3 and 4 respectively. Concluding observations are given in the last Section.

RELATIONSHIP BETWEEN NEW ISSUE MARKET AND STOCK EXCHANGE

The industrial securities market is divided into two parts, namely, NIM and stock market. The relationship between these parts of the market provides an insight into its organisation. One aspect of their relationship is that they differ from each other organisationally as well as in the nature of functions performed by them. They have some similarities also.

Differences

The differences between NIM and stock exchanges pertain to **(i)** Types of securities dealt, **(ii)** Nature of financing, **(iii)** Organisation and **(iv)** Functions. **They are depicted in Exhibit 3.1.**

New vs Old Securities The NIM deals with *new* securities, that is, securities which were not previously available and are, therefore, offered to the investing public for the first time. The market, therefore, derives its name from the fact that it makes available a new block of securities for public subscription. The stock market, on the other hand, is a market for *old* securities which may be defined as securities which have been issued already and granted stock exchange quotation. The stock exchanges, therefore, provide a regular and continuous market for buying and selling of securities. The usual procedure is that when an enterprise is in need of funds, it

Exhibit 3.1 Differences Between Stock Exchange and Primary Market

	New Issue Market	Stock Exchange
1. Types of Security	New	Existing/'old'
2. Nature of Financing	Direct	Indirect
3. Organisation	Physical Existence	Specialist Institutional Triple-services:
4. Functions	• Nexus between savings and investments • Market place • Continuous price formation	• Origination • Underwriting • Distribution

approaches the investing public, both individuals and institutions, to subscribe to its issue of capital. The securities thus floated are subsequently purchased and sold among the individual and institutional investors. There are, in other words, two stages involved in the purchase and sale of securities. In the first stage, the securities are acquired from the issuing companies themselves and these are, in the second stage, purchased and sold continuously among the investors without any involvement of the companies whose securities constitute the stock-in-trade except in the strictly limited sense of registering the transfer of ownership of the securities. The section of the industrial securities market dealing with the first stage is referred to as the NIM, while secondary market covers the second stage of the dealings in securities.

Nature of Financing Another aspect related to the separate functions of these two parts of the securities market is the nature of their contribution to industrial financing. Since the primary market is concerned with new securities, it provides additional funds to the issuing companies either for starting a new enterprise or for the expansion or diversification of the existing one and, therefore, its contribution to company financing is *direct*. In contrast, the secondary markets can in no circumstance supply additional funds since the company is not involved in the transaction. This, however, does not mean that the stock markets have no relevance in the process of transfer of resources from savers to investors. Their role regarding the supply of capital is *indirect*. The usual course in the development of industrial enterprise seems to be that those who bear the initial burden of financing a new enterprise pass it on to others when the enterprise becomes well-established. The existence of secondary markets which provide institutional facilities for the continuous purchase and sale of securities and, to that extent, lend liquidity and marketability, play an important part in the process.

Organisational Differences The two parts of the market have organisational differences also. The stock exchanges have, organisationally speaking, physical existence and are located in a particular geographical area. The NIM is not rooted in any particular spot and has no geographical existence. The NIM has neither any tangible form any administrative organisational setup like that of stock exchanges, nor is it subjected to any centralised control and administration for the consummation of its business. It is recognised only by the services that it renders to the lenders and borrowers of capital funds at the time of any particular operation. The precise nature of the specialised institutional facilities provided by the NIM is described in a subsequent section.

Similarities

Nevertheless, in spite of organisational and functional differences, the NIM and the stock exchanges are inseparably connected.

Stock Exchange Listing One aspect of this inseparable connection between them is that the securities issued in the NIM are invariably listed on a recognised stock exchange for dealings in them. In India, for instance, one of the conditions to which a prospectus is to conform is that it should contain a stipulation that the application has been made, or will be made in due course for admitting the securities to dealings on the stock exchange. The practice of listing of new issues on the stock market is of immense utility to the potential investors who can be sure that should they receive an allotment of new issues, they will subsequently be able to dispose them off any time. The absence of such facilities would act as some sort of psychologicalbarrier to investments in new securities. The facilities provided by the secondary markets, therefore, encourage holdings of new securities and, thus, widen the initial/primary market for them.

Control The stock exchanges exercise considerable control over the organisation of new issues. In terms of regulatory framework related to dealings in securities, the new issues of securities which seek stock quotation/listing have to comply with statutory rules as well as regulations framed by the stock exchanges with the object of ensuring fair dealings in them. If the new issues do not conform to the prescribed stipulations, the stock exchanges would refuse listing facilities to them. This requirement obviously enables the stock exchange to exercise considerable control over the new issues market and is indicative of close relationship between the two.

Economic Interdependence The markets for new and old securities are, economically, an integral part of a single market—the industrial securities market. Their mutual interdependence from the economic point of view has two dimensions. One, the behaviour of the stock exchanges has a significant bearing on the level of activity in the NIM and, therefore, its responses to capital issues: *Activity in the new issues market and the movement in the prices of stock exchange securities are broadly related: new issues increase when share values are rising and vice versa.*[1] This is because the two parts of the industrial securities market are susceptible to common influences and they act and react upon each other. The stock exchanges are usually the first to feel a change in the economic outlook and the effect is quickly transmitted to the new issue section of the market.

The second dimension of the mutual interdependence of the two parts of the market is that the prices of new issues are influenced by the price movements on the stock market. The securities market represents an important case where the *stock-demand-and-supply curves*, as distinguished from *flow-demand-and-supply curves*, exert a dominant influence on price determination.[2] The quantitative predominance of old securities in the market usually ensures that it is these which set the tone of the market as a whole and govern the prices and acceptability of the new issues.[3] Thus, the flow of new savings into new securities is profoundly influenced by the conditions prevailing in the old securities market—the stock exchange.

FUNCTIONS OF STOCK/SECONDARY MARKETS/EXCHANGES

Stock exchanges discharge three vital functions in the orderly growth of capital formation: **(i)** Nexus between savings and investments, **(ii)** Market place and **(iii)** Continuous price formation.

Nexus between Savings and Investment

First and foremost, they are the nexus between the savings and the investments of the community. The savings of the community are mobilised and channelled by stock exchanges for investment into those sectors and units which are favoured by the community at large, on the basis of such criteria as good return, appreciation of capital, and so on. It is the preference of investors for individual units as well as industry groups, which is reflected in the share price, that decides the mode of investment. Stock exchanges render this service by arranging for the preliminary distribution of new issues of capital, offered through prospectus, as also offers for sale of existing securities, in an orderly and systematic manner. They themselves administer the same, by ensuring that the various requisites of listing (such as offering at least the prescribed minimum percentage of capital to the public, keeping the subscription list open for a minimum period of days, making provision for receiving applications at least at the prescribed centres, allotting the shares against applications on a fair and unconditional basis) are duly complied with. Members of stock exchanges also assist in the flotation of new issues by acting **(i)** as brokers, in which capacity they, *inter alia*, try to procure subscription from investors spread all over the country, and **(ii)** as underwriters. This quite often results in their being required to nurse new issues till a time when the new ventures start making profits and reward their shareholders by declaring reasonable dividends when their shares command premiums in the market. Stock companies also provide a forum for trading in rights shares of companies already listed, thereby enabling a new class of investors to take up a part of the rights in the place of existing shareholders who renounce their rights for monetary considerations.

Market Place

The second important function discharged by stock markets/exchanges is that they provide a market place for the purchase and sale of securities, thereby enabling their free transferability through several successive stages from the original subscriber to the neverending stream of buyers, who may be buying them today to sell them at a later date for a variety of considerations like meeting their own needs of liquidity, shuffling their investment portfolios to gear up for the everchanging market situations, and so on. Since the point of aggregate sale and purchase is centralised, with a multiplicity of buyers and sellers at any point of time, by and large, a seller has a ready purchaser and a purchaser has a ready seller at a price which can be said to be competitive. This guarantees saleability to one who has already invested and surety of purchase to the other who desires to invest.

Continuous Price Formation

The third major function, closely related to the second, discharged by the stock exchanges is the process of continuous price formation. The collective judgement of many people operating simultaneously in the market, resulting in the emergence of a large number of buyers and sellers at any point of time, has the effect of bringing about changes in the levels of security prices in small graduations, thereby evening out wide swings in prices. The everchanging demand and supply conditions result in a continuous revaluation of assets, with today's prices being yesterday's prices, altered, corrected, and adjusted, and tomorrows values being again today's values altered, corrected and adjusted. The process is an unending one. Stock exchanges thus act as a barometer of the state of health of the nations economy, by constantly measuring its progress or otherwise. An investor can always have his eyes turned towards the stock exchanges to know, at any point of time, the value of the investments and plan his personal needs accordingly.

FUNCTIONS OF NEW ISSUES/PRIMARY MARKET

The main function of NIM is to facilitate the transfer of resources from savers to entrepreneurs seeking to establish new enterprise or to expand/diversify existing ones. Such facilities are of crucial importance in the context of the dichotonomy of funds available for capital uses from those in whose hands they accumulate, and those by whom they are applied to productive uses. Conceptually, the NIM should not, however, be conceived as exclusively serving the purpose of raising finance for new capital expenditure. In fact, the organisation and facilities of the market are also utilised for selling concerns to the public as going concerns through the conversion of existing proprietary enterprises or private companies into public companies. The NIM is a complex of institutions through which funds can be obtained directly or indirectly by those who require them from investors who have savings.

New issues can be classified in various ways. The first category of new issues are by new companies and old companies. This classification was first suggested by R.F. Henderson.[4] The distinction between *new* also called *initial*, and *old* also known as *further*, does not bear any relation to the age of the company. The securities issued by companies for the first time either after the incorporation or conversion from private to public companies are designated as initial issues, while those issued by companies which already have stock exchange quotation, either by public issue or by *rights* to existing shareholders, are referred to as further or old.

The new issues by corporate enterprise can also be classified on the basis of companies seeking quotation, namely, new money issues and no new money issues. The term *new money issues* refers to the issues of capital involving newly created shares; *no new money issues* represent the sale of securities already in existence and sold by their holders. The *new money issues* provide funds to enterprises for additional capital investment. According to Merrett and others,[5] *new money* refers to the sum of money equivalent to the number of newly created shares multiplied by the price per share minus all the administrative cost associated with the issue. This money may not be used for additional capital investment; it may be used wholly or partly to repay debt. Henderson[6] uses the term in a rather limited sense so that it is the net of repayment of long-term debt and sums paid to vendors of existing securities. The differences in the approaches by Merrett and others, on the one hand, and Henderson, on the other, arise because of the fact that while the concern of the former is with both flow of funds into the market as well as flow of money money, Henderson was interested only in the latter.

However, two types of issues are excluded from the category of new issues. First, *bonus/capitalisation* issues which represent only book-keeping entries, and, second, *exchange* issues by which shares in one company are exchanged for securities of another.

The general function of the NIM, namely, the channelling of investible funds into industrial enterprises, can be split from the operational stand-point, into three services:[7] **(i)** Origination, **(ii)** Underwriting, and **(iii)** Distribution. The institutional setup dealing with these can be said to constitute the NIM organisation. In other words, the NIM facilitates the transfer of resources by providing specialist institutional facilities to perform the *triple-service function*.

Origination

The term *origination* refers to the work of investigation and analysis and processing of new proposals. These two functions[8] are performed by the specialist agencies which act as the sponsors of issues. One aspect is the preliminary investigation which entails a careful study of technical, economic, financial, and legal aspects of the issuing companies. This is to ensure that it warrants the backing of the issue houses in the sense of lending their name to the company and, thus, give the issue the stamp of respectability, to satisfy themselves that the company is strongly-based, has good market prospects, is well-managed and is worthy of stock exchange quotation. In the process of origination the sponsoring institutions render, as a second function, some services of an advisory nature which go to improve the quality of capital issues. These services include advice on such aspects of capital issues as: **(i)** determination of the class of security to be issued and price of the issues in the light of market conditions, **(ii)** the timing and magnitude of issues, **(iii)** methods of flotation, and **(iv)** technique of selling, and so on. The importance of the specialised services provided by the NIM organisation in this respect can hardly be overstressed in view of its pivotal position in the process of flotation of capital in the NIM. On the thoroughness of investigation and soundness of judgement of the sponsoring institutions depends, to a large extent, the allocative efficiency of the market.

Underwriting

The origination howsoever thoroughly done, will not, by itself, guarantee the success of an issue. To ensure success of an issue, therefore, the second specialist service—*underwriting*—provided by the institutional setup of the NIM takes the form of a guarantee that the issues would be sold by eliminating the risk arising from uncertainty of public response. That adequate institutional arrangement for the provision of underwriting is of crucial significance both to the issuing companies as well as the investing public cannot be overstressed.[9]

Distribution

Underwriting, however, is only a stop-gap arrangement to guarantee the success of an issue. The success of an issue, in the ultimate analysis, depends on the issues being acquired by the investing public. The sale of securities to the ultimate investors is referred to as *distribution*. It is a specialist job which can best be performed by brokers and dealers in securities, who maintain regular and direct contact with the ultimate investors.

Thus, the NIM is a complex of institutions through which funds can be obtained by those who require them from investors who have savings. The ability of the NIM to cope with the growing requirements of the expanding corporate sector would depend on the presence of specialist agencies to perform the *triple-service function* of origination, underwriting and distribution. While the nature of the services provided by an organised NIM is the same in all developed countries,[10] the degree of development and specialisation of market organisation, the type of institutions found and the actual procedures followed differ from country to country, as they are determined partly by history and partly by the particular legal, social, political, and economic environment.

ISSUE MECHANISM

The success of an issue depends, partly, on the issue mechanism. The methods by which new issues are made are: **(i)** Public issue through prospectus, **(ii)** Tender/Book building, **(iii)** Offer for sale **(iv)** Placement and **(v)** Rights issue.

Public Issue Through Prospectus

A common method followed by corporate enterprises to raise capital through the issue of securities is by means of a prospectus inviting subscription from the investing public. Under this method, the issuing companies themselves offer directly to the general public a fixed number of shares at a stated price, which in the case of new companies is invariably the face value of the securities, and in the case of existing companies, it may sometimes include a premium amount, if any. Another feature of public issue method is that generally the issues are underwritten to ensure success arising out of unsatisfactory public response.

The foundation of the public issue method is a prospectus, the minimum contents of which are prescribed by the Companies Act, 1956. It also provides both civil and criminal liability for any misstatement in the prospectus. Additional disclosure requirements are also mandated by the SEBI.The contents of the prospectus, *inter alia*, include: **(i)** Name and registered office of the issuing company; **(ii)** Existing and proposed activities; **(iii)** Board of directors; **(iv)** Location of the industry; (v) Authorised, subscribed and proposed issue of capital to public; (vi) Dates of opening and closing of subscription list; (vii) Name of broker, underwriters, and others, from whom application forms along with copies of prospectus can be obtained; (viii) Minimum subscription; (ix) Names of underwriters, if any, along with a statement that in the opinion of the directors, the resources of the underwriters are sufficient to meet the underwriting obligations; and (x) A statement that the company will make an application to stock exchange(s) for the permission to deal in or for a quotation of its shares and so on. A detailed account of the regulatory framework relating to issues of capital is given in the next chapter.

The public issue method through prospectus has the advantage that the transaction is carried on in the full light of publicity coupled with approach to the entire investing public. Moreover, a fixed quantity of stock has to be allotted among applicants on a non-discriminatory basis. The issues are, thus, widely distributed and the danger of an artificial restriction on the quantity of shares available is avoided. It would ensure that the share ownership is widely-diffused, thereby contributing to the prevention of concentration of wealth and economic power.

A serious drawback of public issue, as a method to raise capital through the sale of securities, is that it is a highly expensive method. The cost of flotation involves underwriting expenses, brokerage, and other administrative expenses. The administrative cost includes printing charges of prospectus, advertisement/publicity charges, accountancy charges, legal charges, bank charges, stamp duty, listing fee, registration charges, travelling expenses, filling of document charges, mortgage deed registration fee and postage and so on.[11] In view of the high cost involved in raising capital, the public issue method is suitable for large issues and it cannot be availed of in case of small issues.

Tender/Book Building Method

The essence of the tender/book building method is that the pricing of the issues is left to the investors. The issuing company incorporates all the details of the issue proposal in the offer document on the lines of the public issue method including the reserve/minimum price. The investors are required to quote the number of securities and the price at which they wish to acquire. **A detailed accunt of book building mechanism in India in given in Chapter 7.**

Offer for Sale

Another method by which securities can be issued is by means of an offer for sale. Under this method, instead of the issuing company itself offering its shares directly to the public, it offers through the intermediary of issue houses/merchant banks/investment banks or firms of stock-brokers. The *modus operandi* of the offer of sale is akin to the public issue method in that the prospectus with strictly prescribed minimum contents which constitutes the foundation for the sale of securities, and a known quantity of shares are distributed to the applicants in a non-discriminatory manner. Moreover, the issues are underwritten to avoid the possibility of the issue being left largely in the hands of the issuing houses. But the mechanism adopted is different. The sale of securities with an offer for sale method is done in two stages.

In the first stage, the issuing company sells the securities *enbloc* to the issuing houses or stockbrokers at an agreed fixed price and the securities, thus acquired by the sponsoring institutions, are resold, in the second stage, by the issuing houses to the ultimate investors. The securities are offered to the public at a price higher than the price at which they were acquired from the company. The difference between the sale and the purchase price, technically called as *turn*, represents the remuneration of the issuing houses. In the case of public method, the issuing houses receive a fee based upon the size and the complications involved in supervision as they act as agents of the issuing companies. Although this is theoretically possible, but usually the issuing houses' remuneration in offer for sale is the turn' out of which they also meet subsidiary expenses such as underwriting commission, the cost of advertisement and prospectus, and so on, whereas these are borne by the companies themselves in the case of public issue method.

The offer for sale method shares the advantage available to public issue method. One additional advantage of this method is that the issuing company is saved from the cost and trouble of selling the shares to the public. Apart from being expensive, like the public issue method, it suffers from another serious shortcoming. The securities are sold to the investing public usually at a premium. The margin between the amount received by the company and the price paid by the public does not become additional funds, but it is pocketed by the issuing houses or the existing shareholders.

Placement Method

Yet another method to float new issues of capital is the placing method defined by London Stock Exchange as *"sale by an issue house or broker to their own clients of securities which have been previously purchased or subscribed"*.[12] Under this method, securities are acquired by the issue houses, as in offer for sale method, but instead of being subsequently offered to the public, they are placed with the clients of the issue houses, both individual and institutional investors. Each issue house has a list of large private and institutional investors who are always prepared to subscribe to any securities which are issued in this manner. Thus, the flotation of the securities involves two stages: In the first stage, shares are acquired by the issuing houses and in the second stage, they are made available to their investor-clients. The issue houses usually place the securities at a higher price than the price they pay and the difference, that is, the *turn* is their remuneration. Alternatively, though rarely, they may arrange the placing in return for a fee and act merely as an agent and not principal.

Another feature of placing is that the placing letter and the other documents, when taken together, constitute a *prospectus/offer document* and the information concerning the issue has to be published. In this method, no formal underwriting of the issue is required as the placement itself amounts to underwriting since the issue houses agree to place the issue with their clients. They endeavour to ensure the success of the issue by carefully *vetting* the issuing company concerned and offering generous subscription terms.

Placing of securities that are unquoted is known as *private placing*. The securities are usually in small companies but these may occasionally be in large companies. When the securities to be placed are newly quoted, the method is officially known as stock exchange placing.[13]

The main advantage of placing, as a method of issuing new securities, is its relative cheapness. This is partly because many of the items of expenses in public issue and offer for sale methods like underwriting commission, expense relating to applications and allotment of shares, and so on are avoided. Moreover, the stock exchange requirements relating to contents of the prospectus and its advertisement are less onerous in the case of placing.[14]

Its weakness arises from the point of view of distribution of securities. As the securities are offered only to a select group of investors, it may lead to the concentration of shares into a few hands who may create artificial scarcity of scrips in times of hectic dealings in such shares in the market.

The placement method is advantageous to the issuing companies but it is not favourably received by the investing public. The method is suitable in case of small issues which cannot bear the high expenses entailed in a public issue, and also in such issues which are unlikely to arouse much interest among the general investing public. Thus, with the placement method, new issues can be floated by small companies which suffer from a financial disadvantage in the form of prohibitively high cost of capital in the case of other methods of flotation as well as at times when conditions in the market may not be favourable as it does not depend for its success on public response. This underscores the relevance of this method from the viewpoint of the market.

Rights Issue

The methods discussed above can be used both by new companies as well as by established companies. In the case of companies whose shares are already listed and widely-held, shares can be offered to the existing shareholders. This is called *rights issue*. Under this method, the existing shareholders are offered the right to subscribe to new shares in proportion to the number of shares they already hold. This offer is made by circular to 'existing shareholders' only.

In India, Section 81 of the Companies Act, 1956 provides that where a company increases its subscribed capital by the issue of new shares, either after two years of its formation or after one year of first issue of shares whichever is earlier, these have to be first offered to the existing shareholders with a right to renounce them in favour of a nominee. A company can, however, dispense with this requirement by passing a special resolution to the same effect.

Rights issues are not normally underwritten but to ensure full subscription and as a measure of abundant precaution, a few companies have resorted to underwriting of rights shares. The experience of these companies has been that underwriters were not called upon to take up shares in terms of their obligations. It is, therefore, observed that such underwriting serves little economically useful purpose in that "it represents insurance against a risk which is **(i)** readily avoidable and **(ii)** of extremely rare occurrence even where no special steps are taken to avoid it."[15] The chief merit of rights issue is that it is an inexpensive method. The usual expenses like underwriting commission, brokerage and other administrative expenses are either non-existent or are very small. Advertising expenses have to be incurred only for sending a letter of rights to shareholders. The management of applications and allotment is less cumbersome because the number is limited. As already mentioned, this method can be used only by existing companies and the general investing public has no opportunity to participate in the new companies. The pre-emptive right of existing shareholders may conflict with the broader objective of wider diffusion of share-ownership.

The above discussion shows that the available methods of flotation of new issues are suitable in different circumstances and for different types of enterprises. The issue mechanism would vary from market to market.

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12. Committee of the Federation of Stock Exchange in Great Britain and Ireland, *London Stock Exchange: Admission of Securities to Quotation*, 1966.
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15. *Ibid*, p. 58.

CONCLUDING OBSERVATIONS

- The industrial securities market consists of the new issue (NIM)/primary market and the secondary/stock exchange market. The two parts of the market have some differences as well as some similarities.
- The difference between the NIM and stock exchanges pertain to the types of securities dealt with, the nature of financing and organisation.
- The NIM deals in new securities, which are offered to the investing public for the first time. The stock market is a market for old securities, which have been issued already and granted a stock exchange quotation.
- The NIM provides additional funds to the issuing companies, directly. The contribution of the stock exchange to corporate financing is indirect as, the issuing company is not involved in the transaction.
- Organisationally, stock exchanges have a physical existence and are located in a particular geographical area. An NIM has no physical/geographical existence and is recognised only by the services it renders at the time of flotation of new securities.
- The similarities between the two parts of the securities market relate to listing, control and economic interdependence.
- The securities issued in the NIM are invariably listed on the stock exchange, enabling investors to dispose them off. It encourages holding of new securities and widens the primary market.

- The stock exchanges exercise considerable control over the NIM in terms of compliance with listing requirements, to ensure fair dealings.
- One aspect of the economic interdependence between the two segments of the market is that the activity in the NIM and the prices of securities in the stock exchange are broadly related. Similarly, prices of new issues are influenced by the price movements in the stock markets.
- Stock exchanges discharge three vital functions in the orderly growth of capital formation: it creates a nexus between savings and investments, it acts as a market place and it facilitates continuous price formation. As a nexus, the stock exchanges arrange for the preliminary distribution of new issues. Their members act as brokers and underwriters. As a market place, they guarantee saleability of securities to investors who have already invested and surety of purchase to those who desire to invest. The collective judgement of many players in the market brings about changes in security prices in small graduation, thereby evening out wide swings in the price and ensuring continuous price formation.
- The main function of the NIM is to facilitate the transfer of resources from the savers to the entrepreneurs. Its general function is split, up operationall,y into a triple service function: origination, underwriting and distribution.
- Origination refers to the investigation and analysis and processing of new issue proposals. One aspect is the preliminary investigation, entailing a careful study of the technical, economic, financial and legal aspects of the issuer to ensure that the issue is a sound one. To improve the quality of the capital issue, the sponsor also renders services of an advisory natures such as type and price, timing and magnitude of issues, methods of flotation and so on.
- Underwriting is a form of institutional guarantee that the issue would be sold by eliminating the risk arising from uncertainty of public response.
- The sale of securities to the ultimate investors is known as distribution.
- The methods of flotation of issues are: prospectus/public issue, book building, offer for sale, placements and rights issues.
- Under the prospectus/public issue method, issuing companies offer directly to the general public, through a prospectus, a fixed number of shares, at a stated (par/premium) price. To ensure success, issues are generally underwritten. It is, however, an expensive method and is, therefore, suitable only for larger issues.
- The book building method is a volume and price discovery method. The investors quote the number of securities and the price at which they wish to acquire them.
- The Offer for sale method involves offering/sale of shares by the existing holders (promoters) to dilute their holdings in existing companies.
- Under the placement method, the entire block of securities is offered to a select group of investors. It is an inexpensive method and the success of an issue does not depend upon public response. Securities can be sold through this method even at times when conditions in the market may not be favourable.
- The existing shareholders are offered the right to subscribe to new shares in proportion to the number of shares held in the issuing company in rights issues. This method can be used only by existing companies.

CHAPTER 4

Regulatory Framework: Primary Market

INTRODUCTION

The regulatory framework of the securities market in India pertains to the **(i)** primary and **(ii)** stock market segments. The main elements of the basic legal framework relating to the primary/new issue segment, namely, company law, Securities and Exchange Board of India (SEBI), buy-back of securities, SEBI intermediaries regulations, SEBI public offer and listing of securitised debt instruments regulation are discussed in this Chapter. The main elements of the regulatory framework relating to the secondary/stock market segment are: **(i)** Securities Contracts (Regulations) Act/Rules, **(ii)** Securities Contracts (Regulation) Stock Exchange/Clearing Corporations Regulations, **(iii)** listing regulations comprising delisting regulations and listing agreement. They are depicted in Exhibit 4.1. They are covered in Chapter 5.

This chapter is concerned with the broad scheme of regulation of the primary market contained in the legal framework. **A detailed account of the procedures is beyond the scope of this book**. Section 1 provides a synoptic view of the company law regulations in relation to dealing in securities. Section 2 outlines the role/functions of the SEBI. The SEBI **(i)** Ombudsman, **(ii)** Buy-back of Securities by Listed Companies, **(iii)** Intermediaries and **(iv)** Public Offer and Listing of Securitised Debt Instruments Regulations are discussed in Sections 3-6 respectively. Concluding observations are given in the last section.

COMPANY LAW REGULATIONS

The major issuers of securities, which are marketable in the securities market and in which the public are interested, are the public limited companies. The Companies Act, while providing for regulation of companies, includes a general framework for dealings in the securities of such enterprises. This section briefly outlines the relevant aspects of the scheme of regulation of such dealings. The main coverage of the section relates to share capital/issue of shares, prospectus/abridged prospectus, issues of shares on rights basis, issue of debentures, allotment of shares and issue of shares certificates.

Exhibit 4.1 Regulatory Framework of Securities Market

Company Law Regulations:
- Issue of Shares
- Prospectus
- Rights Issue
- Debentures
- Allotment of Shares
- Shares Certificates

Securities Contracts (Regulation) Act
- Object
- Recognition of Stock Exchanges
- Listing of Securities
- Penalties

Securities Contracts (Regulations) Rules
- Recognition of Stock Exchange
- Membership Qualifications
- Obligations of Governing Body
- Listing of Securities

Securities and Exchange Board of India Act
- Powers and Functions
- Registration of Intermediaries
- Prohibition of Manipulative and Deceptive Devices, Insider Trading and Substantial Acquisition of Securities/Control
- Penalties/Adjudiation
- Securities Appellate Tribunal

Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulation, 2012:
- Recognition
- Network
- Ownership
- Governance
- General Obligations
- Listing

Listing Obligations and Disclosure Requirements Regulation
- Principles Governing Disclosures and Obligations
- Common Obligations
- Obligations of Entities Issuing Designated Securities
- Duties/Obligations of Stock Exchanges
- Action in Default

Delisting of Equity Shares Regulation
- Delisting of Equity Shares
- Voluntary Delisting
- Exit Opportunity
- Without Exit Opportunity
- Compulsary Delisting
- Special Provisions

Ombdusman/ Stipdendary Ombdusman Regulation:
- Qualification/ Disqualification
- Powers/ Functions
- Procedure
- Settlement
- Implementation
- Display of Particulars

Buy-Back of Securities By Listed Companies Regulation:
- Companies Act Requirements
- SEBI Buy-Back of Securities By Listed Companies Regulation

Intermediaries Regulation, 2008:
- Registration
- General Obligations
- Inspcetion and Disciplinary Proceedings
- Action in Case of Default
- Directions

Public Offer and Listing of Securitised Debt Instruments Regulation, 2008:
- Registration of Trustees
- Constituiton/ Management of SPDEs
- Schemes of SPDEs
- Public Offer of SDIs
- Rights of Invsetors
- Listing of SDIs
- Inspection
- Action In Default

Share Capital/Issue of Shares

A company can be incorporated under the Companies Act as a company having a share capital or a company not having one. In the case of a company having share capital with limited liability, its memorandum of association must state the amount of share capital with which it is to be registered (authorised capital), and its division into shares of a fixed amount (nominal/face value). The authorised capital is an amount of shares up to which the company can at any time raise the capital by issuing shares for subscription (issued capital) and collect money from the subscribers/shareholders (paid-up capital).

A **share** is the right to a specified amount of the share capital of a company carrying with it certain rights and liabilities while the company is a going concern and even while it is winding up. A share is a movable property with all the attributes of such a property. It is transferable. While a transfer may be effective between the transferor and transferee from the date of transfer, the transfer is duly complete and the transferee becomes a shareholder with all the rights only when the transfer is registered in the register of the members of the company. The evidence of ownership of shares (shareholding) is a share certificate issued by a company under its common seal. The share certificate specifies the name(s) of the person(s) in whose favour the certificate is issued, the shares with the appropriate number to which it relates and the amount paid.

A public limited company can issue two types of shares: *equity* and *preference*. Preference capital carries a preferential right to fixed dividend and to the return of the capital amount when it is wound up. All preference shares are redeemable within 10 years. Companies can also issue cumulative convertible preference shares which embrace the features of both equity and preference shares. They can be converted into equity shares. Shares other than preference shares are equity/ordinary shares.

Alteration A company can **(a)** increase its share capital by issuing new shares, **(b)** consolidate an divide it into shares of larger amount than the existing shares, **(c)** convert its fully paid-up shares into stocks and reconvert that stock into fully paid-up shares of any denomination, **(d)** sub-divide its shares into shares of smaller amount and **(e)** cancel shares which have not been taken/agreed to be taken by any person and diminish the amount of its share capital by the amount of the cancelled shares. These powers to alter the share capital can be exercised by a company in a general meeting through an ordinary resolution. Any reduction in the share capital requires special resolution and confirmation by the court. The difference between cancellation and redemption in capital lies in the fact that while the former has the effect of reducing the authorised capital, the latter has the effect of reducing the subscribed capital of the company.

Director's Power The power to issue new shares is vested in the Board of Directors. The power of the directors to increase capital by the issue of new shares is a fiduciary power to be exercised by them *bonafide* for the general advantage of the company and not merely for the purpose of maintaining their control over the affairs of the company or for defeating the wishes of the existing majority shareholders.

Issue of Shares at Premium A company is empowered to issue shares at premium. The amount of premium should be transferred to the share premium account. The amount of share premium can be used for the following purposes: **(a)** issue of fully-paid bonus shares, **(b)** writing off the preliminary expenses, **(c)** writing off the expense of, or the commission paid, or discount allowed on, any issue of shares/debentures and **(d)** provision for premium payable on the reduction of any redeemable preference shares/ debentures.

Issue of Share at Discount Shares can be issued at a discount on the fulfillment of certain conditions, namely, **(i)** it is authorised by the Government; **(ii)** the resolution specifies the maximum rate of discount, generally not exceeding 10 per cent. However, a higher discount may be allowed by the Government in special circumstances; **(iii)** not less than one year has elapsed since the date on which the company was entitled to commence business; and **(iv)** the shares at discount must be issued within two months after the sanction by the Government or within such extended time as the Government may allow.

The shares issued at discount must be one of the same class as already issued. Every prospectus issued by the company subsequent to the issue of shares at discount must contain the particulars of the discount allowed, or that part of the discount which has not been written off on the date of the issue of the prospectus. Any default in compliance with these requirements is punishable with a fine up to ₹500.

Repurchase of Shares by Companies Earlier, the public limited companies were prohibited from purchasing their own shares. A company was not allowed to give loans/provide financial assistance for the purchase of its own shares. However, there were three exceptions to these restrictions: **(a)** lending of money by a bank in the course of its business, **(b)** provision by a company, in accordance with any scheme, for the purchase of/subscription for fully paid shares in the company, being a purchase/subscription by trustees of the shares made for the benefit of employees of the company, **(c)** advancing loans to employees (other than directors) to purchase/subscribe fully-paid shares to be held by them by way of beneficial ownership. Such loans could not exceed six months' salary/wages of the employee. Any violation of the restrictions by a company or its officers was punishable with a fine of ₹1,000.

However, companies have been permitted since October 1998 to purchase/buy-back their own shares or other specified securities. A company can buy-back shares/ specified securities (including employees' stock option) from out of **(i)** its free reserves; **(ii)** the securities premium account; and **(iii)** the proceeds of any shares or other specified securities. However, a company can purchase its own shares/specified securities only if:

- Articles permit buy-back;
- A special resolution in general meeting authorises buy-back. The notice of the meeting at which special resolution is proposed to be passed should be accompanied by an explanatory statement stating **(a)** a full and complete disclosure of all material facts, **(b)** the necessity for the buy-back, **(c)** the class of security intended to be purchased under the buy-back, **(d)** the amount to be invested under the buy-back and **(e)** the time limit for the completion of buy-back. The buy-back should be completed within a period of 12 months from the date of passing the special resolution or a Board resolution;
- Buy-back does not exceed 25 per cent of the total paid-up capital plus free reserves of the company;
- Ratio of debt to equity (capital and free reserves) of the company does not exceed 2:1;
- Shares/specified securities are fully paid-up; and
- Buy-back is in accordance with SEBI/other regulations in this behalf. These are elaborated in Section 5 of this chapter.
- The buy-back may be from **(i)** existing securityholders on a proportionate basis, **(ii)** the open market, **(iii)** odd lots, that is, where the lot of securities in a listed public company is smaller than such market lot as may be specified by the stock exchange and by **(iv)** purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

Sweat equity shares mean equity shares issued at a discount or for a consideration other than cash for providing the know-how or making available rights in the nature of intellectual property rights or value addition by whatever name called. The Companies (Amendment) Act, 1999 permits issue of such shares if **(i)** authorised by a resolution in a general meeting of shareholders of the company, specifying the number of shares, their value and the class(es) of directors or employees to whom issued, **(ii)** not less than one year has elapsed since the date of commencement of business, and **(iii)** are issued in accordance with the SEBI regulations in this behalf. All the restrictions/limitations/ provisions relating to equity shares are also applicable to such shares.

Before making purchases under the buy-back scheme, all the listed companies have to file with the Registrar of Companies (ROCs) and SEBI a declaration of solvency in the prescribed form and verified by an affidavit to the effect that the Board of Directors have made a full inquiry into the affairs of the company as a result of which it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board of Directors and signed by at least two directors of the company one of whom should be the managing director, if any. Unlisted companies are, however, not required to file the declaration of solvency.

The securities purchased under the buy-back arrangement should be extinguished and physically destroyed within seven days of the last date of completion of buy-back. A company which buys back its securities is prohibited from further issue of securities within a period of two years, except bonus issues or issues in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares/debentures into equity shares. Such a company is also required to maintain a register of securities bought, the consideration paid, the date of cancellation of securities, and so on. Within 30 days of the completion of buy-back, a return containing these particulars must be filed with the ROCs and SEBI. Any default to comply with these requirements/other rules, is punishable with imprisonment up to two years or with fine up to ₹50,000 or with both.

However, companies are not allowed to buy-back securities: **(i)** through any/own subsidiary company(ies); **(ii)** through any/group of investment company(ies) and **(iii)** if a default subsists in respect of repayment of deposits/term loans to any financial institution and redemption of debentures/preference shares.

Calls on Shares Ordinarily, a part of the nominal/par/face value of a share is payable on application and a part on allotment. The balance payable on application each year cannot be less than 5 per cent of the nominal value. Calls on shares must be made on a uniform basis on all shares of the same class. Every call must be made by the Board of Directors by a resolution passed at its meeting. All calls must also be made in accordance with the provisions of the articles of the company.

Forfeiture of Shares A member's failure to pay call money on the appointed day may lead to forfeiture of his shares. In order to forfeit the shares, the Board of Directors have to serve a notice on the defaulting member requiring the payment of the unpaid amount together with accrued interest and a resolution of the directors to that effect. No forfeiture of shares can be made unless every condition precedent has been strictly and literally complied with.

Membership of a Company A person may become a member of a company by **(a)** subscribing its memorandum of association before its registration, **(b)** taking shares from the company and being placed on the register of members, **(c)** taking a transfer of shares and being placed on the register of members, **(d)** registration on succession to a deceased/bankrupt member and

(e) allowing his name to be on the register of members or otherwise holding himself out or allowing himself to be held out as a member.

A member can participate and exercise his vote at a meeting of a company. The privileges of the member can be exercised by only that person whose name is entered in the register of members. When the holder of a share whose name is included in the register of members hands over his shares with blank transfer forms duly signed, the transferee cannot claim the rights of a member as against the company concerned until his name is entered in the register of members.

Voting Rights Equity/ordinary shareholders are entitled to vote on every resolution placed at any general meeting of the company. Preference shareholders can vote only on those resolutions by which any of their rights is directly affected. However, in the following circumstances, a preference shareholder has the right to vote on every resolution at par with the equity shareholders: **(a)** if the dividend on cumulative preference share capital has not been paid by the company for two years preceding the date of commencement of any general meeting and **(b)** if dividend on non-cumulative preference capital has not been paid either **(i)** for two years or **(ii)** for three or more years out of six years ending with the expiry of the financial year immediately preceding the commencement of any general meeting.

Prospectus

Prospectus refers to any document by which a capital is offered to the public and upon the basis of which the applicants actually subscribe. Its main purpose is to invite offers from the public for the subscription/purchase of any securities (shares/debentures) of a company. Every prospectus has to comply with the requirements of the Companies Act. The Act prescribes the form of prospectus. The main contents of a draft prospectus as prescribed by Part I of Schedule II of the Companies Act are summarised below.

Contents of Prospectus

PART I

I. General Information: **(a)** Name and address of the registered office of the company **(b) (i)** Consent of the Central Government (SEBI) for the present issue and declaration of Central Government (SEBI) about non-responsibility for financial soundness or correctness of statements **(ii)** Letter of intent/industrial licence and declaration of the central Government (SEBI) about non-responsibility for financial soundness or correctness of statements **(c)** Names of regional stock exchanges and other stock exchanges where application made for listing of present issue **(d)** Provisions of sub-section **(1)** of Section 68A of the Companies Act relating to punishment for fictitious applications **(e)** Statement/declaration about refund of the issue if minimum subscription of 90 per cent is not received with 90 days of closure of the issue **(f)** Declaration about the issue of allotment letters/ refunds within a period of 10 weeks and interest in case of any delay in refund at the prescribed rate under section 72**(2)** (2A) **(g)** Date of opening of the issue; date of closing of the issue; date of earliest closing of the issue **(h)** Name and address of auditors, and lead managers **(i)** Name and address of trustee under debenture trust deed (in case of debenture issue) **(j)** Whether rating from CRISIL or any rating agency has been obtained for the proposed debentures/ preference shares issue. If no rating has been obtained, this should be answered as "NO". If yes, the rating should be indicated **(k)** Underwriting of the issue (Names and addresses of the underwriters and the amount underwritten by them. Declaration by board of directors that the underwriters have sufficient resources to discharge their respective obligations)

II. Capital Structure of the Company: **(a)** Authorised, issued, subscribed and paid-up capital **(b)** Size of the present issue giving separately, reservation for preferential allotment to promoters and others **(c)** Paid-up capital: **(i)** after the present issue **(ii)** after conversion of debentures (if applicable)

III. Terms of the Present Issue: **(a)** Terms of payment **(b)** Rights of the instrument holders **(c)** How to apply-availability of forms, prospectus and mode of payment **(d)** Any special tax benefit for the company and its shareholders

IV. Particulars of the Issue: **(a)** Objects **(b)** Project cost **(c)** Means of financing (including contribution of promoters)

V. Company, Management and Project: **(a)** History and main objects and present business of the company **(b)** Subsidiary(ies) of the company, if any (for financial data refer to auditor's report in Part II) **(c)** Promoters and their background **(d)** Names, addresses and occupation of manager, managing director and other directors including nominee directors, whole-time directors, (giving their directorship in other companies) **(e)** Location of project. **(f)** Plant and machinery, technology, process, etc. **(g)** Collaboration, any performance guarantee or assistance in marketing by the collaborators **(h)** Infrastructure facilities for raw material and utilities like water, electricity, etc. **(i)** Schedule for implementation of the project and progress so far, giving details of land acquisition, civil works, installation of plant and machinery, trial production, commercial production, etc. **(j)** Products: **(i)** Nature of the product(s) — consumer/ industrial and end-users, **(ii)** Approach to marketing and proposed marketing setup **(iii)** Export possibilities and export obligations, if any (in case of a company providing any 'service', particulars, as applicable, be furnished) **(k)** Future prospects-expected capacity utilisation during the first three years from the date of commencement of production, and the expected year when the company would be able to earn cash profits and net profits. Stock market data for shares/debentures of the company [high/low price in each of the last three years and monthly high/low during the last six months (where applicable)].

VI. Disclosure of the Particulars of Public Issue Made by the Company and Other Listed Companies under the Same Management: Within the meaning of Section 370(1B), the information required to be given includes the year and type of issue, amount of issue, date of closure of issue, date of completion of delivery of share/debenture certificates, date of completion of project where the issue was made for financing a project and rate of dividend paid.

VII. Disclosure of Particulars of Outstanding Litigation, Criminal Prosecution and Defaults: A company making a public issue is required to state in the prospectus outstanding litigation pertaining to matters likely to affect operation and finances of the company including disputed tax liabilities of any nature. Particulars of any criminal prosecution launched against the company and its directors for alleged offences under the enactments specified in para 1 of Part 1 of schedule XIII of the Act are also required to specify particulars of default, if any, in meeting statutory dues, institutional dues and towards instrument-holders like debentures, fixed deposits and arrears of cumulative preference shares, etc. in relation to the company and other companies promoted by the same promoters which are listed on stock exchange(s).

VIII. Management Perception of Risk factors (e.g. Sensitivity to Foreign Exchange Rate Fluctuations, Difficulty in Availability of Raw Materials or in Marketing of Products, Cost/Time Over-run, etc.).

PART II

I. General Information: **(a)** Consent of directors, auditors, solicitors/advocates, managers to issue, registrar of issue, bankers to the company, bankers to the issue and experts **(b)** Expert opinion obtained, if any **(c)** Change, if any, in directors and auditors during the last three years and reasons thereof **(d)** Authority for the issue and details of resolution passed for the issue **(e)** Procedure and time schedule for allotment and issue of certificates **(f)** Names and addresses of the company secretary, legal advisers, lead managers, co-managers, auditors, bankers to the company, bankers to the issue and brokers to the issue

II. Financial Information: Under financial information, the reports to be set out have been specified. These are:

(a) A report by the auditors of the company with respect to the profits and losses for the five financial years preceding the issue of prospectus. The report should also show the rates of dividend paid on each class of shares for each of the said years. If the company has been carrying on business for less than five years, the figures are to be given for the actual period if the five financial years immediately preceding the issue of the prospectus cover a period of less than five years, the report should cover as many financial years as may be necessary, so that the aggregate period covered is not less than five years. The report should also give statement of assets and liabilities as at the last date of the latest financial year. The report should indicate the nature of any provision or adjustments made or yet to be made as respects the figure of any profits or losses or assets and liabilities. Assets and liabilities of the subsidiaries as the last date to which the accounts of the company were made up must also be shown in the like manner.

(b) If the company proposes to acquire any business, a report by a chartered accountant, upon the profits and losses of the business for each of the five financial years preceding the issue of prospectus and the assets and liabilities of business.

III. Statutory and Other Information:

(a) Minimum subscription

(b) Expenses of the issue giving separately fee payable to:

- **(i)** Advisors
- **(ii)** Registrars to the issue
- **(iii)** Managers to the issue
- **(iv)** Trustees for the debenture holders

(c) Underwriting commission and brokerage

(d) Previous issue for the cash

(e) Previous public or rights issue, if any (during the last five years)

- **(i)** Date of allotment: Closing Date; Date of refunds; Date of listing on the stock exchange,
- **(ii)** If the issue(s) at premium or discount and the amount thereof, and
- **(iii)** The amount paid or payable by way of premium, if any, on each share which had been issued within two years preceding the date of the prospectus or is to be issued, stating the dates or proposed date of issue and, where some shares have been or are to be issued at a premium and other shares of the same class at a lower premium, or at par or at discount, the reason for the differentiation and how any premiums received have been or are to be disposed off.

(f) Commission or brokerage on previous issue

(g) Issue of shares otherwise than for cash

(h) Debentures and redeemable preference shares and other instruments issued by the company outstanding as on the date of prospectus and term of issue

(i) Option to subscribe

(j) Purchase of property. Where proceeds of the issue to be issued in payment (wholly or partly) of property purchased or proposed to be purchased or acquired or the purchase or acquisition of any property has not been completed at the date of the prospectus, the following particulars are to be given:

- **(i)** The names, addresses, description and occupation of the vendors;
- **(ii)** The amount paid or payable in cash, shares or debentures, to the vendor;
- **(iii)** The nature of the title or interest in such property acquired or to be acquired by the company;
- **(iv)** Short particulars of every transaction relating to the property completed within the two preceding years, in which any vendor of the property to the company or any promoter, or a director or proposed director of the company had any interest.

(k) **(i)** Details of directors, proposed directors, whole-time directors, their remuneration, appointment and remuneration of managing directors, interest of directors, their borrowing powers and qualification shares,

(ii) The dates, parties to, and general nature of

- **(1)** every contract appointing or fixing the remuneration of a managing director whenever entered into, that is to say, whether within or more than two years before the date of every prospectus; and
- **(2)** every other material contract, not being a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company or a contract entered into more than two years before the date of the prospectus. A reasonable time and place at which any such contract or a copy thereof may be inspected.

(iii) Full particulars of the nature and extent of interest, if any, of every director or promoter

- **(1)** in the promotion of the company; or
- **(2)** in any property acquired by the company within two years of the date of the prospectus or proposed to be acquired by it. Where the interest of such a director or promoter consists in being a member of a firm or company, the nature and extent of the interest of the firm or company, with a statement of all sums paid or agreed to be paid to him or to the firm or company in cash or shares or otherwise by any person either to induce him to become, or to qualify him as, a director, or otherwise for services rendered by him or by the firm or company.

(l) Rights of members regarding voting, dividend, lien of shares and the process for modification of such rights and forfeiture of shares

(m) Restrictions, if any, on transfer and transmission of shares/debentures and on their consolidation/ splitting

(n) Revaluation of assets, if any (during last five years)

(o) Material contracts and inspection of documents, for example,

- **(i)** Material contracts,
- **(ii)** Documents, and
- **(iii)** Time and place at which the contracts together with documents will be available from the date of prospectus until the date of closing of the subscription list.

PART III

Part III requires that any report by the accountants under Part II must be made by qualified chartered accountants who should not be an officer or servant or a partner in the company or in employment of an officer or servant of the company or in any of its subsidiary or holding companies.

The time and place at which copies of the balance sheets and profits and loss accounts, materials contracts and documents, etc. can be inspected should also be specified under Part III.

Declaration: The prospectus must end with a declaration by the directors that all the relevant provisions of the Companies Act, 1956 and guidelines issued by the Government (SEBI) have been complied with and that no statement made in prospectus is contrary to the provisions of the Companies Act, 1956 and rules thereunder.

If a prospectus contains any misstatement or conceals facts, the directors/promoters of the company are liable to all persons who subscribe for shares on the faith of the prospectus for the loss that they may sustain by reason of misstatement/ concealment. They are also punishable with imprisonment for a term which may extend to two years or fine which may be extended to ₹5,000 or with both.

Application with Prospectus Section 56(3) states that no application form can be issued for shares or debentures unless it is accompanied by a memorandum containing such salient features of prospectus as may be prescribed. There are, however, four exceptions to this rule: **(a)** where the offer is made in connection with the *bonafide* invitation to a person to enter into an underwriting agreement with respect to the share or debentures; **(b)** where the shares or debentures are not offered to the public; **(c)** where the offer is made only to the existing members or debentureholders of the company with or without a right to renounce; and **(d)** where the shares or debentures offered are in all respects uniform with shares or debentures already issued and quoted on a recognised stock exchange.

In order to ensure compliance with the provisions of Section 56(3), two share application forms should be a part of the abridged prospectus and the share application forms are allowed to bear the same printed number. The investor may detach the share application form along the perforated line after he had an opportunity to study the contents of the abridged prospectus before submitting the same to the company or its designated bankers. Contravention of Section 56(3) is punishable with fine which may extend to ₹5,000.

Abridged Prospectus The salient features required to be included in the abridged prospectus have to be in Form 2A. Form 2A requires information to be given under nine heads detailed below, besides the statements on refund of application money in the event the minimum subscription is not received or on payment of interest if there is a delay in the refund of excess application money.

I. **General Information**: Under the head general information, the name and address of the registered office of the company, name(s) of the stock exchange(s) at which the issue is listed, opening, closing and earliest closing dates of issue, name and addresses of lead managers, credit rating for the debenture/preference shares, if any, obtained from CRISIL or any recognised rating agency are required to be given.

II. **Capital Structure of the Company**: Particulars of issued, subscribed and paid-up capital, size of the present issue giving separately reservations for preferential allotment to promoters and others and paid-up capital after the present issue and after conversion of debentures, if applicable, are required to be stated.

III. Terms of Present Issue: The authority for the issue, terms of payment and procedure, time schedule for allotment and issue of certificates, procedure for applying including availability of forms, prospectus and mode of payment and special tax benefits to company and shareholders under the Income Tax Act, are required to be stated.

IV. Particulars of the Issue: Objects of the issue, the project cost and means of financing including contribution of promoters are to be specified.

V. Company, Management and Project: The following information are required to be stated: **(a)** History, main objects and present business of the company **(b)** Background of the promoters, managing director/whole-time directors and names of nominees of institutions, if any, on the board of directors **(c)** Location of the project **(d)** Plant and machinery, technology, process, etc. **(e)** Collaboration, performance guarantee, if any, or assistance in marketing by the collaborators **(f)** Infrastructure facilities for raw materials and utilities like water, electricity, etc. **(g)** Schedule of implementation of the project and progress made so far, giving details of land acquisition, execution of civil works, installation of plant and machinery, trial production, date of commercial production, if any **(h)** The products: **(i)** Nature of product(s)-consumers and end-users. **(ii)** Existing, licensed and installed capacity of the products, demand of the product-existing and estimated in the coming years as estimated by a Government authority or by any other reliable institution, giving the source of information, and **(iii)** approach to marketing and proposed marketing set up. In case of the company providing services, relevant information in regard to nature/extent of services, etc. are to be furnished **(i)** Future prospects- the expected year when the company, would be able to earn net profit, declare dividend.

VI. Financial Performance of the Company for the Last Five Years: Information based on the audited annual accounts is required to be given under the following heads for the last five years: **(a)** Balance sheet data: equity capital, reserves, (state revaluation reserve, the year of revaluation and its monetary effect on assets) and borrowings **(b)** Profit and loss data: sales, gross profit, net profit, dividend paid, if any **(c)** Any change in accounting policies during the last three financial years and their effect on the profits and the reserves of the company **(d)** Stock market quotation of shares/debentures of the company, if any (high/low price in each of the last three years and monthly high/low price during the last six months).

VII. Payments/Refunds: The company is required to disclose whether all payments specially refunds, debentures, fixed deposits, interest on fixed deposits, debenture interest, institutional dues have been paid up to date. In case, payments/refunds have not been made, details of the arrears, if any, are required to be stated.

VIII. Particulars of Companies Under the Same Management: The following particulars in regard to the listed companies under the same management within the meaning of the Section 370(1B) which made any capital issue in the last three financial years are required to be stated: **(a)** Name of the company **(b)** Year of issue **(c)** Type of issue (public/right/ composite); **(d)** Amount of issue; **(e)** Date of closure of issue; **(f)** Date of despatch of share/debenture certificate completed **(g)** Date of completion of the project where the object of the issue was financing of project **(h)** Rate of dividend paid.

IX. Management Perceptions of Risk Factors: Under this head, the company is required to specify the risk factors which the management perceives, e.g., sensitivity to foreign exchange rate fluctuations, scarce availability of raw materials, marketing of products, cost/time overrun.

Rights Issues

The shares offered to the existing shareholders of a company are called rights issues. According to the Companies Act, any further shares proposed to be issued by a company at any time after the expiry of two years from the incorporation of a company or after the expiry of one year from the first allotment of shares, whichever is earlier, must be offered to the existing holders of equity shares at the date of the offer. The company has to make the offer in the form of a notice, specifying the number of shares offered. The shareholders are given not less than 15 days from the date of the offer to accept, failing which the offer is deemed to have been declined. Thus, the right of the shareholders is also inclusive of the option/right of renunciation. The Board of Directors has the right to dispose off-the shares renounced in such a manner as they think most beneficial for the company.

Issue of Debentures

There are different types of debentures such as redeemable, perpetual, mortgage, convertible and non-convertible. Companies by and large issue redeemable mortgage debentures. They are secured by a mortgage on the whole or a part of the assets of the company. The convertible debentures are either fully/partly convertible into equity shares at par or at a premium. The conversion may be compulsory or at the option of the debentureholders on the specified date of conversion. The non-convertible amount/non-convertible portion of the debenture is redeemed on the specified dates as per the terms of the issue. Non-convertible debentures are redeemed after a specified period of the date of allotment.

The power to issue debenture vests in the Board of Directors to be exercised by a resolution at its meeting. The directors have to obtain the consent of the shareholders by an ordinary resolution if the amount borrowed exceeds the aggregate of the paid-up capital and free reserves.

No company can issue any debentures carrying voting rights. A debentureholder is not entitled to receive a copy of accounts and reports of the company. But he can ask for a copy of the same. He has the right to obtain a copy of the trust deed for securing the issue of debentures. The companies have to keep the trust deed open for inspection by any debenture holder. The right of debentureholders depend solely on their debentures. Usually, by the terms of issue, the following rights are conferred on the debenture- holders which are enumerated in the prospectus/other offer documents: **(a)** Debentures are transferable and transmittable in the same manner and to the same extent and subject to the same restrictions as in the case of equity shares in the company as contained in the articles of association of the company; **(b)** Debentureholders are entitled to inspect the register of debentureholders; **(c)** The right and privileges of debenture holders can be modified/varied/abrogated with the consent, in writing, of the holder of at least three-fourths of the amount outstanding or by a special resolution passed at the meeting of the debenture holders; **(d)** The debentures are subject to the other usual terms and conditions incorporated in the trust deed entered into between the company and the debenture trustees; and **(e)** The debentures *inter se* rank *pari passu* without any preference/ priority of one over the other/others as soon as they become fully paid-up.

Debentures need not necessarily be secured. The Act contains no provision requiring that debentures must be secured. However, it is common to secure the debentures by a mortgage or charge on the company's property. The common practice is to secure debentures by a trust deed which contains a charge or, in other words, which creates or evidences the creation of a mortgage or charge to ensure repayment of the debt. The debenture trust is created by an instrument of trust. The author of the trust transfers the properties, movable/immovable, to the trust and the trustees hold such properties in trust for the benefit of the beneficiary, that is, for the debentureholder, to be used in the event of default of payment of interest or the principal amount of debt advanced under terms agreed upon by selling such properties in the hands of the trustee. The mortgage or charge created to secure debentures must be registered with the Registrar of Companies (RoCs) within 30 days of the creation of the charge.

Most of the provisions of the Act concerning issues of securities, properties, allotment and listing, and so on, which are applicable to shares also apply equally to the debentures.

Allotment of Shares

The first allotment of shares in a public issue is prohibited unless the amount of minimum subscription stated in the prospectus is subscribed and the sum payable on application of shares is received by the company. The application money cannot be less than 5 per cent of nominal amount of each share. If the company does not receive the amount of minimum subscription within 120 days from the date of the first issue of the prospectus, the amount subscribed/ received must be refunded. If the amount is not refunded within 130 days after the issue of the prospectus, interest at the rate of 6 per cent is payable. An allotment should be made by the directors within a reasonable time. A company cannot make allotment until the beginning of the fifth day from the day on which the prospectus was issued or any later day which is specified in the prospectus for this purpose, that is, the day of the opening of the subscription list. A contravention of this restriction would make promotes/directors liable to a penalty up to ₹50,000.

Every company intending to make a public issue of shares/debentures is required, before the issue, to make an application to one/more recognised stock exchanges for permission to list these securities. An allotment of shares would be void if permission is not applied for or permission is not granted by the stock exchange/or each stock exchange, on expiry of 10 weeks from the date of the closing of the subscription list. In such a case, the company is required to repay forthwith without interest all the money received from the applicants. If such money is not repaid within eight days, the company will have to pay interest at a rate not being less than 4 per cent and not more than 15 per cent.

Every company is required to file with the ROC a return of allotment within 30 days from the date of allotment. However, the ROC has the discretionary power to extend time for filing a return of allotment if it is not filed within the prescribed limit.

Issue of Share Certificates

Every company which issues capital has to issue share certificate as a *prima facie* evidence of the title of the member to such shares. In other words, the share certificate is a declaration by the company that the person in whose name the certificate is issued is a shareholder of the company. The objective of issuing the certificate is to enable the person to use it as a proof of ownership of shares and also to enable others to act upon that certificate for any sale/transfer of shares. The certificates stamped, issued under the common seal of the company and signed by the director or an authorised person, are to be delivered within three months after the allotment of shares and within two months after the application for registration of transfer.

On registration of a transfer of a share, the same certificate that was delivered to the company along with the instrument of transfer, is reissued to the transferee after the necessary endorsement of the particulars of the transfer has been recorded on the reverse of the certificate under the signature of the authorised official of the company. When the pages have been utilised, a fresh certificate is issued to the transferee. This also applies where the transfer involves splitting the certificate in case of part transfer of shares.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

The SEBI has been set up under the SEBI Act to **(i)** protect the interest of the investors in securities and **(ii)** promote the development of, and regulate, the securities market by much measures as it thinks fit. This Section discusses SEBI in terms of its establishment, powers and functions; registration certificate; prohibition of manipulative and deceptive devices, insider trading and substantial acquisition of securities/control; penalties and adjudication; appellate tribunal; and miscellaneous.

Establishment

The SEBI is a body corporate. It consists of **(a)** a Chairman appointed by the Government, **(b)** two members from amongst officials of the Ministry of Government of India dealing with Finance and administration of the Companies appointed by the Government, **(c)** one member from amongst the officials of, and nominated by the RBI, **(d)** five members of whom at least two should be whole time members nominated by the Government. Its general superintendence, direction and management is vested in a Board of members which may exercise all powers and do all acts/things which may be exercised/done by the SEBI. The Chairman also has powers to general superintendence and direction of its affairs and may also exercise all powers and do all acts/things exercisable/done by it. The Chairman and other members of the SEBI should be persons of ability, integrity and standing who have shown capacity in dealing with problems relating to the securities market or have special knowledge/experience of law, finance, economics, accountancy, administration or in any other discipline which, in the opinion of the Government, would be useful to the SEBI.

Powers and Functions

The powers and functions of SEBI are discussed below.

Functions Subject to the provisions of the SEBI Act, it is the duty of the SEBI to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit. These measures may provide for the following:

(a) Regulating the business in stock exchange(s) and any other securities market(s);

(b) Registering and regulating the working of stockbrokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with the securities market in any manner;

(ba) Registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as it may, by notification, specify in this behalf;

(c) Registering and regulating the working of venture capital (VC) funds and collective investment schemes including mutual funds;

(d) Promoting and regulating self-regulatory organisations;

(e) Prohibiting fraudulent and unfair trade practices relating to the securities market;

(f) Promoting investors' education and training of intermediaries of the securities market;

(g) Prohibiting insider trading in securities;

(h) Regulating substantial acquisition of shares and takeover of companies;

(i) Calling for information from, undertaking inspection, conducting inquiries and audits, of the stock exchanges, mutual funds, other persons associated with the securities market intermediaries and self-regulatory organisations in the securities market;

(ia) Calling for information and record from any person including any bank or any other authority or board or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which is under investigation or inquiry by the SEBI;

(ib) Calling for information from, or, furnishing information to, other authorities in India/outside India having functions similar to those of the SEBI in matters relating to prevention/detection of violations in respect of securities laws subject to the provisions of other laws. With the prior approval of Government, the SEBI may enter into an agreement/arrangement/understanding with the concerned authority outside India.

(j) Performing such functions and exercise such powers under the provisions of the Securities Contracts (Regulation) Act, as may be delegated to it by the Central Government;

(k) Levying fees or other charges for carrying out the above purposes;

(l) Conducting research for the above purposes;

(la) Calling from, or furnishing to, any such agencies, as may be specified by it, such information as may be considered necessary by it for the efficient discharge of its functions;

(m) Performing such other functions as may be prescribed.

In addition, it may also take measures to undertake inspection of any book, register, or other document or record of any listed public company or public company which intends to get its securities listed on any recognised stock exchange where the SEBI has reasonable grounds to believe that such company has been indulging in insider trading or fraudulent and unfair trade practices relating to the securities market.

In exercising these powers, the SEBI would have the same powers as vested in a civil court under the Code of Civil Procedure, in respect of the following matters, namely:

(i) The discovery and production of books of accounts and other documents, at such place and time as may be specified by it;

(ii) Summoning and enforcing the attendance of persons and examining them on oath;

(iii) Inspection of any books, registers and other documents of any person at any place;

(iv) Inspection of any books, register, or other document or record of the company;

(v) Issuing commissions for the examination of witnesses or documents.

The SEBI may, by an order, for reasons to be recorded in writing, in the interests of investors or the securities market, take any of the following measures, either pending or on completion of an investigation/inquiry, namely:

(a) Suspend the trading of any security in a recognised stock exchange;
(b) Restrain persons from accessing the securities market and prohibit any person associated with the securities market to buy, sell or deal in securities.
(c) Suspend any office-bearer of any stock exchange or self-regulatory organisations from holding such position;
(d) Impound and retain the proceeds or securities in respect of any transaction which is under investigation;
(e) Attach, after passing of an order on an application made for approval by the Judicial Magistrate of the First Class having jurisdiction, for a period not exceeding one month, one or more bank account(s) of any intermediary or any person associated with the securities market in any manner involved in violation of any of the provisions of the SEBI Act/rules/regulations. However, only the bank account(s) or any transaction entered therein, so far it relates to the proceeds actually involved in violation of any of the provisions of the SEBI Act/rules/regulations would be allowed to be attached;
(f) Direct any intermediary or a person associated with the securities market in any manner not to dispose of or alienate an asset forming part of any transaction which is under investigation.

It may take any of the measures specified in clauses **(d)**, **(e)** or **(f)**, in respect of any listed public company or public company which intends to get its securities listed on any recognised stock exchange where it has reasonable grounds to believe that such company has been indulging in insider trading or fraudulent and unfair trade practices relating to the securities market. However, it would, either before or after passing such orders, give an opportunity of hearing to such intermediaries or persons concerned.

The amount disgorged pursuants to directions issued under the SEBI Act (**discussed later**) SCR Act (**discussed in Chapter 5**)/Depositories Act (**discussed in Chapter 8**) should be credited to the SEBI Investors Protection Fund to be utilised in accordance with the provisions of the SEBI Act.

Regulation/Prohibition of Issue of Prospectus, Offer Document, Advertisement Soliciting Money for Issue of Securities The SEBI may, for the protection of investors, **(a)** Specify, by regulations **(i)** the matters relating to issue of capital, transfer of securities and other matters incidental thereto; and **(ii)** the manner in which such matters should be disclosed by the companies; **(b)** By general or special orders **(i)** prohibit any company from issuing prospectus, any offer document, or advertisement soliciting money from the public for the issue of securities; **(ii)** specify the conditions subject to which the prospectus, such offer document or advertisement, if not prohibited, may be issued. It may also specify the requirements for listing and transfer of securities and other matters incidental thereto.

Power To Issue Directions If, after making or causing to be made an enquiry, the SEBI is satisfied that it is necessary **(i)** in the interest of investors/orderly development of securities market; or **(ii)** to prevent the affairs of any intermediary or other persons being conducted in a manner detrimental to the interests of the investors/securities market; or **(iii)** to secure the proper management of any such intermediary or person, it may issue such directions **(a)** to any person(s) associated with the securities market; or **(b)** to any company in respect of matters specified above, as may be appropriate in the interests of investors in securities and the securities market. The power to issue directions would include and always be deemed to have been included the power to direct any person who made profit/averted loss by indulging in transactions/activities in contravention of the provisions of the SEBI Act/regulations to disgorge an amount equivalent to the wrongful gain made/loss averted by the contravention.

Investigation Where the SEBI has reasonable ground to believe that **(a)** the transactions in securities are being dealt with in a manner detrimental to the investors/securities market; or **(b)** any intermediary or any person associated with the securities market has violated any of the provisions of the SEBI Act/rules/regulations/directions, it may, at any time order in writing, direct any **person** (i.e. investigating authority) specified in the order to investigate their affairs and report to the SEBI. It would be the duty of every manager, managing director, officer and other employees of the company and every intermediary or every person associated with the securities market to preserve and to produce to the investigating authority or any person authorised by it in this behalf, all the books, registers, other documents and record of, or relating to, the company/intermediary or such person, which are in their custody/power. The investigating authority may require any intermediary/person associated with the securities market in any manner to furnish such information to, or produce such books, registers or other documents, or record before him to any person authorised by it in this behalf as it may consider necessary, if the furnishing of such information or the production of such books, registers or other documents, or records is relevant or necessary for the purpose of its investigation. It may keep in its custody any books, registers, other documents and record produced for six months and thereafter return the same to the intermediary/any person associated with the securities market. However, it may call for any book, register, other document and record if they are needed again. If the person, on whose behalf the books, registers, other documents and record are produced, requires it, it would give their certified copies to him.

The investigating authority may examine an oath, any manager, managing director, officer and other employee(s) of any intermediary/person associated with securities market in any manner, in relation to the affairs of his business, and may administer an oath accordingly, and for that purpose may require any of those persons to appear before it personally.

If any person fails without reasonable causes or refuses to **(a)** produce to the investigating authority/any person authorised by it in this behalf, any book, register, other document and record which is his duty to produce; **(b)** furnish any information which is his duty; **(c)** appear before the investigating authority personally when required to do so or to answer any question which is put to him by him; and **(d)** sign the notes of any examination, he would be punishable with imprisonment for a term which may extend to one year, or with fine, which may extend to ₹ one crore, or with both, and also with a further fine which may extend to ₹ five lakh for every day during which the failure or refusal continues. Notes on any examination should be taken down in writing and be read to, or by, and signed by, the person examined, and may thereafter be used in evidence against him.

Where in the course of investigation, the investigating authority has reasonable ground to believe that the books, registers, other documents and record of, or relating to, any intermediary/person associated with securities market in any manner, may be destroyed, mutilated, altered, falsified or secreted, it may make an application to the Magistrate or Judge of the designated court in Mumbai for an order for their seizure. The authorised officer may requisition the services of any police officer/officer of the Government/both to assist him who would be duty bound to comply with it. After considering the application and hearing the investigating authority, if necessary, the Magistrate/Judge of the designated court may, by order, authorise it to **(a)** enter, with such assistance, as may be required, the place(s) where such books, registers, other documents and records are kept; **(b)** search the place(s) in the manner specified in the order; and **(c)** seize books, registers, other documents and record, considered necessary for the purpose of investigation. However, the Magistrate would not authorise seizure of books, registers, other documents and record of any listed public/public company which intends to get its securities listed on any recognised stock exchange, unless it indulges in insider trading or market manipulation.

The investigating authority should keep in its custody the books, registers, other documents and record, seized for such period, not later than the conclusion of the investigation, as it considers necessary and thereafter return the same to the company or the other body corporate, or to the managing director or the manager or any other person, from whose custody or power they were seized and inform the Magistrate/Judge of the designated court of such return. It may, before returning them, place identification marks on them. Every search or seizure should be carried out in accordance with the provisions of the Code of Criminal Procedure.

Cease and Desist Proceedings If SEBI finds, after causing an inquiry to be made, that any person has violated, or is likely to violate, any provisions of the SEBI Act/rules/ regulations, it may pass an order requiring such person to cease and desist from committing or causing such violation. However, it would not pass such order in respect of any listed public company or a public company which intends to get its securities listed on any recognised stock exchange, unless it has reasonable grounds to believe that such company has indulged in insider trading or market manipulations.

Registration Certificate No stockbroker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment advisor, depository, custodian of securities, foreign institutional investor, credit rating agency, and such other intermediary who may be associated with securities market should buy, sell or deal in securities except under, and in accordance with, the conditions of a certificate of registration obtained from the SEBI in accordance with the regulations made under the SEBI Act. No person should sponsor or cause to be sponsored or carry on or caused to be carried on any venture capital funds or collective investment schemes including mutual funds, unless he obtains a certificate of registration from the SEBI in accordance with the regulations.

Every application for registration should be in such manner and on payment of such fees as may be determined by the regulations. The SEBI may, by order, suspend or cancel a certificate of registration in such manner as may be determined by the regulations, provided the person concerned has been given a reasonable opportunity of being heard.

Prohibition of Manipulative and Deceptive Devices, Insider Trading and Substantial Acquisition of Securities or Control

No person should directly or indirectly:

(a) Use or employ, in connection with the issue, purchase or sale of any securities listed or proposed to be listed on a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the SEBI Act/rules/regulations;

(b) Employ any device, scheme or artifice to defraud in connection with the issue or dealing in securities which are listed or proposed to be listed on a recognised stock exchange;
(c) Engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person, in connection with the issue, dealing in securities which are listed or proposed to be listed on a recognised stock exchange, in contravention of the provisions of the SEBI Act/rules/ regulations;
(d) Engage in insider trading;
(e) Deal in securities while in possession of material/non-public information or communicate such material/non-public information to any other person, in a manner which is in contravention of the provisions of the SEBI Act/rules/ regulations;
(f) Acquire control of any company or securities more than the percentage of equity share capital of a company whose securities are listed or proposed to be listed on a recognised stock exchange, in contravention of the regulations made under the SEBI Act.

Penalties and Adjudication

The stipulations of the SEBI Act relating to penalties and adjudication are summarised below.

Penalty The SEBI is empowered to impose penalties on different intermediaries for failures/ defaults.

Failure to Furnish Information and Return The SEBI can impose penalties as detailed below:
(a) For failure to furnish any document, return or report: not less than ₹1 lakh but may extend to ₹1 lakh for each day such failure continues subject to a maximum of ₹1 crore;
(b) For failure to file the return/furnish any information, books or documents within the specified time: same as in **(a)**;
(c) For failure to maintain books of accounts/records: same as in **(a)**.

Failure to Enter into Agreement with Clients By a registered intermediary: **same as above.**

Failure to Redress Investors' Grievances By a registered intermediary/listed company having been called upon by SEBI: **same as above**.

Certain Defaults in Case of Mutual Funds/Collective Investment Schemes Default in not **(a)** obtaining a certificate of registration; **(b)** complying with the terms and conditions of the certificate of registration; **(c)** failing to make an application for listing of schemes; **(d)** dispatching the unit certificates; **(e)** to refund application money; and **(f)** failing to invest collected money: **same as above**.

Failure by an Asset Management Company Any failure to observe rules and regulations providing for restrictions on its activities: **same as above**.

Default in Case of Stock Brokers **(a)** For failure to issue contract notes in the form and manner prescribed by the stock exchange not less than ₹1 lakh but may extend to for which the contract note was required to be issued; **(b)** Failure to deliver any security/make payment, the amount due to the investor in the manner and within the period specified in the regulations: not less than ₹1 lakh but may extend to ₹1 lakh for each day of failure subject to a maximum of ₹1 crore; **(c)** For charging brokerage in excess of that prescribed by the regulation, ₹1 lakh or five times the excess charge, whichever is higher.

Penalty for Insider Trading If an insider **(a)** deals in securities on his behalf or on behalf of others, on the basis of an unpublished price-sensitive information; or **(b)** communicates any unpublished price-sensitive information except as required in the course of business or under any law; or **(c)** counsels or procures for any person to deal in such securities on the basis of unpublished price sensitive information, he is liable to a penalty of not less than ₹10 lakh but may extent to ₹25 crore or three times the amount of profit made out of insider trading whichever is higher.

Non-disclosure of Acquisition of Shares and Takeovers Failure to **(i)** disclose the aggregate of shareholding in a company before acquiring any shares of that company **(ii)** make a public announcement for acquiring shares at a minimum price, **(iii)** make public offer by sending letter of offer to the shareholders of the concerned company, **(iv)** make payment of consideration to the shareholders who sold their shares pursuant to the letter of offer, liable to a penalty: **same as above**.

Fraudulent and Unfair Trade Practices For indulgence in fraudulent and unfair trade practices relating to securities: **same as above**.

Contravention Where No Separate Penalty Provided Failure to comply with any provision of the SEBI Act/rules/regulations/directions for which no separate penalty has been provided: not less than ₹1 lakh but may be extend to ₹1 crore.

Power to Adjudicate The SEBI should appoint any officer not below the rank of Division Chief to be an adjudicating officer for holding an inquiry in the prescribed manner after giving any person concerned a reasonable opportunity of being heard for the purpose of imposing any penalty. While holding an inquiry, the adjudicating officer would have the power to summon and enforce the attendance of any person acquainted with the facts and circumstances of the case to give evidence or to produce any document which, in his opinion, may be useful for or relevant to the subject-matter of the inquiry. On being satisfied that the person has failed to comply with the relevant provisions, he may impose such penalty as he thinks fit in accordance with the above provisions. The SEBI may, in the interest of the securities market, enhance the quantum of penalty if circumstances justify. While adjudging quantum of penalty, the adjudicating officer should have due regard to the following factors, namely: **(a)** the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of default; **(b)** the amount of loss caused to an investor or group of investors as a result of the default; **(c)** the repetitive nature of the default. All sums realised by way of penalties would be credited to the Consolidated Fund of India.

Any person against whom any proceedings for the alleged fraud have been initiated may approach the SEBI for settlement. Taking into consideration the nature/gravity/impact of defaults, it may agree for settlement on payment of the amount/other terms determined by it. The concerned party would not be entitled to any appeal to the SAT.

Securities Appellate Tribunal (SAT)

Any person aggrieved by an order by **(i)** the SEBI under the SEBI Act/rules/regulations, or **(ii)** an adjudicating officer may prefer an appeal in the prescribed form, accompanied by the prescribed fee, to a SAT within 45 days from the date on which a copy of the order is received by him. If satisfied that there was sufficient cause for not filing it within that period, the SAT may entertain an appeal after the expiry of the period. The appeal would be dealt with by the SAT as expeditiously as possible so as to dispose it of finally within six months. After giving the parties an opportunity of being heard, it may confirm/modify/set aside the order appealed against. The SAT would not be bound by the procedure laid down by the Code of Criminal Procedure. It would be guided by the principles of natural justice and subject to other provisions of the SEBI Act/rules. It would have powers to regulate its own procedure. To discharge its functions, it is vested with the same powers as vested in a civil court in respect of the following matters:

- Summoning and enforcing the attendance of any person and examining him on oath;
- Requiring the discovery and production of documents;
- Receiving evidence on affidavits;
- Issuing commissions for the examination of witnesses/documents;
- Dismissing an application for default or deciding it *ex parte*;
- Setting aside any order of dismissal of any application or any other order passed by it *ex parte*;
- Any other prescribed matter.

The proceedings before the SAT would be deemed to be a judicial proceeding and it would deemed to be a civil court. No civil court would have jurisdiction to entertain any suit/proceeding in respect of any matter which an adjudicating officer/SAT is empowered to determine. An injunction can also **not** be granted by any court/authority in respect of any action taken/to be taken in pursuance of any power conferred by/under the SEBI Act. Any person aggrieved by any decision/order of the SAT may file an appeal to the Supreme Court within 60 days on any question of law arising out of such order.

Power of Government to Issue Directions

In exercise of its powers or the performance of its functions under the SEBI Act, the SEBI would be bound by such directions on questions of policy as the Central Government may give in writing to it from time to time. The decision of the Government whether a question is one of policy or not would be final.

Power of Central Government to Supersede SEBI

If at any time the Government is of opinion **(a)** that on account of grave emergency, it is unable to discharge the functions and duties imposed on it by or under the provisions of the SEBI Act; or **(b)** that it has persistently made default in complying with any directions issued by the Government or in discharge of its functions and duties, and as a result of such default its financial position or its administration has deteriorated; or **(c)** that circumstances exist which render it necessary in the public interest to do so, the Government may, by notification, supersede the SEBI for a period not exceeding six months.

Returns and Reports

The SEBI should furnish to the Government at such time and in such form and manner as may be prescribed or as it may direct, such returns and statements and particulars in regard to any proposed or existing programme for the promotion and development of the securities market, as it may, from time to time, require. Within 90 days after the end of each financial year, the SEBI should submit to the Government a report in the prescribed form, giving a true and full account of its activities, policy and programmes during the previous financial year. A copy of the report received would be laid, as soon as may be after it is received, before each House of Parliament.

Delegation

The SEBI may, by general or special order in writing, delegate to any of its member, officer or any other person subject to such conditions, if any, as may be specified in the order, such of its powers and functions under the SEBI Act except the powers to make rules (discussed subsequently) as it may deem necessary.

Offences

If any person contravenes or attempts to contravene or abets the contravention of the provisions of the SEBI Act/rules/regulations, he would be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to ₹25 crore or with both.

If any person fails to pay the penalty imposed by the adjudicating officer or fails to comply with any of his directions or orders, he would be punishable with imprisonment for a term not less than one month but which may extend to ten years, or with fine, which may extend to ₹25 crore or with both.

Compounding of Certain Offences

Any offence punishable under the SEBI Act, not being an offence punishable with imprisonment only, or with imprisonment and also with fine, may either before or after the institution of any proceeding, be compounded by a SAT or a court before which such proceedings are pending.

Power to Grant Immunity

The Government may, on recommendation by the SEBI, if it is satisfied, that any person, who is alleged to have violated any of the provisions of the SEBI Act/rules/regulations, has made a full and true disclosures in respect of the alleged violation, grant to such person, subject to such conditions as it may think fit to impose, immunity from prosecution for any offence or also from the imposition of any penalty with respect to the alleged violation. However, no such immunity would be granted in cases where the proceedings for the prosecution for any such offence have been instituted before the date of receipt of application for grant of immunity. The recommendation of the SEBI would not be binding upon the Government.

An immunity granted to a person may, at any time, be withdrawn by the Government, if it is satisfied that such person had, in the course of the proceedings, not complied with the condition on which the immunity was granted or had given false evidence, and thereupon such person may be tried for the offence with respect to which the immunity was granted or for any other offence of which he appears to have been guilty in connection with the contravention. He would also be liable to any penalty imposed under the SEBI Act to which such person would have been liable, had not such immunity been granted.

Establishment of Special Courts

For providing speedy trial of offences under the SEBI Act, the Government may establish/designate special court(s) consisting of a single judge holding the office of session/additional session judge, with the occurrence of the chief justice of the concerned High Court. It would exercise all its powers as if the special court were a court of session trying cases within the local limits of its jurisdiction.

Offences by Companies

Where an offence under the SEBI Act has been committed by a company, every person who was in charge of the company at the time of offence, and was responsible to the company for the conduct of its business, as well as the company, would be deemed to be guilty of the offence and would be liable to be proceeded against and punished accordingly. However, no person would be liable for any punishment, if he proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence. Where an offence has been committed by a company (i.e. body corporate and including a firm/other association of individuals) and if it is proved that the offence has been committed with the consent or connivance of, or is attributable to any neglect on the part of, any director (partners), manager, secretary or other officer of the company, they also would be deemed to be guilty of the offence and would be liable to be proceeded against and punished accordingly.

Recovery of Amounts On failure of a person to **(i)** pay the penalty imposed by the adjudicating officer, **(ii)** comply with SEBI direction for refund of money/of disgorgement order, **(iii)** pay any fee due to the SEBI, a **recovery officer** (i.e. an authorised officer of the SEBI) would proceed to recover the specified amount by **(a)** attachment/sale of movable/immovable properties, **(b)** attachment of bank accounts, **(c)** his arrest and detention in prison, **(d)** appointment of a receiver for the management of his movable/immovable properties. The due amount would be deemed to be a liability under the Income-tax. The recovery officer would be empowered to seek the assistance of the local administration while exercising his power. The due amount would have precedence over any other claim against the person concerned.

Power to Make Rules

The Government may, by notification, make rules for carrying out the purposes of the SEBI Act. In particular, such rules may provide for all or any of the following namely:

- **(a)** The term of office and other conditions of service of the Chairman and the members of the SEBI;
- **(b)** The additional functions that may be performed by the SEBI;
- **(c)** The manner in which the accounts of the SEBI would be maintained;
- **(da)** The manner of inquiry;
- **(db)** The salaries, allowances and other terms and conditions of service of the presiding officer, members and other officers and employees of the SAT;
- **(dc)** The procedure for the investigation of misbehaviour or incapacity of the presiding officers or other members of the SAT;
- **(dd)** The form in which an appeal may be filed before the SAT and the fees payable in respect of such appeal;
- **(e)** The form and the manner in which returns and report to be made to the Government;
- **(f)** Any other matter which is to be, or may be, prescribed, or in respect of which provision is to be, or may be, made by rules.

Powers to Make Regulations

The SEBI may make/notify regulations consistent with the SEBI Act/rules to carry out the purposes of the SEBI Act. In particular, such regulations may provide for all or any of the following matters, namely:

- **(a)** The times and places of SEBI meetings and the procedure to be followed at such meetings including quorum necessary for the transaction of business;
- **(b)** The terms and other conditions of service of officers and employees of the SEBI;
- **(c)** The matters relating to issue of capital, transfer of securities and other matters incidental thereto and the manner in which such matters should be disclosed by the companies;
- **(ca)** The utilisation of the disgorged credited amount;
- **(cb)** The fulfilment of other conditions relating to CISs;
- **(d)** The conditions subject to which certificate of registration is to be issued, the amount of fee to be paid for certificate of registration and the manner of suspension or cancellation of certificate of registration;
- **(da)** The terms determined by the SEBI for settlement of proceedings and the procedure for conducting of settlement proceedings;
- **(db)** Any other matter required to be/may be specified in respect of which provision is to be made.

OMBUDSMAN/STIPENDARY OMBUDSMAN REGULATIONS, 2003

To redress the grievances of investors in securities and for connected matters, the SEBI has established ombudsman/stipendary ombudsmen as per the following stipulations.

The SEBI may appoint one or more ombudsman/stipendary ombudsman (i.e. a person to act as ombudsman in respect of a specific matter(s) in a specific territorial jurisdiction specified in the appointment order) for specified territorial jurisdiction. The office of the ombudsman(men) would be located at the head office/other specified office(s) of the SEBI. The stipendary ombudsman would be located at the place of the specific complainant(s).

Qualifications/Disqualifications

The ombudsman should be a **(i)** citizen of India, **(ii)** of high moral integrity, **(iii)** not below 45 years of age and **(iv)** either **(a)** a retired district judge or qualified to be appointed as such, or **(b)** having a minimum of 10 years experience in any regulatory body, or **(c)** having special knowledge and experience in law, finance, corporate matters, economics, management/administration for at least 10 years, or **(d)** an office-bearer of investors association recognised by the SEBI having experience in dealing with matters relating to investors protection for at least 10 years. A person would not be qualified to hold the office of the ombudsman if he **(i)** is an undischarged insolvent, **(ii)** has been convicted of an offence involving moral turpitude, **(iii)** has been found to be/declared of unsound mind by a competent court, **(iv)** has been chargesheeted for any offence including economic offence or **(v)** has been a whole-time director in the office of the intermediary/listed company and at least 3 years has not elapsed.

A person would be eligible to be appointed as stipendary ombudsman who **(i)** has held a judicial post/an executive office under the Government for at least 10 years, **(ii)** is having experience of at least 10 years in matters relating to consumer/investor protection, **(iii)** has been a legal practitioner in corporate affairs for at least 10 years, **(iv)** has served for a minimum of 10 years in any public financial institution/regulatory body. Unless otherwise specified by the SEBI, the stipendary ombudsman would exercise all powers/functions as are vested in an ombudsman.

Powers and Functions of Ombudsman

The ombudsman would have the powers/functions specified below:

- To receive complaints specified below against any intermediary/listed company/both. The complaint on the following grounds may also be lodged with the SEBI in addition to the ombudsman concerned.
  (1) **(a)** Non-receipt of refund orders/allotment letters in respect of public issue of securities of companies/units of mutual funds or collective investment schemes; **(b)** share certificates, unit certificates, debenture certificates, bonus shares; **(c)** dividend by share/unit-holders; **(d)** interest on debentures, redemption amount of debentures or interest on delayed payment of interest on debentures; **(e)** interest on delayed refund of application money(ies); **(f)** annual reports/statements pertaining to the portfolios; **(g)** redemption amount from a mutual fund/returns from collective investment scheme; **(h)** letter of offer/ consideration in takeover or buyback offer or delisting; and **(i)** statement of holding corporate benefits or any grievances in respect of corporate profits.
  (2) Non-transfer of securities by an issuer company/mutual fund, collective investment management company, depository within the stipulated time.
  (3) Any grievances in respect of public/rights/bonus issues of a listed company.
  (4) Any of the matters covered under Section 55-A of the Companies Act.
  (5) Any grievances in respect of issues/dealing in securities against any intermediary/listed company.
- To consider such complaints and facilitate their resolution by amicable settlement.
- To approve a friendly/amicable settlement of the dispute between the parties.
- To adjudicate such complaints in the event of failure of settlement by friendly or amicable settlement.

The ombudsman would submit to the SEBI within 3 months of the close of each financial year a report containing general review of its activities. It would also furnish from time to time such information as the SEBI may require.

Procedure for Redressal of Grievances

Any person who has a grievance against a listed company/intermediary should himself/through authorised representative or any SEBI-recognised investor association file a complaint in the specified form supported by documents. However, he can make such a complaint only if he had made a written representation to the concerned intermerdiary/company which had rejected it, or no reply was received within one month or he is not satisfied with the reply received. Moreover, the complaint should be made within 6 months from the date of rejection/7 months after the filing of the complaint. The ombudsman may dismiss *in limine* a complaint if **(1)** it is frivolous in his opinion, **(2)** it is in respect of a matter which was settled through the office of the ombudsman/SEBI in any previous proceedings/for which any proceedings before the SEBI/any court/tribunal/arbitrator/any other forum is pending or a decree/award/final order has already been passed, **(3)** it petains to a matter for which action has been taken by the SEBI under the relevant provisions of the SEBI Act/regulations.

For the purpose of carrying out its duties, the ombudsman may require the listed company/intermediary to provide information/furnish certified copy of any document relating to the complaint. Failure to comply on their part may be inferred that the information would be unfavourable to them. He should maintain confidentiality of such information/documents and not disclose them to any person except **(a)** as required by law/or with the consent of the person providing the information, **(b)** to the extent considered by him to be reasonably required to comply with the principles of natural justice and fair play in proceedings and **(c)** to the SEBI.

Settlement

The ombudsman would endeavour to promote a settlement of the complaint by agreement/mediation between the parties. He would pass an award in terms of such settlement within one month and direct the parties to perform their mutual obligations. In case the matter is not resolved by mutual agreement, he would on the basis of the material placed before him and hearing the concerned parties give his award in writing or pass other appropriate directions/orders within 3 months. The award would be final and binding on the parties. Any party aggrieved by the award on adjudication should file within one month of a petition before the SEBI for review of the award. An award may be reviewed by the SEBI only if there is **(i)** substantial miscarriage of justice or **(ii)** an error apparent on the face of the award. The review petition by a party which is obliged to pay would be considered only when it deposits 75 per cent of the amount with the SEBI. The SEBI would endeavour to dispose of the matter within 45 days of filing of the petition and the party concerned should implement the award within 30 days. The ombudsman/SEBI may award reasonable compensation along with interest till date of satisfaction of the award at a rate not exceeding 1 per cent per mensem. They would determine the cost of the proceedings and also may impose cost on the complainant for filing frivolous complaint/review petition.

Implementation

The award should be implemented by the directed party within 30 days failing which he would be deemed to have failed to redress investors grievances and liable to a penalty under Section 15-C of the SEBI Act. He would also be liable for **(i)** action under Section 11(4) of the SEBI Act, **(ii)** suspension/delisting of securities, **(iii)** being debarred from accessing the securities market/dealing in securities, **(iv)** an action for suspension/cancellation of registration and **(v)** such other permissible appropriate action in the circumstances/facts of the case.

Display of Particulars of Ombudsman

Every listed company/intermediary should display the name and address of the ombudsman in its office premises in such manner and at such place that it is put to the notice of the shareholders/investors/unitholders visiting the office premises. They should also give full disclosures about the grievances redressal mechanism through the ombudsman in their offer documents/clients agreements. Failure to display the particulars/disclose the grievance redressal mechanism through the ombudsman would attract the penal provisions contained in Section 15-A of the SEBI Act.

BUY-BACK OF SECURITIES

The buy-back of securities by listed companies has to be in conformity with **(i)** the provisions of the Companies Act, and **(ii)** SEBI Buy-back regulations for listed companies.

Companies Act Requirements

Earlier, the public limited companies were prohibited from purchasing their own shares. A company was not allowed to give loans/provide financial assistance for the purchase of its own shares. However, there were three exceptions to these restrictions: **(a)** lending of money by a bank in the course of its business, **(b)** provision by a company, in accordance with any scheme, for the purchase of/subscription for fully paid shares in the company, being a purchase/subscription by trustees of the shares made for the benefit of employees of the company, **(c)** by advancing loans to employees (other than directors) to purchase/subscribe fully-paid shares to be held by them by way of beneficial ownership. Such loans could not exceed six months' salary/wages of the employee. Any violation of the restriction by a company or its officers was punishable with a fine of ₹1,000.

However, companies have been permitted since October 1998 by the Companies Act to purchase/buy-back their own shares or other specified securities. A company can buy-back shares/specified securities (including employees' stock option) from out of **(i)** its free reserves; **(ii)** the securities premium account; and **(iii)** the proceeds of an earlier issue other than fresh issue of shares made specifically for buy-back purposes. However, a company can purchase its own shares/specified securities only if:

- Articles permit buy-back;
- A special resolution in general meeting authorises buy-back. The notice of the meeting at which special resolution is proposed to be passed should be accompanied by an explanatory statement stating **(a)** a full and complete disclosure of all material facts, **(b)** the necessity for the buy-back, **(c)** the class of security intended to be purchased under the buy-back, **(d)** the amount to be invested under the buy-back and **(e)** the time limit for the completion of buy-back. The buy-back should be completed within a period of 12 months from the date of passing the special resolution;
- Buy-back does not exceed 25 per cent of the total paid-up capital plus free reserves of the company;
- Ratio of debt to equity (capital and free reserves) of the company does not exceed 2:1;
- Shares/specified securities are fully paid-up; and
- Buy-back is in accordance with the SEBI regulations in this behalf. These are elaborated later in this Section.

The buy-back may be from **(i)** existing securityholders on a proportionate basis, **(ii)** the open market, **(iii)** odd lots—where the lot of securities in a listed public company is smaller than such market lot as may be specified by the stock exchange and by **(iv)** purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity. *Sweat equity* shares means equity shares issued at a discount or for a consideration other than cash for providing the know-how or making available rights in the nature of intellectual property rights or value addition by whatever name called. The Companies (Amendment) Act, 1999 permits issue of such shares if **(i)** authorised by a resolution in a general meeting of shareholders of the company, specifying the number of shares, their values and the class(es) of directors or employees to whom issued, **(ii)** not less than one year has elapsed since the date of commencement of businesses, and **(iii)** they are issued in accordance with the SEBI regulations in this behalf. All restrictions/limitations/provisions relating to equity shares are also applicable to such shares.

Before making purchases under the buy-back scheme, all listed companies have to file with the Registrar of Companies (ROCs) and the SEBI, a declaration of solvency in the prescribed form and verified by an affidavit to the effect that the Board of Directors have made a full inquiry into the affairs of the company as a result of which it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year from the date of declaration adopted by the Board of Directors. The declaration should be signed by at least two directors of the company one of whom should be the managing director, if any. Unlisted companies are, however, not required to file the declaration of solvency.

The securities purchased under the buy-back arrangement should be extinguished and physically destroyed within seven days of the last date of completion of buy-back. A company which buys-back its securities is prohibited from further issue of securities within a period of two years, except bonus issues or issues in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares/debentures into equity shares. Such a company is also required to maintain a register of securities bought, the consideration paid, the date of cancellation of securities, and so on. Within 30 days of the completion of buy-back, a return containing these particulars must be filed with the ROCs and SEBI. Any default to comply with these requirements/other rules, is punishable with imprisonment up to two years or with fine up to ₹50,000 or with both.

However, companies are not allowed to buy-back securities: **(i)** through any/own subsidiary company(ies); **(ii)** through any/group of investment company(ies) and **(iii)** if a default subsists in respect of repayment of deposits/term loans to any financial institution and redemption of debentures/preference shares.

SEBI Buy-back of Securities By Listed Companies Regulation, 1998

In pursuance of the amendments in the company law regulations in 1998, SEBI has formulated buy-back regulations for listed companies. The main elements of these regulations are briefly discussed below.

Conditions of Buy-back A company can buy-back its own shares or other specified securities by one of the following methods: **(a)** from the existing securityholders on a proportionate basis through the tender offer; **(b)** from open market through **(i)** book-building process, **(ii)** stock exchange; and **(c)** from odd-lot holders. It cannot buy-back its specified securities from any person through negotiated deals, whether on or of the stock exchange or through spot transactions or other private arrangements. Any person or an insider cannot deal in securities of the company on the basis of unpublished information relating to the buy-back of specified securities of the company. A company cannot make any offer of buy-back within one year from the date of closure of the preceding offer.

To buy-back securities, a company should be authorised by **(i)** a special resolution under Section 77-A(2) of the Companies Act in a general meeting of its shareholders pursuant to Section 173 of the Companies Act or **(ii)** a resolution passed by its Board of Directors under Section 77-A(2)(b)(i).

Special Resolution A copy of the resolution should be filed with SEBI and the concerned stock exchange(s) where the shares and other specified securities are listed within seven days from the date of passing of the resolution. The explanatory statement to be annexed to the notice for the general meeting should contain the details specified below.

Contents of Explanatory Statement/Public Notice The contents are detailed below:

1. The date of the meeting at which the proposal for buy-back was approved by the Board of Directors of the company.
2. The necessity for the buy-back.
3. The company may specify that the security holders at the general meeting may authorise the Board of Directors to adopt one of the three methods of buy-back specified in buy-back conditions above.
4. The maximum amount required under the buy-back and the sources of funds from which the buy-back would be financed.
5. The basis of arriving at the buy-back price.
6. The number of securities that the company proposes to buy-back.
7. **(a)** The aggregate shareholding of the promoter (as defined by the SEBI Substantial Acquisition of Shares and Take over Regulation, 1997) and of the directors of the promoters, where the promoter is a company, and of persons who are in control of the company as on the date of the notice convening the general meeting or the meeting of the Board of Directors,
   (b) Aggregate number of shares and other specified securities purchased or sold by people, including the persons mentioned in **(a)** above, during a period of six months preceding the date of the Board meeting at which the buy-back was approved till the date of the notice convening the general meeting, and
   (c) The maximum and minimum price at which purchases and sales referred to in **(b)** above were made, along with the relevant dates.
8. Intention of the promoters and persons in control of the company, to tender shares and other specified securities for the buy-back, indicating the number of shares and other specified securities, details of acquisition with dates and price. 'Control' includes the right to appoint a majority of the directors or to control the management or policy decisions exercised by a person(s) acting individually or in concert, directly or indirectly, by virtue of their shareholding or management rights, or securityholders voting agreements or in any other manner.
9. A confirmation that there are no defaults subsisting in repayment of deposits, redemption of debentures or preference shares or repayment of term loans to any financial institution(s) or bank(s).
10. A confirmation that the Board of Directors has made a full enquiry into the affairs and prospects of the company and that they have formed the opinion:
    (a) That immediately following the date on which the general meeting or the meeting of the Board of Directors is convened, there would be no grounds on which the company could be found unable to pay its debts;
    (b) As regards its prospects for the year immediately following that date, with respect to the management of the company's business during that year, and to the amount and character of the financial resources that would, in their view, be available to the company during that year, the company, should show that it would be able to meet its liabilities when they fall due and would not be rendered insolvent within a period of one year from that date; and

(c) In forming their opinion for the above purpose, the directors should take into account the liabilities as if the company were being wound up under the provisions of the Companies Act, 1956 (including prospective and contingent liabilities).

11. A report addressed to the Board of Directors by the company's auditors stating that:

(a) They have inquired into the company's state of affairs;

(b) The amount of the permissible capital payment for the securities in question is in their view properly determined; and

(c) The Board of Directors have formed the opinion as specified in clause **(x)** above on reasonable grounds and that the company, in the regard to its state of affairs, would not be rendered insolvent within a period of one year from that date.

Board Resolution A company authorised by a resolution of its Board of Directors may buy-back its shares and other specified securities subject to the following conditions: **(i)** before making a public announcement (discussed subsequently) should give a public notice in at least one English national daily, one Hindi national daily and a regional language daily, all with wide circulation at the place where the registered office of the company is situated within two days of the passing of the Board resolution, **(ii)** the public notice should contain the same disclosures as given in the explanatory statement annexed to the notice of the general meeting of shareholders in case of special resolution (discussed below). A copy of the Board resolution should be filed with SEBI/the concerned stock exchange(s) within two days.

Buy-back through Tender Offer A tender offer means an offer by a company to buy-back its shares or other specified securities through a letter of offer from the holders of the shares or other specified securities of the company. The stipulations relating to buy-back through tender officer are as follows.

Buy-back from Existing Shareholders A company may buy-back its shares or other specified securities from existing securityholders on a proportionate basis. However, 15 per cent of the higher of number of securities **(i)** the company proposes to buy back, **(ii)** entitled as per their shareholding should be reserved for **small shareholders**, that is, those who hold shares/securities whose market value based on their closing price on the stock exchange in which the highest trading value as on the record date does not exceed ₹2,00,000. The explanatory statement annexed to the notice for the meeting of the shareholders or the public notice in connection with Board resolution authorising buy-back should contain the following additional disclosures: **(i)** The maximum price at which the buy-back of shares or other specified securities would be made; **(ii)** If the promoters intend to offer their shares or other specified securities, **(a)** the quantum of shares or other specified securities proposed to be tendered, and **(b)** the details of their transactions and their holdings for the last six months prior to the passing of the special resolution for the buy-back, including information of the number of shares or other specified securities acquired, the price and the date of acquisition.

Filing of Offer Documents The company, authorised by a special resolution of shareholders/Board resolution, should make a public announcement within two working days from the date of the resolution in at least one English national daily, one Hindi national daily and regional language daily, all with wide circulation at the place where the registered office of the company is situated and should contain all the material information specified by the SEBI.

A copy of the public announcement along with the soft copy should also be submitted to the SEBI simultaneously through a merchant banker.

The company should, within five working days of the public announcement, file a draft letter of offer with the SEBI along with the soft copy containing the disclosure as specified by the SEBI, through a merchant banker who is not associated with the company.

The draft letter of offer should be accompanied by the fees specified below:

	Offer size	*Fee*
(1)	Upto ₹10 crore	₹1,00,000
(2)	₹10—1,000 crore	0.125 per cent of offer size
(3)	₹1,000—5,000 crore	₹one crore twentyfive lakhs plus 0.03125 per cent of the portion of the offer size in excess of ₹1,000 crore
(4)	More than ₹5,000 crore	A flat charge of ₹3 crore

The SEBI may within seven days of its receipt give comments on the draft letter of offer. If the SEBI has, however, sought clarifications/additional information from the concerned merchant banker, the period would be extended to the seventh working day from the date of the receipt of the satisfactory reply. Any changes specified by the SEBI should be incorporated before despatching the letter of offer to the shareholders.

Offer Procedure The company concerned should announce a record date for determining the eligibility/entitlement of the security holders. The letter of offer and the tender form should be despatched to the eligible participants within five working days from the receipt of the SEBI's comments. The date of opening of the offer should be within five working days from the date of despatch of the letter of offer and the offer for buy-back should remain open for ten days. The company should accept shares/specified securities on the basis of entitlement of security holders on the record date. The entitlement of a shareholder should be calculated category-wise for reserved category of small shareholders and general category for others. After acceptance of tender on the basis of entitlement, shares/specified securities left to be bought back in one category should be first accepted in proportion to the tender over and above of entitlement by security holders in that category and thereafter from the other category.

Escrow Account The company should deposit, in an escrow account, 25 per cent of the consideration payable up to ₹100 crore and 10 per cent thereafter by way of security for the performance of its obligations under these regulations, on or before the opening of the offer. The escrow account should consist of **(a)** cash deposited with a scheduled commercial bank, or **(b)** bank guarantee in favour of the merchant banker, or **(c)** a deposit of acceptable securities, with an appropriate margin, with the merchant banker or **(d)** a combination of **(a)**, **(b)** and **(c)**.

Where the escrow account consists of a deposit with a scheduled commercial bank, the company should, while opening the account, empower the merchant banker to instruct the bank to issue a banker's cheque or demand draft for the amount in the escrow account. Where the escrow account consists of bank guarantee, such a bank guarantee should be in favour of the merchant banker and should be valid until thirty days after the closure of the offer. The company should, in case the escrow account consists of securities, empower the merchant banker to realise the value of such an escrow account by sale or otherwise, and if there is any deficit on realisation of the value of the securities, the merchant banker would be liable to make good any such deficit. In case the escrow account consists of a bank guarantee or approved securities, these should not be returned by the merchant banker till all obligations are complete as per these regulations. In such a case, the company should also deposit with the bank, in cash, a sum of atleast one per cent of the total consideration payable as and by way of security for the fulfilment of the obligations under these regulations of the company. On payment of consideration to all the securityholders who have accepted the offer and after the completion of all formalities of the buy-back, the amount, guarantee and securities in the escrow, if any, should be released to the company. In the interests of the securityholders, the SEBI may, in case of non-fulfilment of obligations under these regulations by the company, forfeit the escrow account either in full or in part. The amount forfeited may be distributed *pro rata* amongst the securityholders who accepted the offer and the balance, if any, would be utilised for investor protection.

Payment to Securityholders The company should, immediately after the date of closure of the offer, open a special account with banker to issue, registered with the SEBI, and deposit therein such sum as would, together with 90 per cent of the amount lying in the escrow account, make up the entire sum due and payable as consideration for the buy-back, and for this purpose may transfer the funds from the escrow account. It should complete the verification of offers received and make payment of consideration/return the securities within seven working days of the closure of the offer.

Extinguishment of Certificates The company should extinguish and physically destroy the security certificates bought back in the presence of a registrar to issue or the merchant banker, and the statutory auditor, within 15 days of the date of acceptance of the shares and specifie securities. The company should ensure that all the securities bought back are extinguished within 7 days of the last day of completion of buy-back. The securities offered for the buy-back, if already dematerialised, should be extinguished and destroyed in the manner specified under the SEBI (Depositories and Participants) Regulations, 1996 and the bye-laws framed thereunder.

The company should furnish a certificate of compliance to the SEBI, duly verified by **(a)** the registrar and whenever there is no registrar through the merchant banker, **(b)** two directors, including the Managing Director and **(c)** the statutory auditor of the company. The certificate should be submitted to SEBI on monthly basis by the 7th day of the succeeding month. The particulars of the extinguished and destroyed security certificates should be furnished to the stock exchange(s), where the securities of the company are listed, on a monthly basis by the 7th day of the succeeding month. The company should maintain a record of the security certificates that have been cancelled and destroyed.

Odd-lot Buy-back The provisions pertaining to buy-back through tender offer are applicable *mutatis mutandis* to odd-lot shares or other specified securities.

Buy-back from the Open Market The buy-back of shares or specified securities from the open market may be through: **(a)** stock exchange, and **(b)** book-building process. The company should ensure that at least 50 per cent of the amount earmarked for buy-back is utilised for the purpose.

Buy-back Through Stock Exchange The special resolution passed by the shareholders or the resolution passed by the Board of Directors authorising the buy-back should specify the maximum price at which the buy-back would be made. The buy-back of the securities cannot be made by the promoters or persons in control of the company. The company has to appoint a merchant banker and make, as in the case of buy-back through tender offer, a public announcement within seven days from the date of passing the resolution, containing the information specified by the SEBI. Simultaneously with the issue of public announcement, the company should file a copy with the SEBI along with the specified fees as in the case of buy-back through a tender offer. The public announcement should also contain disclosures regarding the details of the brokers and stock exchanges through which the buy-back of shares or other specified securities would be made. The buy-back should be made only **(i)** on stock exchanges with nation-wide trading terminals; **(ii)** through the order matching mechanism except all or none order matching system. The company should submit the information to the stock exchange, on a daily basis in the SEBI-specified form and the stock exchange should upload it on its official website immediately. The company should upload the information regarding the buy-back on its website on a daily basis. The identity of the company as a purchaser should appear on the electronic screen when the order is placed. The offer should be open within 7 working days of public announcement and close within 6 months from the date of its opening.

Buy-back of Physical Shares/Other Specified Securities A company should buy-back its shares/specified securities in physical form from open market method through a separate window at their volume weighted average price other than in physical form during the calendar week in which they are received by the broker.

Escrow Account The company should create an escrow account and deposit 25 per cent of the amount earmarked for the buy-back in the form of cash deposit with a bank or bank guarantee in favour of the merchant banker (along with 2.5 per cent of the amount in cash). The escrow account may be released for making payment to shareholders retaining at least 2.5 per cent of the amount at all points of time. On fulfilling the obligations, the amount/guarantee remaining in the account would be released to the company. In the event of their non-compliance, the SEBI may direct the merchant banker to forfeit the escrow account upto 2.5 per cent of the amount earmarked for buy-back.

Extinguishment of Certificates The provisions pertaining to extinguishment of certificates in the tender offer are applicable *mutatis mutandis*. The company should complete the verification of acceptances within fifteen days of the payout. The company should extinguish and physically destroy the security certificates bought back during the month in the presence of the merchant banker and the statutory auditor on/before the 15th day of the succeeding months. It should ensure that all securities are extinguished within 7 days of the last date of completion of buy-back.

Buy-back Through Book Building The special resolution/Board resolution should specify the maximum price at which the buy-back would be made. The company has to appoint a merchant banker and make, as in the case of buy-back through tender method, a public announcement at least seven days prior to the commencement of the buy-back. The provision of escrow account, applicable to buy-back through public offer, is applicable to buy-back through book-building too. But, the deposit in the escrow account should be made before the date of the public announcement and the amount should be determined with reference to the maximum price, as specified in the public announcement. A copy of the public announcement should be filed with the SEBI within two days of such announcement along with the specified fees as in the tender offer. The public announcement should also contain a detailed methodology of the book building process, the manner of acceptance, the format of acceptance to be sent by the securityholders, pursuant to the public announcement and the details of bidding centres. The book building process should be made through an electronically linked transparent facility. The number of bidding centres should not be less than thirty and there should be at least one electronically linked computer terminal at all the bidding centres. The offer for buy-back should remain open to the security holders for a period of not less than fifteen days and not exceeding thirty days. The merchant banker and the company should determine the buy-back price based on the acceptances received. The final buy-back price, which should be the highest price accepted, should be paid to all holders whose shares and other specified securities have been accepted for the buy-back.

The provisions pertaining to the verification of acceptances, the opening of special account and payment of consideration, applicable to the tender offer, are applicable *mutatis mutandis* to buy-back from the open market.

Extinguishment of Certificates The provisions pertaining to extinguishment of certificates applicable to tender offer of buy-back are also applicable *mutatis mutandis* to this method of buy-back.

General Obligations They relate to **(i)** obligations of the company **(ii)** obligations of the merchant banker, **(iii)** action against intermediaries.

Obligations of the Company The company must ensure that: **(a)** the letter of offer, the public announcement of the offer or any other advertisement, circular, brochure, publicity material should contain true, factual and material information and not contain any misleading information and must state that the directors of the company accept the responsibility for the information contained in such documents; **(b)** the company should not issue any shares or other specified securities, including by way of bonus, till the date of closure of the offer made under these regulations; **(c)** the company should pay the consideration only by way of cash; **(d)** the company should not withdraw the offer of buy-back after the draft letter of offer is filed with the SEBI or a public announcement of the offer to buy-back is made; and **(e)** the promoter or the person in control should not deal in the shares or other specified securities of the company in the stock exchange or off-market including *inter se* transfer of shares among promoters during the period from the date of passing the resolution till the closing of the offer. The company should not raise further capital for one year from the closure of the offer except in discharge of its subsisting obligations.

No public announcement of buy-back should be made during the pendency of any scheme of amalgamation or compromise or arrangement pursuant to the provisions of the Companies Act. The company should nominate a compliance officer and investor service centre for compliance with the buy-back regulations and to redress the grievances of the investors. The particulars of the security certificates extinguished and destroyed should be furnished by the company to the stock exchange(s) where the shares or other specified securities of the company are listed, within seven days of extinguishment and destruction of the certificates. The company should not buy-back the locked-in shares or other specified securities and non-transferable shares or other specified securities till the pendency of the lock-in or till the shares or other specified securities become transferable.

The company should, within two days of the completion of buy-back, issue a public advertisement in a national daily, *inter-alia*, disclosing: **(i)** the number of the shares or other specified securities bought; **(ii)** price at which the shares or other specified securities have been bought; **(iii)** total amount invested in the buy-back; **(iv)** details of the securityholders from whom shares or other specified securities exceeding one per cent of total shares or other specified securities have been bought back; and **(v)** the consequent changes in the capital structure and the shareholding pattern after and before the buy-back. The company, in addition to these regulations, should comply with the provisions of buy-back as contained in the Companies Act and other applicable laws.

Obligations of the Merchant Banker The merchant banker has to ensure that: **(a)** the company is able to implement the offer; **(b)** the provision relating to escrow account has been made; **(c)**

firm arrangement for moneys for payment, to fulfil the obligations under the offer, are in place; **(d)** the public announcement of the buy-back is made in terms of these regulations; **(e)** the letter of offer has been filed in terms of these regulations; **(f)** a due diligence certificate, which should accompany the draft letter of offer, has been filed with the SEBI; **(g)** the contents of the public announcement of offer as wel1 as the letter of offer are true, fair and adequate and quoting the source wherever necessary; **(h)** the compliance of Section 77-A and Section 77-B of the Companies Act and any other laws as may be applicable in this regard; **(i)** upon fulfilment of al1 the obligations by the company under these regulations, the bank with whom the escrow or special accounts has been deposited has been informed to release the balance amount to the company; and **(j)** a final report has been sent to the SEBI in the specified form, within fifteen days from the date of closure of the buy-back offer.

Action Against Intermediaries The SEBI may, on the failure to comply with the obligations or observe due diligence, initiate action against the merchant banker in terms of the SEBI (Merchant Bankers) Regulations, 1992. It may also, on the failure to comply with the provisions of these regulations or observe due diligence, initiate action against the registrar or the broker in terms of these regulations applicable to such intermediaries.

Penalties and Procedure The SEBI may, *suo motu* or upon information received by it, make an investigation in respect of the conduct and affairs of any person associated with the process of buy-back, by appointing an officer of the SEBI: **(a)** to ascertain whether there are any circumstances which would render any person guilty of having contravened any of these regulations or any directions issued thereunder; and **(b)** to investigate into any complaint of any contravention of the regulation received from any investor, intermediary or any other person.

Every person, in respect of whom an investigation has been ordered, would be duty bound to produce before the investigating officer such books, accounts and other documents in his custody or control and furnish him with such statements and information as he may require. Such a person should **(a)** extend to the investigating officer reasonable facilities for examining the books, accounts and other documents in his custody or control (whether kept manually or in computer or in any other form) reasonably required for the purpose for the investigations; **(b)** provide him the copies of such books, accounts and records which, in his opinion, are relevant to the investigation or, as the case may be, allow him to take out the computer printouts thereof; and **(c)** provide such assistance and cooperation as may be required in connection with the investigation and to furnish information relevant to such investigation as may be sought by him. The investigating officer would, for the purpose of investigation, have the full power to summon and enforce the attendance of persons; and to examine orally and to record on oath the statement of the persons concerned—any director, partner, member or employee of such person. The investigating officer should, on the completion of the investigation, after taking into account all relevant facts and circumstances, submit a report to the SEBI. On the receipt of report, the SEBI may initiate such action as it may be empowered to do so in the interests of investors and the securities market.

Power of the SEBI to Issue Directions The SEBI may, in the interest of the securities market and without prejudice to its right to initiate action including criminal prosecution under Section 24 of the SEBI Act, give directions as it deems fit, including:

(a) Directing the person concerned not to further deal in securities in any particular manner;

(b) Prohibiting the person concerned from cancelling any of the securities bought back in violation of the Companies Act;

(c) Directing the person concerned to sell or divest the shares or other specified securities acquired in violation of the provisions of these regulations or any other law or regulations;
(d) Taking action against the intermediaries registered with the SEBI in accordance with the regulations applicable to them;
(e) Prohibiting the persons concerned, its director, partners, members, employee and associates of such person from accessing the securities market;
(f) Disgorgement of any ill-gotten gains or profit or avoidance of loss; and
(g) Restraining the company from making a further offer for the buy-back.

In case any person is guilty of insider trading or market manipulation, the person concerned should be dealt with in accordance with the provisions of the SEBI (Insider Trading) Regulations, 1992 and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to the Securities Market) Regulations, 1995.

SEBI INTERMEDIARIES REGULATIONS, 2008

Intermediaries are stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, depositories/participants, custodians, credit rating agencies and other intermediaries associated with the securities market in any manner/ specified by the SEBI including an asset management company, a clearing member of a clearing corporation/house, foreign portfolio investor and a trading member of a derivative/currency derivative stock exchange but does not include, a foreign venture capital investor, mutual fund, collective investment scheme and venture capital fund. The main elements of the regulation are registration, general obligations, inspection and disciplinary proceedings, action in case of default and miscellaneous.

Registration

To act as an intermediary, a certificate of registration from the SEBI under the applicable regulations is necessary. The application for registration should be made in the prescribed form with such additional information and application fee as required under the regulations made by the SEBI applicable to that class of intermediary. The application to act as a broker/sub-broker/ trading member/clearing member/depository participant should be made through the concerned stock exchange/clearing corporation/ trading member/depository. For intermediaries specified by the SEBI, the application would have to be made to a self-regulatory organisation, that is, an organisation of a class of intermediaries duly recognised/registered with the SEBI including a stock exchange. The stock/clearing corporation/depository/self-regulatory organisation (SRO) would examine the eligibility of the applicant in terms of these regulations/regulation applicable to the class of intermediary/the rules/ regulations/bye-laws of the concerned stock exchange/ clearing corporation/depository/SRO and forward it along with the fee and its recommendations to the SEBI within 30 days of the receipt of the complete application and the specified fee. Separate certificates would be necessary to carry on each activity. Any material change in the material furnished should be updated by the intermediary within a maximum of 15 days of the occurrence of the change.

For considering the eligibility of the applicant and grant the certificate, the SEBI would take into account all relevant matters including whether **(i)** the applicant/associates have been refused certificate, **(ii)** the applicant/directors/partners/trustees/principal officer is involved in any pending legislation having an adverse bearing on the business of the applicant, development/functioning of the securities market, **(iii)** the applicant satisfies the eligibility criteria/ other requirements, **(iv)** the grant of the certificate is in the interest of the investors and the development of the securities market. **Associate** means **(i)** any person controlled directly/indirectly by the intermediary, **(ii)** any person who controls directly/indirectly the intermediary, **(iii)** any entity/person under common control with the intermediary. Where such intermediary is a natural person, associate will include relative and in case of body corporate will include group companies/companies under the same management. **Control** would include the power to directly/indirectly control the management/policy decisions by person(s) acting individually or in concert. **Principal officer** means any person responsible for the activities of an intermediary including proprietor, partner, whole time managing director/executive director, trustee, any key employee and any person designated as principal officer under the applicable regulations.

Any application would be rejected by the SEBI if **(1)** it is not complete in all respects, **(2)** does not contain the required additional information, **(3)** is incorrect/false/misleading in nature, **(4)** the non-compliance of the applicant with the eligibility requirements, **(5)** is not fit and proper person and **(6)** the principal officer does not have the requisite qualifications/experience. To determine whether an applicant/intermediary is a **fit and proper person**, the SEBI may take into account any consideration it deems fit including **(a)** integrity, reputation and character, **(b)** absence of conviction and restraint orders and **(c)** competence including financial solvency and networth in relation to the applicant/intermediary/principal officer/key management personnel.

The certificate granted by the SEBI to an intermediary would be subject to the following conditions:

- Where it proposes to change its status/constitution [i.e. **(i)** amalgamation/ demergers/consolidation/any other kind of corporate restructuring, **(ii)** change in control of the intermediary, **(iii)** any change in legal status], it would obtain prior approval of the SEBI. The SEBI should convey its approval within 60 days failing which the approval would be deemed to have been given.
- It would: **(a)** pay the applicable fee in accordance with the applicable regulations, **(b)** abide by the provisions of the securities law [i.e. Securities Contract (Regulation) Act, Depositories Act and the rules/regulations] and the directions/guidelines/circulars, **(c)** continuously comply with the requirement of disclosing information, and **(d)** meet the eligibility criteria/other requirements specified in these and other applicable regulations. The SEBI may impose other conditions as it may deem fit in the interest of the investors/orderly development of the securities market/regulation of the working of the intermediary.

The effect of refusal to grant certificate to an intermediary or expiry of the certificate would be that the intermediary should **(a)** forth with cease to act, **(b)** transfer its activities to another intermediary and allow its clients/investors to withdraw/transfer their securities/ funds held in its custody without any additional cost, **(c)** provide for liability incurred/assumed by the intermediary and **(d)** take other action as required under the applicable regulations or as directed by the SEBI. While refusing registration, the SEBI may impose such conditions as it deems fit for protecting investors/securities market.

The certificate granted to an intermediary would be permanent unless surrendered by the intermediary or suspended/cancelled by the SEBI.

General Obligations

The obligations of intermediaries are: general obligations; redressal of investor grievances; appointment of compliance officer; investment advice, and code of conduct.

General Obligations An intermediary should provide the SEBI with a certificate of its compliance officer on April 1 each year certifying **(i)** its compliance with all obligations, responsibilities, and the fulfilment of eligibility criteria on a continuous basis under these regulations and the regulations applicable to it, and **(ii)** that all disclosures are true and complete. A photocopy of the certificate should be prominently displayed at all its offices including branch offices. The name and contact details of the compliance officer to whom complaint may be made of any investor grievance should also be prominently displayed. The intermediary should maintain books of accounts and records specified in these regulations.

Redressal of Investor Grievances Endeavaours should be made by the intermediary to redress investor grievances promptly within 45 days of the its receipt. It should redress such grievances within the time specific by the SEBI. It should maintain records of investors grievances and their redressal. At the end of each quarter, the intermediary should upload information about the **(a)** number of grievances **(i)** received/redressed and **(ii)** unresolved beyond 3 months of their receipt on the website specified by the SEBI.

Appointment of Compliance Officer Every intermediary should appoint a compliance officer for monitoring compliance by it of the requirements of the **(i)** SEBI Act/rules/ regulations/ notifications/guidelines/circulars and orders made/issued by the SEBI/Central Government or **(ii)** the rules/regulations and bye-laws of the concerned stock exchange/the SRO. He should report to the intermediary/its Board of Directors in writing of any material non-compliance.

Investment Advice An intermediary/its directors/officers/employees/key management personnel should not render, directly/indirectly, any investment advice about any security in the publicity accessible media, whether real time or non-real time, unless a disclosure of its interest, direct or indirect including its long and short position in the security, has been made while rendering such advice. If they are rendering such advice, the intermediary should ensure that they disclose their interest, the interest of his dependent family members and that of the employer including his long/short position in the security. He should not make any recommendation to any client/ investor who may be expected to rely thereon to acquire/dispose of/retain any securities unless he has reasonable ground to believe that the recommendation is suitable.

Code of Conduct An intermediary/its directors/officers/employees/key management personnel should continuously abide by the code of conduct specified below:

Investor Protection An intermediary should:

(i) Make all efforts to protect the interest of the investors and render the best possible advice to its clients having regard to their needs and the environments and his own professional skills,

(ii) Ensure that it/its key management personnel/employees/contractors/agents would in the conduct of their business observe high standards of integrity, dignity, fairness, ethics and professionalism and all professional dealings would be affected in a prompt, effective and efficient manner. It would be responsible for the acts of omissions/commissions of its employees.

(iii) At all times render high standards of service, exercise due skills and diligence over persons employed/appointed by it, ensure proper care and exercise independent professional judgement and not at any time act in collusion with other intermediaries in a manner detrimental to the investors, and

(iv) Not increase charges/fees for the services rendered without proper advance notice to clients/investors.

Disbursal of Amount An intermediary should be prompt in disbursing dividends/ interest/any accrual income received/collected by it on behalf of the clients/investors.

Disclose of Information An intermediary should **(i)** ensure that adequate disclosures are made to the investors/clients in a comprehensible and timely manner so as to enable them to make a balanced and informed decision, **(ii)** not make any misrepresentation and ensure that the information is not misleading, **(iii)** not make any exaggerated oral/written statement about its qualifications/capability to render certain services or its achievements in regard to services rendered to other clients/investors, and **(iv)** not divulge to anybody orally/in writing, directly/ indirectly any confidential information about its, clients which has come to its knowledge without their prior permission except for compliance with any law.

Conflict of Interest An intermediary should avoid any conflict of interest and make adequate disclosures of his interest and put in place a mechanism to resolve any such situation in the conduct of its business and take reasonable steps to resolve the same in an equitable manner in case such a situation arises. It should make appropriate disclosure of its possible source/potential area of conflict of duties/interest which would impair its ability to render fair, objective and unbiased services. An intermediary/its director(s)/employee(s)/associate should not through its account/their respective accounts/their family members/relatives/friends indulge in any insider trading.

Compliance with Corporate Governance An intermediary should:

(i) Ensure that good corporate policies/governance is in place. It should not **(a)** engage in fraudulent and manipulative transactions in the listed securities, **(b)** indulge in any unfair competition, including resorting to unfair means for inducing clients of an other intermediary, likely to harm the interest of other intermediaries/investors/place them in a disadvantageous position while competing for/executing any assignment,

(ii) Taking adequate/necessary steps to ensure continuity in maintaining data/record keeping and that they are not lost/destroyed. It should also ensure that for electronic records/data up-to-date backup in always available.

(iii) Not be a party to, instrumental/indulge in **(a)** creation of false market/price rigging/ manipulation of prices/passing of unpublished price sensitive information in respect of securities listed/proposed to be listed on any stock exchange, and **(b)** any activity for distorting market equilibrium or which may affect the smooth functioning of the market for personal gain,

(iv) Cooperate with the SEBI/any designated authority as and when required and not make any untrue statement/suppress any material fact in any documents/reports/papers/information furnished to the SEBI or neglect/fail/ refuse to submit to the SEBI/other agencies with which registered, such books of accounts/documents/correspondence/papers as may be demanded/requested from time to time.

(v) Ensure that any change in registration status/any penal action by the SEBI/any material change in financials which may adversely affect the interest of the clients/investors is promptly informed to them and any outstanding business is transferred to another registered person in accordance with any instructions of the affected clients/as per the instructions of the SEBI/the provisions of any of the applicable regulations.

(vi) Maintain an appropriate level of knowledge and competency and abide by the provisions of any Act/regulation/circulars/guidelines of the Government/RBI/ SEBI/stock exchange/ any other applicable authority to the intermediary in respect of the business carried on by it. It should also comply with the award of the Ombudsman passed under the SEBI Ombudsman Regulations, 2003.

(vii) Ensure that the SEBI is promptly informed about any action, legal proceedings and so on initiated it in respect of any material breach/non-compliance of any law/regulations/ directions of the SEBI/any other regulatory body.

Infrastructure Requirements An intermediary should

- Have internal control procedures and financial/operational capabilities which can be reasonably expected to protect its operations/clients, investors/other registered entities from financial loss arising from theft/fraud/other dishonest acts/professional misconduct/ omissions.
- Registered with the SEBI in any other capacity/category, endeavour to ensure arm's length relationship in terms of both manpower and infrastructure between the activities carried out as an intermediary and other permitted activities.
- Establish/maintain adequate infrastructural facility to discharge its service to the satisfaction of clients/investors and its operating procedures/system should be well documented/ backed by operations manual.
- Create/maintain the records of all documents/data in their capacity in such a manner that their tracing is facilitated in the event of the loss of original records/documents for any reason.

Inspection and Disciplinary Proceedings

Subject to the provisions of Section 11-C of the SEBI Act, the SEBI may appoint a person(s) as inspecting authority to undertake inspection of the books/accounts/records including telephone/ electronic records/documents of an intermediary for any purpose including the following: **(i)** ensure that they are being maintained in the required manner, **(ii)** ascertain that adequate internal control systems/procedures/safeguards have been established and are being followed to fulfil the obligations, **(iii)** ascertain whether any circumstances exist which would render it unfit/uneligible, **(iv)** ascertain compliance with the provisions of the securities laws/directions/ circulars, **(v)** enquire into complaints from investors/clients/other market participants/any other person or any matter having a bearing on its activities and **(vi)** enquire *suo motu* into such matters as may be deemed fit in the interest of the investors/securities market.

Every director/proprietor/partner/trustee/officer/employee/any agent of the concerned intermediary would be duty bound to **(i)** produce to the inspecting authority the required books/ accounts/documents in his custody/control and **(ii)** to furnish with all the required statements/ information relating to its activities within the specified time.

The inspecting authority should have reasonable access to the premises occupied by the intermediary/any other person on its behalf. It should also have reasonable facility for examining any books/records/documents and access to copies of documents/other material relevant for inspection purposes. The directors/proprietors/partners/trustees/ officers/employees would be duty bound to give all assistance reasonably required for inspection purposes.

The SEBI may appoint a qualified auditor to inspect the books of accounts/affairs of an intermediary. He would have all the powers of the inspecting authority. The SEBI may also appoint or direct the intermediary to appoint a qualified valuer. The expenses of the audit/valuation would be borne by the intermediary. On the basis of the inspection report, the SEBI may take action(s) it may deem fit and appropriate.

Action in Case of Default

Failure of a registered intermediary to comply with any condition subject to which registration has been granted and contravention of any provision of the securities laws/directions/instructions/circulars would result in the action and in the manner specified below.

Procedure The designated member (i.e. the Chairman/Whole Time Member of the SEBI) would appoint an officer/a bench of three officers not below the rank of Division Chief of SEBI as the designated authority. It would issue to the concerned intermediary a notice to show cause as to why its registration should not be suspended/cancelled or other specified action taken. The noticee would have to submit within a maximum of 21 days a written representation along with documentary evidence in support of it. If the noticee does not reply to the show cause notice, the designated authority may proceed with the mater *exparte* and make recommendations on the basis of the material facts before it. After taking into account the representations of the noticee, the facts and circumstances of the case and the applicable provisions of law, it would submit a report to the SEBI recommending: **(i)** suspension of registration for a specified period, **(ii)** cancellation of registration, **(iii)** prohibition on taking up new assignment/contract/launch a new scheme for the specified period, **(iv)** debar the principal officer from employment/association with any registered intermediary/person for the specified period, **(v)** debar a branch/office from carrying out activities for the specified period, and **(vi)** issue of a warning to the intermediary.

On receipt of the report of the designated authority, the designated member would issue a show-cause notice to the concerned intermediary to submit a written representation within 21 days as well as an oral submission as to why an appropriate action should not be taken. The designated member would pass the order within 120 days. A copy of the order should be sent to the concerned intermediary (noticee) and also uploaded on the website of the SEBI. If the noticee is a member, a copy of the report should also be sent to the concerned stock exchange/clearing corporation/ depository/self-regulatory organisation.

Effect of Debarment/Suspension On/from the date of debarment/suspension of registration, the person concerned should:

- Not undertake any new assignment/contract/launch any new scheme. It would cease to carry on any activity in respect of which registration had been granted.
- Allow its clients/investors to withdraw/transfer their securities/funds held in its custody or withdraw any given assignment without any additional cost.
- Make provisions for liability incurred/assumed by it.
- Take such other action including the action relating to any records/documents/ securities/money of the investors in its custody/control within the specified time period and in the specified manner.

Surrender of Certificate of Registration A registered intermediary/person desirous of giving up its activity may surrender the certificate to the SEBI. The SEBI may require the concerned intermediary to satisfy it about factors it deems fit including, *inter-alia*, the following: **(i)** the arrangements for maintenance/preservation of records/other documents required to be maintained under the applicable regulations, **(ii)** redressal of investor grievances, **(iii)** transfer of records, funds/

securities of clients, **(iv)** arrangements made for ensuring continuity of service to the clients, and **(v)** defaults/pending action, if any. While accepting surrender, the SEBI may impose conditions on the person as it deems fit for protection of investors/its clients/securities market.

After surrender/cancellation of registration, the concerned person should:

- Return the cancelled certificate to the SEBI and not represent itself to be holder of certificate for carrying out the activity;
- Cease to carry on any concerned activity,
- Transfer its activities to another person holding a valid certificate to carry on such activity and allow its investors/clients to withdraw/transfer their securities/funds held in its custody or to withdraw any assignment given to sit without any additional cost.
- Provide for liability incurred/assumed by it.
- Take other action including action relating to any records/documents/securities/ money of the investors that may be in its custody/control within the time period and in the manner required under the applicable regulations or as directed by the SEBI.

Securities Appellate Tribunal (SAT) Any person aggrieved by an order of the SEBI may prefer an appeal to the SAT against such order.

Directions

The SEBI may, in the interest of the securities market/investors or for securing the proper management of any intermediary, issue necessary directions including, *inter-alia*, the following:

(i) Direct the intermediary/other person associated with the securities market **(a)** to refund any money/securities collected from the investors under any scheme/otherwise with/without interest, **(b)** not to access the capital market/deal in securities for a particular period/associate with any intermediary/capital market activity;

(ii) Direct the stock exchange concerned **(a)** not to permit trading, **(b)** suspend trading in the securities/units issued by the mutual fund/collective investment scheme.

(iii) Any other direction which it may deem fit and proper in the circumstances of the case.

However, the concerned person should be given in an opportunity of being heard before issuing any directions. If the circumstances warrant any interim direction immediately, the SEBI should give a reasonable opportunity for personal hearing after the issue of the direction without any undue delay.

SEBI PUBLIC OFFER AND LISTING OF SECURITISED DEBT INSTRUMENTS REGULATIONS, 2008

The main elements of these regulations relating to public offers of securitised debt instruments (SDIs)/listing of SDIs issued to public/any person(s) on a recognised stock exchange are **(1)** registration of trustees, **(2)** constitution/management of special purpose distinct entities, **(3)** schemes of specific purpose distinct entities, **(4)** public offer of SDIs, **(5)** rights of investors, **(6)** listing of SDIs, **(7)** inspection and disciplinary proceedings and **(8)** action in case of defaults.

Registration of Trustees

The requirements relating to registration of trustees are discussed below.

Eligibility of Trustees A person can make a public offer/seek listing of the SDIs only if **(i)** it is constituted as a special purpose distinct entity (SPDE), **(ii)** all its trustees are registered with the SEBI, and **(iii)** it complies with all the applicable provisions of these regulations and the Securities Contract (Regulation) Act. However, the following person(s) would not need registration to act as trustees of SPDEs: **(i)** Debenture trustee registered with the SEBI, **(ii)** A securitisation/asset reconstruction company registered with the RBI, **(iii)** The National Housing Bank (NHB), **(iv)** NABARD, **(v)** banks other than regional rural banks, **(vi)** PFIs, **(vii)** others specified by the SEBI. The applicant: **(i)** should have a minimum networth of ₹2 crore, **(ii)** has in its employment at least 2 persons who have at least 5 years total experience in activities related to securitisation and at least one should have professional qualification in law from a recognised institution/University in India/abroad. However, the NHB/NABARD are exempt from this requirement.

Factors for Consideration An application for registration should be made by the trustee to the SEBI in the prescribed form with non-refundable fee of ₹25,000. While considering the application, the SEBI would have regard to all relevant factors including: **(i)** the track record, professional competence and general reputation of the applicant/its promoters and directors, **(ii)** objectives of a body corporate applicant as per its memorandum of association/other constitutional documents, composition of its Board of Directors and other relevant matter, **(iii)** adequacy of infrastructure to ensure **(a)** proper servicing of securitisation transactions, adherence to the terms of the transaction documents by the originator, underwriter, enhancement provider, liquidity provider and other parties to the securitisation transaction and **(b)** compliance with the provisions of the Securities Contracts (Regulation) Act, these regulations, **(iv)** Compliance of the applicant and the SPDE with the requirements of these regulations, **(v)** rejection by the SEBI of any previous application by a person directly/indirectly connected with the applicant and **(vi)** the applicant/its promotes and directors are fit and proper persons. On payment of the registration fee of ₹50,000, the SEBI would grant a permanent certificate of registration.

Conditions of Registration The registration of the trustees would be subject to the following conditions: **(a)** obtain prior approval of the SEBI to change its management/control, **(b)** pay the annual fee of ₹10,000, **(c)** take adequate steps for redressal of investors grievances within one month and inform the SEBI about the number/nature and other particulars of the complaints received, **(d)** abide by the provisions of the Securities Contracts (Regulations) Act and these regulations in respect of the regulated activities of the SPDE, **(e)** forthwith inform the SEBI if any information/particulars provisionally submitted is found to be misleading/false, **(f)** forthwith inform the SEBI of any material change in the information/particulars furnished and **(g)** abide by the code of conduct specified below.

Code of Conduct The schemes of a SPDE should not be organised, operated, managed in the interest of the originator/sponsor/special class of investors. The interests of all classes of investors should be taken into account in such organisation, operation and management. A SPDE and its trustees should:

- Ensure the dissemination to all investors of adequate, accurate, explicit and timely information fairly presented in a simple language about the asset pools, transactions and arrangement with the originator, credit enhancer, underwriter, liquidity provider, SDIs, financial position, credit ratings and general affairs of the scheme/any other party to the securitisation or regulated entity,
- Avoid conflict of interests in managing the affairs of the scheme(s)/other regulated entities and keep the interests of all investors paramount in all respects,

- Ensure scheme-wise segregation of bank accounts, asset pools and SDIs-holders' accounts/ portfolio,
- Carry out the business in accordance with objectives stated in the offer documents and take decisions solely in the interest of investors,
- Not use any unfair/unethical means directly/indirectly to sell/market or induce any investor to buy the SDIs,
- Not employ any unfair/unethical means in valuation and conversion of assets pool or in the course of securitisation or any other regulated entity,
- Maintain high standards of integrity and fairness in all their dealings and in the conduct of their business,
- Render at all times high standards of service, exercise due diligence and independent professional judgment and take reasonable care/skill in performing its functions,
- Not make any exaggerated oral/written statement about their qualification/ capability to render services or their achievements or in respect of asset pools, and
- Always ensure that the debt and receivables acquired by it are through a genuine transaction amounting to a true sale of assets legally realisable by it.

A **special purpose distinct entity (SPDE)** means a trust which acquires debts/other receivables out of funds mobilised by it by issue of SDIs including any trust set up by the NHB and the NABARD. **Debt/receivables** means any right that generates or results into a cash flow and includes: **(i)** mortgage debt, **(ii)** such receivables arising out of securities specified by the SEBI and **(iii)** any financial asset in terms of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (**discussed in Chapter 11**). **Securitised debt instrument (SDI)** means any certificate/instrument by whatever name called issued to an investor by any issuer being a SPDE which possesses any debt/receivables including mortgage debt assigned to such entity and acknowledging beneficial interest of such investor in such debt/ receivables including mortgage debt. **Investor** means a person holding any SDI by which it acknowledges his interest in the debt/receivables assigned to the SPDE. **Securitisation** means acquisition of debt/receivables by any SPDE from any originator(s) for the purpose of issuance of SDIs to investors based on such debt/receivables and such issuance. **Originator** means the assignor of debt/receivables to a SPDE for the purpose of securitisation. **Liquidity provider** means a person who agrees to provide funds to the SPDE for settlement of payments due to investors according to the schedule of payments contained in the terms of the issue of the SDI issued to them in the event of any short-term cashflow shortfalls of the SPDE. **Issue** means an offer of SDI by a SPDE or under any scheme of such entity to the public/any person(s) proposed to be listed on a recognised stock exchange. **Credit enhancement** means any arrangement intended to increase the likelihood of a default on the SDIs including subordination, insurance, letter of credit, over-collateralisation, undertakings and guarantees. **Regulated activity** means any of the activities of the SPDE regulated by the SEBI under the Securities Contracts (Regulation) Act and these regulations and includes **(i)** making a public offer of SDIs/disclosures in connection with such issue, **(ii)** the performance of obligations relating to public offer/listing/redemption of such instruments, **(iii)** management/administration of schemes for issue of SDIs under which such instruments are issued, **(iv)** valuation/maintenance of accounts having a bearing on their value and **(v)** any other related activity specified by the SEBI. **Sponsor** means any person who establishes/promotes a SPDE. **Asset pools** means the total debt/receivables assigned to a SPDE and in which investors of such schemes have beneficial interest. **Offer document** means any document including electronic document described/issued as an offer document/prospectus and includes any notice, circular, advertisement or other document inviting public subscription/purchase of any SDI. **Servicer** means a person appointed by the SPDE who is responsible **(i)** for the management/collection of the asset pool, or **(ii)** making allocations/distributions to holders of the SDI but does not include a trustee for the issuer if the trustee receives such allocations/distributions.

Constitution and Management of SPDEs

The main elements relating to the constitution/management of SPDEs are listed below.

Structure for SPDE The SPDE should be constituted as a trust entitled to issue SDIs. The trust deed should be executed by the sponsor in favour of the trustees. The instrument of the trust/trust deed should contain clauses mentioned below and such other clauses which are necessary to protect the interests of the investors in the SDI.

Contents of Trust Deed The trustees should take in their custody/under their control the debts/receivables of the schemes of the SPDE and hold in trust for the benefit of the investors. The investors in the SDI have such beneficial interest in the underlying debt/receivables as have been offered by the scheme. The trustees themselves do not have any beneficial interest in the underlying debt/receivables. Their duties and obligations should be clearly specified. The particulars of their interest/association with the originator/sponsor should be furnished to the Board of Trustees/trustee company. The originator/any associate(s) should not exercise control over them. They should act in the best interest of the investors and provide information/disclosures to investors and the SEBI specified by it. They should take reasonable and due care to ensure that the funds raised under the schemes launched by the SPDE are in accordance with the provisions of the Securities Contracts (Regulation) Act and these regulations. They should also **(i)** issue certificates/instrument evidencing the beneficial interest of the investors in the debt/receivables assigned to the SPDE, **(ii)** declare that they/SPDE would not make/guarantee loans or take up any unregulated activity, **(iii)** lay down broad policies regarding allocation of payments, **(iv)** furnish annual report about the pool performance and the investor servicing to the investors, **(v)** determine trusteeship fee, and **(vi)** not carry out amendments to the trust deed prejudicially affecting the interest of the investors. Further, the removal of trustees would require the SEBI's prior approval. Finally, the trust deed should lay down the procedure for seeking approval of the investors under the circumstances specified in these regulations.

The trust deed should not contain clauses which have the effect of limiting/extinguishing/restricting/waiving/indemnifying **(1)** the obligations/liabilities of the trustees/SPDE in relation to any scheme/the rights or interests of investors, **(2)** the provisions of the Securities Contracts (Regulation) Act/these regulations/SEBI guidelines/circulars, **(3)** the trustees/SPDE for loss/damage caused to investors by their act of negligence/commission/omission.

The SPDE/trustees should adopt internal procedures to avoid conflict of interest. The SPDE should not raise money in the form debt/issue debt securities except through SDIs/security receipts. The SPDE should be entitled to segregate the debt/receivables out of the asset pool for servicing of any SDI. It should not be dissolved until the SDI issued under all its schemes are fully redeemed/written off according to their terms of issue. Not more than one-half of the trustees should be nominees of the sponsor/originator/ associates/company in the same management. In case of multiple schemes, **(i)** the SPDE should be capable of segregating the multiple securitisation schemes and **(ii)** the terms of issue of the SDI under each schemes/each series of such instruments should restrict the rights of the investors to the relevant asset pool alone.

The SPDE should carry on only regulated activities and not engage in **(i)** business of lending/investment except making passive financial investments required by the scheme; **(ii)** activities of an asset management company (AMC)/portfolio manager/ mutual fund. The restriction in **(i)** would not apply to any trust/body promoted by the NHB/NABARD/a securitisation or asset reconstruction company/any securitisation undertaken by a SPDE involving private placement of any instrument(s) representing securitised debt which would not be listed on any recognised stock exchange.

Assignment of Debt or Receivables The originator and the trustee should ensure in respect of the debt or receivables assigned to the SPDE that the following conditions are fulfilled:

(a) The debt/receivables generates/is reasonably expected to generate identifiable cash flows for the purpose of servicing the SDI;

(b) The originator has a valid enforceable interest in the assets and in the cash flow of the assets prior to the securitisation;

(c) The debt/receivables is free from any encumbrances/impediments to their free transfer or the transfer of the rights attaching thereto and their transfer does not constitute an event of default or acceleration trigger under any agreement;

(d) The necessary regulatory/contractual permissions/consents have been obtained in order to effect the transfer of such debt/receivables from the originator to the SPDE;

(e) The originator has not done/omitted to do anything which enables any of his debtors to exercise the right of set-off in relation to such assets;

(f) The debt/receivables transferred is at a price arrived at through an arms' length transaction and solely on commercial considerations; and

(g) Any representations and warrants made by the originator regarding the debt/receivables are duly adhered to.

The SPDE and the originator should take all necessary steps to ensure that the debt/receivable acquired by the SPDE are duly assigned in its name and are legally realisable by it. No SPDE should acquire any debt/receivables from any originator which is part of the same group or which is under the same management as the trustee.

The securitisation transaction should be structured in such a manner so as to minimise the risk of the asset pool being consolidated with the assets of the originator or the sponsor, in the event of insolvency or winding up of either of them.

The SPDE and its trustee should ensure that the debt and receivables assigned to it are through a genuine transaction amounting to a true sale and are legally realisable by it and the SPDE should be remote from the risk of bankruptcy, insolvency and winding up of the originator, sponsor and any other entity.

Obligations of Trustees A trustee should carry out his duties and perform his functions under these regulations, the trust deed or other document, with due care and diligence. He should ensure that the covenants in the trust deed and any other transaction documents are complied with by the concerned parties. He should: **(a)** supervise the implementation of the covenants regarding creation of security for the SDIs, **(b)** do necessary acts in the event the security becomes enforceable and supervise the enforcement of the security interest, **(c)** carry out necessary acts for resolving the investors' grievances and protection of their interests, **(d)** ensure the availability of trust property to pay the SDIs, **(e)** exercise due diligence to ensure compliance by the originators with the listing agreement/other transaction documents and in case of a bank/

NBFC with the RBI guidelines for securitisation, **(f)** take appropriate measures to protect the interest of the investors including any action/legal proceedings in respect of any material breach/ non-compliance of any law/rules/regulations/directions of the SEBI/ other regulatory body, **(g)** ensure that the SDIS have been repaid/ redeemed as per the provisions/conditions of their offer to the investors, **(h)** call for atleast quarterly reports from the originator regarding the performance of the underlying asset pool, **(i)** communicate atleast quarterly to the investors regarding the compliance by the servicer with its obligations and actions taken, **(j)** obtain on a quarterly basis a certificate from the auditors of the originator regarding the disclosures of the underlying asset pool assigned to the securitisation trust, **(k)** share the reports/auditors certificate from the originator/its auditors with the concerned rating agency, **(l)** call a meeting of the investors **(i)** on requisition in writing signed by atleast 10 per cent of the outstanding investors or **(ii)** at the occurrence of an event constituting a servicer default or **(iii)** which affects the interest of the investors, **(m) (i)** maintain the required networth on a continuous basis **(ii)** report any shortfall to the SEBI immediately and, **(iii)** take necessary corrective actions to restore it within 6 months, **(n)** promptly inform the investors of any change in registration status/administrative, civil, penal action by the SEBI/material change in financial position adversely affecting their interest, **(o)** not relinquish responsibility as trustee until the appointment of a another trustee in its place, **(p)** have necessary infrastructure to discharge duties including: **(i)** collecting information/reports from servicers/originators, **(ii)** generating cashflows/payment reports and meet all the reporting requirements under the RBI guidelines/circulars, **(iii)** recording investor information, **(iv)** entering/maintaining data for the SPDE including cashflows/audited financials/taxation aspects, **(v)** issuing cheques/demand drafts/generating RTGS/NEFT request for interest/principal payments, **(vi)** sufficient access controls to ensure confidentiality of data/systems for back-up and disaster recovery, **(q)** appoint a compliance officer for performing duties including: **(i)** monitoring the compliance of the acts/rules/regulation/notifications issued by the SEBI/Government, **(ii)** redressal of investor grievances.

Schemes of Special Purpose Distinct Entities

The provisions relating to the schemes of the SPDEs are discussed below.

Launching of Scheme A SPDE may raise funds by making an offer of SDIs through formulating schemes. Where there are multiple schemes, it should maintain separate and distinct accounts in respect of each and not commingle asset pools or realisations of a scheme with those of other schemes. The SPDE and trustees should ensure that realisations of debts and receivables are held and correctly applied towards redemption of SDIs issued under the respective schemes or towards payment of returns on such instruments or towards other permissible expenditure of the scheme. The terms of issue of the SDIs may provide for exercise of a clean-up call option by the SPDE subject to adequate disclosures. A **clean-up call option** means an option retained and exercisable by the originator to purchase the debt/receivables assigned to a SPDE if the residual value falls below a specified percentage of the price at which it was assigned. No expenses should be charged to the scheme in excess of the allowable expenses as may be specified in the scheme and any such expenditure, if incurred, should be brone by the trustees.

Obligations to Redeem Securitised Debt Instruments The trustee and the SPDE should ensure timely payment of interest and redemption amounts to the investors in terms of the offer document or other terms of issue of the SDI out of the reasliations from the asset pool, credit enhancer or liquidity provider. The trustee should ensure that the servicer adopts such prudent measures as may be expected under the origination documents to recover the dues from the obligors in the event of any default in any portion thereof. The expected period of maturity of each scheme and the possibility of extension or shortening of such period should be disclosed in the offer document together with the likely circumstances in which such extension or shortening may take place.

Credit Enhancement and Liquidity Facilities A SPDE may **(i)** opt for credit enhancement of the asset pool, **(ii)** avail the services of a liquidity provider, subject to making full disclosures of the arrangements in the offer document or the particulars submitted to the recognised stock exchange.

Servicers A SPDE may appoint either the originator or any other person as servicer in respect of any of its schemes, subject to the following. The trustee should ensure that the servicer **(i)** keeps proper accounts in respect of the activities delegated to him; **(ii)** has adequate operational systems and resources to administer the asset pool in relation to a securitisation transaction.

The servicer may be appointed by the SPDE to do all or any of the following: **(i)** coordinate with the obligors, manage the asset pool and collections therefrom; **(ii)** administer the cash flows of such asset pool, distributions to investors, and reinvestment, if any, in accordance with the scheme; and **(iii)** manage incidental matters. Where a SPDE appoints the originator as servicer, it should adopt internal procedures designed to avoid conflict of interest.

Accounts Without prejudice to provisions of the Companies Act/any other law, a SPDE should, maintain or cause to be maintained proper accounts and records to enable a true and fair view to be formed of its assets, liabilities, income and expenditure and those of all its schemes to comply with the disclosure requirements of these regulations and other applicable laws. The accounts should be maintained in such a manner so as to disclose as on the recent pay out date, the financial position of the scheme and should in particular give a true and fair view of the state of affairs of the scheme. The accounts of the SPDE and all its schemes should be maintained in accordance with the generally accepted accounting principles and having regard to the guidance issued by the Institute of Chartered Accountants of India or as maybe specified by the SEBI in respect of accounting for schemes.

Audit The accounts of the schemes formulated by SPDE should be audited by a chartered accountant at such frequency a may be specified in the listing agreement or conditions. Such audit should be conducted in accordance with generally accepted auditing standards. The scope of such audit may be specified by the SEBI.

Maintenance of Records A SPDE should maintain or cause to be maintained other records and documents, including a register of holders of SDIs, for each scheme so as to explain its transactions and its accounts. The register of beneficial owners maintained by a depository in respect of SDIs held in dematerialised form with it would be deemed to be a register of holders for the purpose. The SPDE should intimate to the SEBI the places where the records, documents and the accounts maintained are kept. It should maintain its books of account, records and other documents in respect of its schemes for a minimum period eight years from the redemption of all instruments issued under the scheme.

Holding of Originator No originator should at any time subscribe to, or hold, SDIs in excess of 20 per cent of the total SDIs issued by the SPDE in a particular scheme. This limit would not apply to the holdings of an originator acquired on account of underwriting of a public issue or in pursuance of an arrangement for credit enhancement. The possibilities of such holdings should be disclosed in the offer document or in the listing particulars.

Winding Up of Schemes A scheme may be wound up in the event of the following: **(a)** when the SDIs have been fully redeemed as per the scheme; **(b)** upon legal maturity as stated in the terms of issue of the SDI. However, if any debt/receivable is outstanding on legal maturity, the trustees should dispose off the same in accordance with the scheme and distribute the proceeds; **(c)** by vote of investors by a special resolution.

Public Offer of Securitised Debt Instruments

The requirements pertaining to the public offer of the SDIs are examined below.

Offer to the Public An offer would be treated as made to the public, if it can properly be regarded, in all the circumstances **(a)** as not being likely to result, directly or indirectly, in the SDIs becoming available for subscription or purchase by persons other than those receiving the offer, **(b)** otherwise as being the domestic concern of the persons making and receiving the offer. Any offer made to 50 or more persons in a financial year would always be deemed to have been made to the public only in respect of SDIs which belong to the same tranche and which are *pari passu* in all respects.

Submission of Draft Offer Document and Filling of Final Offer Document To make an offer of SDIs to the public, a SPDE/trustees should file a draft offer document with SEBI at least 15 working days before the proposed opening of the issue along with the minimum filing fee of 0.03 per cent of the amount raised subject to a minimum and maximum of ₹10,000 and ₹25,000. If the SEBI specifies any changes to be made in the offer document, the SPDE and trustee should carry out such changes prior to filing it with the designated stock exchange. The final offer document should be filed with the SEBI and with every recognised stock exchange to which an application for listing of the SDIs is proposed to be made prior to its issuance to public.

Arrangements for Dematerialisation Prior to submitting the draft offer document with the SEBI, the SPDE should enter into an arrangement with a registered depository for dematerialisation of the SDIs that are proposed to be issued to the public. The investors should be given an option to receive the SDIs either in the physical form or in dematerialised form. The holders of dematerialised instruments would have the same rights and liabilities as holders of physical instruments.

Mandatory Listing The SPDE desirous of making an offer of SDIs to the public should make an application for listing to one or more recognised stock exchanges.

Credit Rating To offer SDIs to the public, credit rating should be obtained from not less than two registered credit rating agencies. All credit ratings obtained by a SPDE should be disclosed in the offer document, including unaccepted credit ratings. The rating agency should include reference to the following in the rating rationale: **(a)** quality of the asset pool and the strength of cash flows; **(b)** payment structure; **(c)** adequacy of credit enhancements; **(d)** originator profile; **(e)** risks and concerns for investors and mitigating factors; **(f)** quality and experience of the servicer; **(g)** terms of the servicer contact; **(h)** provision for appointment of back-up servicer, if any; **(i)** any other relevant information.

Contents of Offer Document An offer issued by a SPDE/trustee should contain all material information which is true, fair and adequate for an investor to make informed investment decision and also disclose the matters specified in **Appendix 4-A on the website. The website address is http://www.mhhe.com/khanifs10e.**

An offer document should not include a statement purporting to be made by an expert unless: **(a)** he has given his written consent to the offer document being issued with the statement included in the form and context in which it is included; **(b)** such consent is not revoked by him prior to its filing with the SEBI; and **(c)** a statement that he has given and has not withdrawn his consent as aforesaid appears in the offer document.

Prohibition of Mistatements in the Offer Document An offer document or any report or memorandum issued by a SPDE in connection with an offer of SDIs should not **(i)** contain any false or misleading statement; **(ii)** omit disclosure of any material fact which may make the statements made therein, in light of the circumstances under which they are made, misleading.

Underwriting of the Issue A public offer made by a SPDE may be underwritten by an underwriter registered with the SEBI.

Offer Period No public offer of SDIs would remain open for more than 30 days.

Minimum Subscription The offer document should disclose the minimum subscription (i.e. the amount which, in the opinion of the directors of the originator and trustees of the SPDE, must be raised by issue of SDIs) it seeks to raise under the scheme. No SDI should be allotted under the public offer unless subscription have been received in respect of the minimum number of SDIs which will constitute minimum subscription. In the event of non-receipt of minimum subscription or refusal of listing by any recognised stock exchange, all application moneys received in the public offer should be refunded forthwith to the applicants.

Allotment and Other Obligations The SDIs should be allotted to the investors within the following time periods: **(a)** in case of dematerialised securitised debt instruments, within 5 days of closure of the offer; **(b)** in case of SDIs in the physical form, the certificates should be dispatched within 8 days of closure of the offer. No SPDE should retain any oversubscription received in public offer. In the event of over-subscription, the allotment should be made as per the basis of allotment finalised in consultation with the recognised stock exchanges to which an application for listing was made. The SPDE should dispatch refund orders to unsuccessful or partially successful applicants within 8 days of closure of the offer. In a case where the issue proceeds become liable to be refunded in accordance with the disclosures made in the offer document, the refund orders should be dispatched within 8 days of closure of the offer. Where the allotment is not made within the same specified period, or where the certificates are not dispatched within the time mentioned, the SPDE/trustee, and where any such trustee is a body corporate, every director thereof, who is in default would, on and from the expiry of such period, be jointly and severally liable to pay interest at the rate of 15 per cent per annum to the concerned applicants. Where the refund orders are not dispatched within the time mentioned, the SPDE/trustee thereof, and where any such trustee is a body corporate, every director thereof, who is in default would, on and from the expiry of the eighth day, be jointly and severally liable to repay that money with interest at the rate of 15 per cent per annum. Credit to the demat accounts of the allottees should be made by the issuer within 2 days from the date of allotment.

Post-issue Obligation The SPDE should file such reports and furnish such information to the SEBI or to the investors, as directed by the SEBI from time to time.

Rights of Investors

The rights of investors in a SDI are as follows.

Transferability of Securitised Debt Instruments The SDIs issued to the public or listed on a recognised sock exchange should be freely transferable.

Rights of Investors in Securities Issued by Special Purpose Distinct Entity The trust deed or other instrument comprising the terms of issue of the SDIs issued by a SPDE should provide that investors holding such SDIs have such beneficial interest in the underlying debt or receivables as may have been conferred by the scheme. In the event of failure of the SPDe to redeem any SDIs offered through an offer document or listed, within the time and in accordance with the conditions stated in the offer document or other terms of issue, the investors holding not less than 10 per cent in nominal value of such SDIs would be entitled to call a meeting of all such investors. In such meeting, the investors may move a motion to **(a)** call upon the trustee and the SPDE to wind up the scheme and distribute the realisations; **(b)** remove the trustee; **(c)** appoint a new trustee in place of the one removed. Any such decision should be taken by means of a special resolution of the investors of the scheme and provisions of the Companies Act, would *mutates mutandis* apply to such special resolution. The trustee and the SPDE should take all reasonable steps to carry out the resolutions passed by the investors. Any reasonable expenses incurred **(i)** in calling and holding a meeting **(ii)** by the trustee or the new trustee, in winding up the scheme and incidental activities would be met from or reimbursed out of realisations from the asset pool. The terms of issue of SDIs should not be adversely varied without the consent of the investors. Investors should be deemed to have given their consent to variation if and only if 21 days notice is given to them of the proposed variation and it is approved by a special resolution passed by them through postal ballot.

Listing of Securitised Debt Instruments

The listing the requirements of the SDIs are listed below.

Application for Listing A SPDE should make an application to the stock exchange in the form specified by it along with the following documents and particulars: **(a)** trust deed or other constitutional document, as the case may be; **(b)** copies of all offer documents and advertisement in connection with offer of SDIs by the SPDE or its trustee at any time; **(c)** certified copy of every material document or proposed document which is referred to in any such offer document; **(d)** certified copies of agreements or memoranda of understanding relating to acquisition or proposed acquisition of debt or receivables from a financial institution or other person; **(e)** certified copy of certificate of registration granted by the SEBI to the trustee under these regulations; **(f)** specimen of any other SDI issued by the SPDE which are listed or proposed to be listed; **(g)** any other document or particular as may be required by the stock exchange.

As a condition for listing, the SDIs issued by a SPDE should have the following characteristics: **(a)** free transferability; **(b)** being in the nature of such undivided beneficial interest of the investors in the asset pool as is specified in the scheme, and not constituting debt of the SPDe or originator; **(c)** maintenance of a record of the holders, thereof, whether holding the same in physical form or dematerilaised form.

The SPDE should enter into a listing agreement with the recognised stock exchanges where the SDIs are proposed to be listed.

Listing Agreement The SPDEs should execute an agreement with the concerned stock exchange(s) for listing the SDIs.

Security Deposit The issuers should deposit, before the opening of the subscription list, equal to 1 per cent of the amount of securities offered to the public for subscription and refundable/ forfeitable in the SEBI-specified manner.

Minimum Public Offering for Listing In respect of public offers of SDIs, the SPDE or trustee should satisfy the recognised stock exchange to which a listing application is made that each scheme of SDIs was offered to the public for subscription through advertisements in newspapers for a period of not less than two days and that applications received in pursuance of the offer were allotted in accordance with these regulations and the disclosures made in the offer document.

In case of a private placement, the SPDE should **(i)** ensure that it has obtained credit rating from a recognised credit rating agency in respect of its SDIs, **(ii)** file listing particulars with the recognised stock exchange along with the application made containing such information as may be necessary for any investor in the secondary market to make an informed investment decision in respect of its SDIs and the SPDI should promptly disseminate the prescribed information in the stock exchange-determined manner.

All credit ratings obtained, including unaccepted ratings, if any, should be disclosed in the listing particulars filed with the recognised stock exchange.

Continuous Listing Conditions The SPDE or trustee should submit such information, including financial information relating to the schemes, to the stock exchanges and investors and comply with such other continuing obligations as may be stipulated in the listing agreement.

Trading of Securitised Debt Instruments The SDIs issued to the public or on a private placement basis, which are listed in recognised stock exchanges, should be traded and such trades should be cleared and settled subject to conditions specified by the SEBI.

Inspection and Disciplinary Proceedings

The provisions relating to inspection and disciplinary proceedings are discussed below.

Power to Call for Information The SEBI may call for information from the originator, SPDE, trustee (whether registered with the SEBI or not), sponsor, servicers, underwriters, credit enhancers, liquidity providers or any other person associated with securitisation or any regulated activity.

Right of Inspection by the SEBI The SEBI may appoint one or more persons to undertake the inspection of the books of account, records and documents of the SPDE or any of its schemes or its trustee (whether registered with the SEBI or note) or servicer or any other agent for any of the purposes specified below: **(a)** To verify whether **(i)** the books of account are being maintained and valuations are being done in a proper manner, **(ii)** the provisions of the Securities Contracts (Regulation) Act, the SEBI Act, the rules and regulations made thereunder are being complied with; **(b)** To inquire into **(i)** the complaints received from investors, other market participants or any other persons or any matter having a bearing on the regulated activities of the SPDE; **(ii)** affairs of the SPDE *suo moto* in the interest of investor protection or the integrity of the market in so far as it relates to its regulated activities, **(iii)** securitisation or regulated activity is being carried on as per provisions of the Securities Contract (Regulation) Act and these regulations; and **(iv)** the code of conduct has been observed.

Before undertaking an inspection, the SEBI would give a reasonable notice to the SDPE or other person. However, where the SEBI is satisfied that in the interest of the investors no such notice should be given, it may be by an order in writing direct that the inspection of the affairs of the SPDE or other person be taken up without such notice. During the course of inspection the SPDE and other persons would be bound to discharge its obligations as provided below.

Obligations of Special Purpose Distinct Entities on Inspection It should be the duty of every director, trustee, officer, employee, servicer or any other agent of the SPDE who is being inspected to produce to the inspecting authority such books of account and other documents in his custody or control and furnish him with such statements and information relating to regulated activities of the SPDE as he may require within the specified time. They should allow the inspecting authority to have a reasonable access to the premises occupied by the SPDE/any other person, on its behalf and also extend reasonable facility for examining any books, records, documents, computer systems and computer data in the possession of the SPDE or any such other person and also provide copies of documents or other material which in the opinion of the inspecting authority are relevant for the purposes of the inspection.

The inspecting authority would in the course of inspection, be entitled to examine or record statements of any principal officer, director, partner, proprietor and employee of the SPDE or the other person whose records or other documents are being inspected.

It would be the duty of every director, proprietor, partner, officer, employee, servicer or other agent of the SPDE or the other person whose records or other documents are being inspected to give to the inspecting authority all assistance in connection with the inspection which the special purpose distinct entity may reasonably be expected to give.

Appointment of Auditor or Valuer The SEBI may appoint a qualified auditor to inspect the books of account or inquire in to the affairs of the SPDE, servicer or other agent of the SPDE insofar as it concerns its regulated activities. The auditor would have the same, powers of the inspecting authority and the obligation of the SPDE and its employees to the inspection authority would be applicable to the investigation under this regulation.

The SEBI may appoint a valuer or direct a valuer to be appointed, if so required in the interest of investors in a scheme for the purpose of proper valuation of asset pools acquired or held by a SPDE. The expenses of such audit would or valuation be borne by the originator, trustee, or other person if so specified by the SEBI.

Submission of Report to the SEBI The inspecting authority would as soon as may be possible, submit an inspection report to the SEBI. On submission of the inspection report, SEBI may take such action thereon as it may deem fit and appropriate.

Procedure for Action in Case of Default

The actions for default are listed below.

Cancellation or Suspension of Registration The registration granted to a trustee who **(a)** fails to comply with any conditions subject to which certificate has been granted; **(b)** contravenes any of the provisions of the Securities Contracts (Regulation) Act, the SEBI Act or the regulations made thereunder may be cancelled or suspended by the SEBI. While passing an order of suspension or cancellation of registration of a trustee, the SEBI may also direct winding up of the schemes (i.e. liquidation of the asset pool and payment of the proceeds to the investors) of the SPDE within such period and in such manner as may be directed.

Directions In the interest of the securities market/investors or for the purpose of securing the proper management of any SPDE or trustee, the SEBI may pass, any or all of the following directions: **(a)** directing the originator or any other persons associated with securitisation or regulated activity to refund any money collected under an issue to the investors with or without requisite interest, as the case may be; **(b)** directing the persons associated with securitisation or regulated activity concerned not to access the capital market or not to deal in securities or SDIs for a particular period or not to engage in securitisation unregulated activities; **(c)** directing the recognised stock exchange concerned not to permit trading in the SDIs; **(d)** directing the recognised stock exchange concerned to suspend trading in SDIs; **(e)** any other direction which the SEBI may deem fit and proper in the circumstances of the case.

Appeal A person aggrieved by an order of the SEBI or adjudicating officer under the Securities Contracts (Regulation) Act, the SEBI Act, or these regulations or refusal of listing by a recognised sock exchange may prefer an appeal to the Securities Appellate Tribunal.

CONCLUDING OBSERVATIONS

- The main elements of the basic legal framework of the securities market in India are–company law, securities contracts regulations and rules, listing of securities, and SEBI buy-back of securities regulations.
- The Companies Act, while providing for regulation of companies, includes a general framework for dealings in securities of public limited companies. It relates, *inter-alia*, to share capital/ issue of shares, prospectus/abridged prospectus, issue of shares on a rights basis, issue of debentures, allotment of shares and issue of share certificates.
- The memorandum of association of a limited company should state its authorised capital, that is, the amount of shares upto which it can, at any time, raise capital by issuing shares for subscription (issued capital) and collect money from the shareholders (paid-up capital). A share is the right to a specified amount of the share capital of a company, carrying with it certain rights and liabilities. It is transferable. There are two types of shares: equity and preference. Preference shares carry preferential rights to a fixed dividend and return of capital, redeemable within 10 years. Cumulative convertible preference shares can be converted into equity shares. Shares other than preference shares are the equity shares.
- The power to issue shares is vested in the Board of Directors. Shares can be issued at a premium/discount.

- A company can buy-back its shares/other specified securities. The buy-back may be from **(i)** the existing securityholders, on a proportionate basis, **(ii)** the open market, **(iii)** odd lots and **(iv)** employees who have been issued securities pursuant to a scheme of stock option/sweat equity, that is, shares issued at a discount for consideration other than cash. The securities bought back should be extinguished and physically destroyed within 7 days of the completion of buy-back. A company which buys back its securities is prohibited from further issue of securities for 2 years.
- A prospectus refers to any document by which capital is offered to the public and upon the basis of which the applicants actually subscribe. Its main purpose is to invite offers from the public for the subscription/purchase of securities of a company. The main contents of a prospectus are prescribed by Part I of Schedule-II of the Companies Act.
- The shares offered to existing shareholders are called rights issues. Any further issues of shares of a company must be offered to the existing shareholders. They have also the right of renunciation.
- There are different types of debentures, such as perpetual, redeemable, mortgage, convertible and non-convertible. Companies by and large, issue redeemable mortgage debentures. The convertible debentures can be fully/partly convertible. The conversion can be compulsory or optional. No company can issue debentures carrying voting rights. The rights of debenture-holders depend solely on the terms of their issue. The provisions relating to allotment, listing and so on, applicable to shares, are also applicable to debentures.
- Allotment of shares in public issues is prohibited unless the amount of minimum subscription stated in the prospectus is subscribed and the application money received. A company issuing shares/debentures must apply for permission to list these securities. The return of allotment should be filed with the Registrar of Companies within 30 days from the date of allotment.
- A share certificate is a prima facie evidence of the title of the member to such shares. It is a proof of ownership of shares.
- The SEBI has been set up to protect the interest of the investors in the securities market and to promote the development of, and to regulate the securities market by measures, *inter alia*, such as regulating the business in stock exchanges/any other securities market(s); registering and regulating the working of intermediaries (i.e.) brokers, share transfer agents, bankers to an issue, trustees, registrar to an issue, merchant bankers, underwriters, portfolio managers, investment advisors, depositories, custodian, depository participants, FIIs, credit rating agencies, venture capital funds, mutual funds, and so on); prohibiting fraudulent and unfair trade practices/insider trading; regulating acquisition of shares and takeover of companies; promoting investor education and training of intermediaries; performing functions and exercising powers under the provisions of the SCRA; taking action against defaulters and so on.
- The SEBI may, for the protection of investors, specify regulations/prohibition of issue of prospectus, offer document, advertisement or soliciting money for issue of securities.
- In the interest of investors/the orderly development of the securities market or to prevent the affairs of an intermediary being conducted in a manner detrimental to the interests or to secure proper management of such intermediary, SEBI may issue appropriate directions.
- In case of (i) violation of any provision of the SEBI Act/rules/regulations/ directions or (ii) transactions being dealt with in a manner detrimental to the securities market/investors, SEBI can conduct an investigation into the affairs of the violators.
- The SEBI is empowered to prohibit manipulative and deceptive devices, insider trading and substantial acquisition of shares.

- All intermediaries should conduct their business in accordance with the conditions of the certificate of registration from SEBI and the relevant regulations.
- Penalties can be imposed by the SEBI on different intermediaries, for failures/defaults, such as, a failure to furnish information/return and maintain books of accounts/records/documents; failure to enter into an agreement with clients/to redress investors grievances; failure by an AMC to observe rules/regulations; defaults in case of mutual funds/stock brokers; insider tradings; non-disclosure of substantial acquisition of shares and takeover bids; fraudulent and unfair trade practices and so on.
- The Central Government can issue directions to the SEBI on questions of policy. It can supersede the SEBI. Any contravention of the provisions of the SEBI Act/regulations/ rules is punishable with imprisonment upto 10 years or fine upto ₹25 crore or both.
- To redress the grievances of investors, the SEBI has established an ombudsman/stipendary ombudsman. The ombudsman would receive complaints, facilitate their resolution by amicable settlement, approve an amicable settlement between parties and adjudicate complaints in the event of failure of amicable settlement.
- The Companies Act permits buy-back of shares/specified securities, from out of the reserves/ securities premium account and the proceeds of an earlier issue other than a fresh issue made specifically for buy-back purposes. The stipulations for buy-back are: the articles of association must permit, it, authorisation by a special resolution in a general meeting, ceiling of 25 per cent of paid-up capital and free reserves, ratio of debt to equity, should not exceed 2:1, fully paid-up shares/specified securities and in conformity with SEBI regulations.
- Companies are not allowed to buy-back securities **(i)** through subsidiary/investment companies and **(ii)** if default subsits in respect of repayment of deposists/term loans/redemption of debentures/preference shares.
- The buy-back may be from **(i)** the existing securityholders on a proportionate basis, **(ii)** open market, **(iii)** odd lots and **(iv)** employees, pursuant to a scheme of stock option/sweet equity issued for considerations other than cash.
- All listed companies have to file with the ROCs/SEBI, a declaration of solvency. The securities purchased under the buy-back arrangement should be extinguished and physically destroyed within 7 days of the last date of completion of buy-back. Within 30 days of the completion of the buy-back, a return containing all the particulars must be filed with the ROCs/SEBI.
- The main elements of the SEBI Buy-Back of Securities Regulations are: conditions of buy-back, buy-back through tender offer, buy-back from the open-market, general obligations and penalties and procedures.
- To buy-back securities, a listed company should be authorised to do so by a special resolution in a general meeting of the shareholders or through a resolution by its Board of Directors. A copy of the special resolution should be filed with the SEBI/concerned stock exchange(s) within 7 days from the date of passing the resolution. In the case of a Board resolution, public announcement should be preceded by a notice within two days, in at least one English national daily, one Hindi daily and a regional language daily. A copy of the resolution should be filed with the SEBI in case of a Board resolution and the explanatory statement annexed to the notice for general meeting in case of the special resolution would be the same.
- A tender offer means an offer by a company to buy-back through a letter of offer, from the holders of shares or other specified securities, on a proportionate basis. The explanatory statement/public announcement should also discuss the maximum price at which the buy-back would be made and the quantum proposed to be tendered by the promoters, together with details of their transactions and holdings for the last six months, including information about

the number of shares/securities acquired, and the price and the date of acquisition. The offer should remain for a minimum of 15 days and a maximum of 30 days. The date of opening of the offer should not be earlier than 7 days or later than 30 days from the specified date. The letter of offer should reach the securityholders before the opening of the offer. The company should deposit in an escrow account, 25 per cent on or before the opening of the offer. In case of non-fulfillment of obligations by the company, the escrow account may be forfeited by the SEBI. The company should pay the consideration within 7 days of the time specified for accepted offers. The security certificates should be extinguished and destroyed within 15 days of acceptance of the shares/securities. A certificate of compliance should be furnished to the SEBI.

- The provisions pertaining to buy-back through a tender offer are also applicable to odd-lot shares/other specified securities.
- A buy-back from the open market may be through a stock exchange and book-building process.
- The buy-back through a stock exchange can be made only on a stock exchange with nation-wide trading terminals and through the order matching mechanism. The maximum price at which the buy-back would be made should be specified. Information on a daily basis regarding purchases for the buy-back should be given to the stock exchange and published in a national daily on a fortnightly basis and every time an additional 5 per cent of the buy-back has been completed. The provisions pertaining to the extinguishment of certificates in the case of a tender offer are also applicable in this method.
- The public announcement in case of buy-back through book building should contain a detailed methodology of the book building process, the manner of acceptance, the details of the bidding centres and so on. The offer should remain open for 15-30 days. The final (highest) buy-back price, based on the acceptances received, should be paid to all holders whose shares/securities have been accepted for buy-back. The provisions pertaining to the verification of acceptances, opening of a special account, payment of consideration and extinguishment of certificates, applicable to a tender offer, are also applicable to this method.
- The company and the merchant banker have to ensure compliance with the obligations prescribed by the SEBI. On a failure to comply with the obligations or to observe due diligence, the SEBI may initiate action against the merchant banker in terms of the relevant SEBI regulations. Similarly, it can initiate action against the registrar to the issue or the broker, in terms of the SEBI regulations applicable to them.
- The SEBI may order an investigation in respect of the conduct of affairs of any person associated with the process of buy-back, to ascertain any contravention of the SEBI regulations. It can also issue directions as it deems fit. Any person guilty of insider trading or market manipulation would be dealt with according to the provisions of the SEBI Insider Trading Regulations and the Prohibition of Fraudulent and Unfair Trading Practices, relating to securities regulations.
- Intermediary means brokers/sub-brokers/share transfer agents/bankers to an issue, trustees, registrar to an issue, merchant bankers, underwriters, portfolio managers, investment advisors, depositories/participants/ custodians, credit rating agencies and other intermediaries associated with the securities market in any manner/specified by the SEBI including an asset management company, clearing member of a clearing corporation/house and a trading member of a derivative exchange but does not include a FII, foreign venture capital investor, mutual fund, collective investment scheme and venture capital fund.
- The main elements of the regulation of intermediaries is registration, obligations, inspection and disciplinarian proceedings and action in case of default.
- To act as an intermediary, a registration with the SEBI under the applicable regulations is necessary. Separate registration would be necessary to carry on each activity.

- For granting registration, the SEBI would take into account all relevant matters including whether **(1)** the applicant/associate has been refused registration, **(2)** the applicant/director/partner trustee/principal officer is involved in any pending legislation, **(3)** the applicant satisfies the eligibility criteria an **(4)** the registration is in the interest of the investors and the development of the securities market.
- The applicant should also be a fit and proper person in terms, *inter-alia*, **(i)** integrity reputation and character, **(ii)** absence of conviction and restraint order and **(iii)** competence including financial solvency and networth.
- The registration would be permanent but subject to the following conditions: **(i)** obtain prior approval of the SEBI to change its status/constitution, **(ii)** pay the applicable fee; abide by the securities laws; continuously comply with disclosures requirements; and meet the specified eligibility criteria.
- The obligations of the intermediaries are: general obligation, redressal of investor grievances, appointment of compliance office, investment advice and code of conduct.
- The compliance officer should certify on April 1 every year its compliance with all obligations/responsibilities and the fulfilment of eligibility criteria on a continuous basis and that all disclosures are true and complete.
- Investors grievances should be redressed within a maximum of 45 days.
- While giving any investment advice, its interest in the security should be disclosed.
- The intermediary/directors/officers/employees key management personnel should continuously abide by the code of conduct in terms of **(1)** investor protection, **(2)** disbursal of amount, **(3)** disclosure of information, **(4)** conflict of interest, **(5)** compliance with corporate governance and **(6)** infrastructure requirements.
- The SEBI may appoint inspecting authority/auditor/valuer to undertake inspection of books/accounts/records/documents of an intermediary **(i)** to ensure maintenance in the required manner, **(ii)** establishment and following of adequate internal control systems/procedures/safeguards, **(iii)** to ensure compliance with the provisions of the securities laws, **(iv)** enquire into a complaints from any concerned party and so on.
- Failure of a registered intermediary to comply with any conditions subject to which registration has been granted and contravention of provisions of the securities laws would result in **(1)** its suspension/cancellation of its registration, **(2)** prohibition on taking up new assignment, **(3)** debarring **(a)** principal officer from employment, **(b)** branch from carrying out activities, and **(4)** issue of warning.
- Any aggrieved party by an order of the SEBI may appeal an appeal to the SAT against such order.
- The SEBI may, in the interest of the securities market/investor and for securing the proper management of an intermediary, issue the specified directions.
- The main elements of the regulations relating to public offers of securitised debt instruments (SDIs) and listing on a recognised stock exchange are: registration of trustees, constitution/management of special purpose distinct entities (SPDEs), schemes of SPDEs, public offer of SDIs, rights of investors, listing of SDIs, inspection and disciplinary proceedings, and action in case of default.
- Public offer and listing of SDIs can be made only by SPDEs if its trustees are registered with the SEBI and it complies with all the applicable provisions of these regulations and the Securities Contracts (Regulation) Act. However, SEBI-registered debenture trustees, RBI-registered securitisation/asset reconstruction companies, NHB and NABARD would not require registration to act as trustees. A **SDI** means any certificate/instrument issued to an investor by SPDE which

possesses any debt/receivables including mortgage debt assigned to it and acknowledging beneficial interest of such investors.

- While considering registration, the SEBI would have regard to all relevant factors, including: **(i)** track record, professional competence and general reputation of the applicant, **(ii)** objectives of a body corporate applicant, **(iii)** adequacy of its infrastructure, **(iv)** compliance with the provisions of these regulations, **(v)** rejection by the SEBI of any previous application, and **(vi)** the applicant/promoters/directors are fit and proper person.
- The registration of the trustees would be subject to the following conditions: **(i)** prior approval of the SEBI to change its management/control, **(ii)** adequate steps for redressal of investors grievances, **(iii)** abide by the provisions of these regulations/Securities Contracts (Regulation) Act, **(iv)** forthwith inform the SEBI **(a)** if information/particulars previously submitted is false/misleading, **(b)** of any material change in the information submitted and **(v)** abide by the specified code of conduct.
- The SPDE should be constituted as a trust entitled to issue SDIs. The trust deed should contain the specified clauses.
- A SPDE may raise funds by offering SDIs through a scheme. The scheme should consist of the following elements: **(i)** obligation to redeem the SDIs, **(ii)** credit enhancement and liquidity facilities, **(iii)** servicers, **(iv)** accounts, **(v)** audit, **(vi)** maintenance of records, **(vi)** holding of originator and **(viii)** winding up.
- The stipulations relating to the public offer of the SDIs are: **(i)** offer to the public, **(ii)** submission of draft offer document and filing of final offer document, **(iii)** arrangement for dematerialisaion, **(iv)** mandatory listing, **(v)** credit rating, **(vi)** contents of the offer document, **(vii)** prohibition on misstatements in the offer document, **(viii)** underwriting of the issue, **(ix)** offer period, **(x)** minimum subscription, (xi) allotment and other obligations and **(xii)** post-issue obligations.
- The rights of investors are two-folds: free transferability of the SDIs and their rights in the securities issued by the SPDE.
- The provisions relating to the listing of the SDIs include: **(a)** application for listing, **(b)** minimum public offering for listing, **(c)** continuous listing conditions and **(d)** trading.
- As regards, inspection and disciplinary proceedings, the provisions relate to **(1)** power of the SEBI to call for information, **(2)** right of inspection by the SEBI, **(3)** obligations of the SPDE on inspection, **(4)** appointment of auditor/valuer and **(5)** submission of report to the SEBI.
- Action in case of default would result in suspension/cancellation of registration of the SPDE. The SEBI may also pass the specified directions to the SPDE/trustees. An aggrieved party may prefer an appeal to the SAT.

CHAPTER 5

Regulatory Framework: Secondary Market

INTRODUCTION

The chapter focuses on the regulatory framework relating to the secondary market in India. Section 1-2 cover the Securities Contracts (Regulation) Act and the Securities Contracts (Regulation) Rules respectively. The Securities Contracts Regulation (Stock Exchanges and Clearing Corporations) Regulation 2012 is discussed in Section 3. Sections 4-5 cover the SEBI **(i)** Listing Obligations and Disclosure Requirement Regulations 2015, **(ii)** Delisting of Securities Regulation respectively. Concluding observations are given in the last Section.

SECURITIES CONTRACTS (REGULATION) ACT

The first legislative measure providing for the regulation of stock exchanges was enacted in 1925—the Bombay Securities Contracts Control Act, 1925—to regulate and control certain contracts for the purchase and sale of securities in the city of Bombay and elsewhere in the Bombay Presidency. However, the impact of the Act on the regulation of trading in securities was rather insignificant. In 1951, a draft bill on stock exchange regulation in India, based on the report of a committee, was prepared and referred to an expert committee under the chairmanship of A.D. Gorawala. The recommendations of the Gorawala Committee (1954) culminated in the enactment of the Securities Contracts (Regulation) Act (SCRA), 1956, which has been amended from time to time. The SCRA provides the broad framework of the present scheme of stock exchange regulation in India. Stock exchange means **(a)** any body of individuals, whether incor-porated or not, constituted before corporatisation and demutualisation or **(b)** a body corporate incorporated under the Companies Act, whether under a scheme of corporatisation or demutualisation or otherwise for the purpose of assisting/regulat-ing/controlling the business of buying, selling or dealing in securities. Corporatisation means the succession of a recognised stock exchange, being a body of individuals or a society regis-tered under the Societies Registration Act by another stock exchange, being a company incorporated for the purpose of assist-ing/regulating/controlling the business of buying/selling/deal-ing in securities carried on by such individuals/

society. Demutualisation means the segregation of ownership and management from the trading rights of the members of a recognised stock exchange in accordance with a scheme by the SEBI. Such a scheme means a scheme for corporatisation and demutualisation of a recognised stock exchange which may provide for:

- The issue of shares for a lawful consideration and provision of trading rights in lieu of membership cards of the members of a recognised stock exchange,
- The restriction on voting rights,
- The transfer of property/business/assets/rights/liabilities/recognitions/contracts of the stock exchange/legal proceedings by or against, the stock exchange, which in the name of the stock exchange or any trustee or otherwise and any permission given to, or by the stock ex-change,
- Transfer of employees of a recognised stock exchange to another recognised stock exchange,
- Any other matter required for the purpose of, or in connection with, the corporatisation/ demutualisationof the recognised stock exchange.

Object

The object of the SCRA is to prevent undesirable transactions in securities by regulating the business of dealing therein, by providing for certain other matters connected therewith. It also seeks to regulate the buying and selling of securities outside the limits of stock exchanges through the licensing of security dealers. The SCRA sets up a general framework of control that makes the Government/SEBI influence all pervasive. At the same time, as an enabling legislative measure, it provides the Government/SEBI with a flexible apparatus for the regulation of the stock market in India. Securities include

(1) shares, scrips, stocks, bonds/debentures/debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate,

(2) derivatives, which include (A) a security derived from a debt instrument, share, secured/ unsecured loan, risk instrument or contract for differences therefor or any other form of security; (B) a contract which derives its value from the prices/index of prices of underlying securities;

(3) units or any other instrument issued by any collective investment scheme or units or any other such instrument issued to invest ors under any mutual fund scheme,

(4) Government securities,

(5) such other instruments as may be decided by the Government to be security [e.g. onshore rupee bonds isssued by the Asian Development Bank (ADB) and the International Finance Corporation (IFC)]

(6) rights or interests in securities,

(7) security receipts issued by asset reconstruction companies and

(8) any certificate/instrument (by whatever name called) issued to an investor by any special purpose distinct entity which possesses any debt or receivables including mortgage debt assigned to such entity and acknowledging beneficial interest of such investor in such debt/receivable including mortgage debt.

The main scheme of regulation provided by the SCRA can broadly be divided under five main headings: **(i)** Constitution of recognised stock exchanges, **(ii)** Contracts and options in securities, **(iii)** Listing of securities, **(iv)** Penalties and procedures and **(v)** Miscellaneous/ other matters.

Recognition of Stock Exchanges

The main stipulation relating to the recognition of stock exchanges pertain to **(i)** Application, **(ii)** Conditions, **(iii)** Terms, **(iv)** Withdrawl, **(v)** Periodical returns, **(vi)** Inquiries, **(vii)** Annual reports, **(viii)** Making/amending rules, **(ix)** Bye-laws of recognised stock exchanges and **(x)** Powers of the SEBI.

Application For recognition, a stock exchange should apply to the government/SEBI in the prescribed manner accompanied by a copy of the bye-laws, of the stock exchange, for regulation and control of contracts as well as a copy of the rules relating in general to its constitution and in particular to **(a)** the governing body of the stock exchange, its constitution and powers of management and the manner in which its business is to be transacted; **(b)** the powers and duties of the office bearers of the stock exchange; **(c)** the admission of various classes of members into the stock exchange, the qualifications needed for membership, and the exclusion, suspension, expulsion, and readmission of members therefrom or thereinto and **(d)** the procedure of registration of partnerships as members of the stock exchange and the nomination and appointment of authorised representatives and clerks by the stock exchange.

Conditions In granting recognition, the SEBI may impose conditions relating to **(i)** the qualification for membership of the stock exchange; **(ii)** the manner in which contracts should be entered into and enforced as between members; **(iii)** the representation of the Central Government (SEBI) by its nominees on the stock exchanges; and **(iv)** the maintenance of the accounts of members and their periodical audit by chartered accountants. The rules of any recognised stock exchange relating to any of these matters/condition cannot be amended without the approval of the Government/SEBI.

Terms Recognition may be granted to a stock exchange by the SEBI on a permanent or temporary basis. A temporary recognition is for not less than a year and can be renewed further. Once a stock exchange is recognised, its rules can be amended only with the approval of the SEBI.

Corporatisation and Demutualisation of Stock Exchanges All recognised stock exchanges should be corporatised/demutualised in accordance with the provisions/procedures discussed below.

All recognised stock exchanges should submit a scheme for the purpose to the SEBI which after **(i)** making necessary inquiry and obtaining further information as required and **(ii)** being satisfied that it would be in the interest of trade and also in the public interest would approve the scheme with/without modification. It would not approve any scheme if the issue of shares for a lawful consideration or payment of dividend or provision of trading rights in lieu of membership card of the members of the recognised stock exchange have been proposed out of any reserves/assets of the stock exchange. It would also not approve the scheme if it is satisfied that it would not be in the interest of the trade and also in the public interest. The ap-proved scheme would be binding on all persons and authorities including all members/creditors/depositors/employees of the recognised stock exchanges and on all persons having any con-tract/right/power/obligation/liability with, against, one, to or in connection with the concerned stock exchange or its members. While approving the scheme, the SEBI may restrict **(a)** the voting rights of the shareholders who are also stock brokers of the stock exchange, **(b)** the rights of shareholders/stocks brokers of the stock exchange to appoint the representatives on its govern-ing Board, **(c)** the maximum number of representatives of the stock brokers to be appointed on its governing body, not exceeding one-fourth of the total strength.

Every stock exchange in respect of which the scheme for corporatisation/ demutualisation has been approved by the SEBI, should either by fresh issue of equity shares to the public or in any other manner specified by the SEBI regulations ensure that at least 50 per cent of its equity capital is held by the public other than shareholders having trading rights.

Withdrawal In the interest of the trade or in public interest, after due notice, giving opportunity to show cause against withdrawal and considering its representations, the Government/SEBI may, by notification, withdraw the recognition given to a stock exchange. Where the recognised stock exchange has not been corporatised/demutualised or fails to submit the scheme for the purpose to the SEBI within the specified time or the scheme has been rejected by the SEBI, its recognition would stand withdrawn.

Periodical Returns Recognised stock exchanges have to furnish, to the SEBI, periodical returns relating to their affairs. Every stock exchange and every member has to maintain such books of accounts and other documents as the SEBI may prescribe, in the interest of the trade or in the public interest. These books of accounts and documents can be inspected by the SEBI at any time. No notice of inspection is required to be given nor is the power of inspection circumscribed by any limitation such as disclosure of reason or purpose of such inspection.

The SEBI also has the power to call for information or explanations from a recognised stock exchange or from any member of stock exchange, provided it is satisfied that it is in the interest of the trade or in public interest to do so. To exercise this power, the SEBI must issue an order in writing.

Inquiries The SEBI has the power to direct inquiry into the affairs of the governing body or of any member in relation to the affairs of the stock exchange. The inquiry may be conducted by one/more person(s) appointed by the SEBI. However, in the case of an inquiry in relation to the affairs of a member, the SEBI may direct the governing body of the stock exchange itself to conduct the inquiry in the manner directed by the SEBI. The person(s) appointed to conduct the inquiry has to submit a report of the result of the inquiry to the SEBI. In such an inquiry, the following persons are bound to produce all such books, accounts, correspondence and other documents in their custody or power relating to, or having a bearing on, the subject matter of inquiry, as may be required of him: **(a)** every director, manager, secretary or other officers of the stock exchange; **(b)** every member of the stock exchange; **(c)** if the member of the stock exchange is a firm, every partner, manager, secretary or other officer of the firm; and **(d)** every other person or body of persons who has had dealings in the course of business with any of the persons mentioned in clauses **(a)**, **(b)** and **(c)**, whether directly or indirectly. It is also their duty to furnish all relevant statements or information asked for by the person conducting the inquiry.

Annual Reports Every recognised stock exchange has to furnish to the Government/SEBI a copy of its annual reports containing such particulars as may be prescribed by it.

Make/Amend Rules The SEBI can make or amend any rule, or direct the recognised stock exchanges to do so in respect of the matters pertaining to conditions imposed while granting registration. It has the power to direct stock exchanges generally or any particular stock exchange to make or amend any rule thereof, and upon such direction being issued, it is the duty of the stock exchanges, or the concerned stock exchange, to make or amend the rule within two months from the date of the order by which such a direction was given. If the stock exchange fails or neglects to comply with it within the two month period, the SEBI can itself make or amend the rule either in the form specified in the order issued or in any other manner, but in the latter case, the SEBI and the stock exchange(s) has/have to approve the modification. The rules made/amended would have an overriding effect on the provisions made in the Companies Act or any other law which is in force for the time being, to make/amend the rules.

Clearing Corporation A recognised stock exchange with the prior approval of the SEBI may transfer the duties and functions of a clearing house to a Clearing Corporation (CC), being a company incorporated under the Companies Act for the purpose of **(a)** periodical settlement of contracts and differences there under, **(b)** delivery of, and payment for, securities and **(c)** any other matter which is incidental to or connected with such transfer. The CC should get its bye-laws approved by the SEBI.

The provisions relating to **(1)** grant of recognition, **(2)** with-drawal of recognition, **(3)** periodical returns to the Government, **(4)** annual reports to the Government, **(5)** form of Government to direct/make rules, **(b)** form of SEBI to make/amend rules, **(7)** supersession of the governing Board by the Government and, **(8)** suspension of business applicable to a recognised stock exchange are also applicable to the CC.

Bye-laws of Recognised Stock Exchanges Any recognised stock exchange may with the prior approval of the SEBI make bye-laws for the regulation and control of contracts to provide for:

(a) The opening and closing of markets and regulation of the hours of trade;
(b) Clearing houses for the periodical settlement of contracts and differences thereunder, the delivery and payment of securities, the passing on of delivery orders and the regulation and maintenance of such clearing houses;
(c) Submission to the SEBI, by the clearing house, after each periodical settlement of all or any of the following particulars from time to time, as it may, require, namely: **(i)** the total number of each category of security carried over from one settlement period to another **(ii)** the total number of each category of security contracts which have been squared up during the course of each settlement period **(iii)** the total number of each category of securities actually delivered at each clearing;
(d) Publication, by the clearing house, of all or any of the particulars submitted under clause (c) above, subject to the directions, if any, issued by the SEBI in this behalf;
(e) Regulation or prohibition of blank transfers;
(f) Number of classes of contracts in respect of which settlements are to be made or differences are to be paid through the clearing houses;
(g) Regulation or prohibition of badlas or carry over settlements;
(h) Fixing, altering or postponing of days for making settlements;
(i) Determination and declaration of market rates, including the opening, closing, highest and lowest rates for securities;
(j) Terms, conditions and incidents of contracts, including the prescription of margin requirements, if any, and conditions relating thereto, and the forms of contracts in writing;
(k) Regulation of the entering into, making, performance, recession and termination, of contracts, including contracts between members or between a member and his constituent or between a member and a person who is not a member; the consequences of default or insolvency on the part of the seller or buyer or intermediary, the consequences of a breach or omission by a seller or buyer and the responsibility of members who are not party to such contracts;
(l) Regulation of *taravani* business including the placing of limitations thereon;
(m) Listing of securities on the stock exchange, the inclusion of any security for the purpose of dealing and the suspension or withdrawal of any such security and the suspension or prohibition of trading in any specified securities;
(n) Method and procedure for the settlement of claims or disputes, including settlement by arbitration;

(o) Levy and recovery of fees, fines and penalties;
(p) Regulation of the course of business between parties to contracts in any capacity;
(q) Fixing of a scale of brokerage and other charges;
(r) Making, comparing, setting and closing of bargains;
(s) Emergencies that arise in trade, whether as a result of poor or syndicated operations or cornering or otherwise, and the exercise of powers in such emergencies including the power to fix maximum and minimum prices for securities;
(t) Regulation of dealings by members on their own account;
(u) Separation of the functions of jobbers and brokers;
(v) Limitations on the volume of trade done by any individual member in exceptional circumstances;
(w) Obligation of members to supply such information or explanation and to produce such documents relating to the business as the governing body may require.

These bye-laws also: **(a)** specify the bye-laws, the contravention of which would make a contract, entered into otherwise than in accordance with the bye-laws, void; and **(b)** provide that the contravention of any of the bye-laws would render the member concerned liable to one or more of the following punishments, namely, fine, expulsion from membership for a specified period or any other penalty of a like nature, not involving the payment of money.

Powers of the SEBI The SEBI can make as well as amend bye-laws for all or any of the above matters. It can also supersede the governing body of the stock exchange and appoint any person/persons to exercise and perform all the powers and duties of the governing body. Where more than one person is appointed, one of the such persons may be appointed as its chairman and another as vice-chairman. The SEBI can also direct a stock exchange to suspend its business in an emergency for a period not exceeding seven days and extend the period from time to time in the interests of the trade and the public.

If satisfied after an inquiry that it is necessary **(a)** in the interest of the investors or orderly development of the securities market or **(b)** to prevent the affairs of a recognised stock exchange/clearing corporation/such other agency or person providing trading/settlement facilities in respect of securities, being conducted in a manner detrimental to the interest of the investors/securities market or **(c)** to secure the proper management of any stock exchange/clearing corporation/agency/person, the SEBI may issue to them as well as any company whose securities are listed/proposed to be listed, such directions as may be appropriate in the interest of the investors in securities and the securities market. The power to issue directions would include and always be deemed to have been included the power to direct any person who made profits/averted loss by indulging in any transaction/activity of the provisions of the SCRA/regulations to disgorge an amount equivalent to the wrongful gain made/loss averted by the contravention.

Contracts and Options in Securities

The main stipulation relating to contracts and options in securities relate to **(i)** contracts, **(ii)** power to prohibit contracts, **(iii)** licensing of dealers in securities, **(iv)** additional trading floor **(v)** contracts in derivatives.

Contracts Contracts in securities, except spot delivery contracts, can be entered into only between, through or with the members of a recognised stock exchange. All the other contracts are illegal. A spot delivery contract means a contract which provides for **(a)** the actual delivery of securities and payment on the day of the contract or on the next day and **(b)** transfer of securities by the depository from the account of a beneficial owner to the account of another beneficial owner when securities are dealt with by a depository.

Power to Prohibit Contracts With a view to prevent undesirable speculation in specified securities in any area/state, the SEBI can prohibit any contract in any specified security made by any person without its prior approval. All contracts entered into after the prohibition would be illegal. The SEBI is also empowered to exempt from the prohibition and permit contracts to be entered into in the specified manner.

Licensing of Dealers in Securities To regulate the business of dealing in securities, every person doing such business has to acquire a license from the SEBI. The restriction does not apply to spot delivery contracts and dealings in securities by or on behalf of a member of a recognised stock exchange. However, the exemption for spot delivery contracts may be withdrawn by the SEBI in the interest of trade or in public interest.

Issue of Securities By Special Purpose Distinct Entities (SPDE) Such entities can offer securities to the public/listed on a recognised stock exchange only if they fulfil the eligibility criteria and comply with other requirements specified by the SEBI. Before issuing the offer document to the public, they should apply to stock exchange(s) for permission to list the certificate/instrument to be issued. If the requisite permission is not granted/refused, moneys received from applicants should be repaid within 8 days following which, the issuer would have to repay the money with 15 per cent per annum interest. All the provisions of the SCRA relating to listing of securities of a public company would *mutates mutandis* apply to the listing of the securities of the SPDE.

Exclusion of Spot Delivery Contracts The provisions relating to **(i)** contracts in notified areas ille-gal, invalid in certain circumstances, **(ii)** members may not act as principals in certain circumstances, and **(iii)** licensing of deal-ers in securities in certain areas are not applicable to spot delivery contracts **(a)** for direct sale/delivery of any security pursuant to a family arrangement amongst relations, **(b)** for transaction in government securities in a manner specified by the SEBI/RBI, **(c)** for transaction for sale/delivery of securities in accordance with the SEBI Substantial Acquisition of Shares and Takeover Regulations, **(d)** being contracts with the approval of the Government for purchase/sale of securities by any Government company, **(e)** for transactions for sale/delivery of securities by or to any NRI under specific approval under the Foreign Exchange Management Act from the Government/RBI, **(f)** being contracts by any development/investment agency of the Government/any interna-tional finance agency for financing industrial projects, **(g)** for sale/delivery of securities of a company in terms of pre-emption/similar right contained in the pre-emption or collabora-tion arrangements approved by the Government/SEBI, **(h)** for any other transaction/classes of transactions for sale/delivery of securities specified by the Government/SEBI. However, the Govern-ment may in the interest of trade or in public interest to regu-late spot delivery contracts apply these provisions.

Additional Trading Floor A stock exchange can establish additional trading floor(s) with the prior approval of, and in accordance with the terms and conditions stipulated by, the SEBI. An additional trading floor is a trading ring/ facility offered by a recognised stock exchange outside its area of operation to enable the investors to buy/sell securities, through this trading floor, under the regulatory framework of the stock exchange.

Contract in Derivatives Such contracts are valid and legal if **(a)** traded on a recognised stock exchange and **(b)** settled on the clearing house of the recognised stock exchange in accordance with its rules/bye-laws.

Listing of Securities

The stipulations relating to the listing of securities are summerised below.

Listing Listing denotes registration of a security as officially approved for dealing or trading on a stock exchange. It means the admission of the securities of a company to trading privileges on a stock exchange. The principal objectives of listing are to provide ready marketability and impart liquidity and free negotiability to securities, ensure proper supervision and control of dealings in them and protect the interests of shareholders and general investing public.

Listing is not compulsory under the Companies Act, but where a public limited company desires to issue shares/ debentures to the public through a prospectus, listing is necessary under Section 73 of the Act.

Where securities are listed on the application of any person in any recognised stock exchange, such a person has to comply with the conditions of the listing agreement of the stock exchange.

Delisting of Securities A recognised stock exchange may delist securities if:

- The listed company **(a)** has incurred losses/its networth has been reduced to less than its paid-up capital, **(b)** has failed to comply with the requirements of the listing agreement or provi-sions of any law, **(c)** fails to redress investors grievances;
- The securities of the listed company have not been continuously traded;
- The listed company/its promoters/directors indulge in insider trading/unfair trade practices in securities;
- The promoters/its directors/persons in management indulge in malpractices including malpractices in dematerialisation of securities in excess of issued securities or delivery of securities which are not listed or for which trading permission has not been given;
- The addresses of promoters/directors of a company are not known/are false or the company changes its registered office in contravention of the provisions of the Companies Act;
- Trading in securities of the company has remained suspended for more than 6 months;
- Shareholdings of the company held by the public has come below the limit specified in the listing agreement under the SCR Act.

The SEBI may specify any other ground(s) in which the securities of a company can be delisted.

No delisting of securities would be allowed by the stock exchange unless the company obtains prior approval of the holders of such securities by a special resolution and after giving an exit opportunity to the shareholders at a fair price and complying with conditions specified by the SEBI/stock exchange with the approval of the SEBI.

A listed company/an aggrieved investor may file an appeal before the SAT against the decision of the stock exchange within 15 days.

If the stock exchange refuses to list the securities of any company, it must furnish the reasons for refusal. (The company may **(i)** within 15 days of furnishing of reasons for the refusal or **(ii)** where the stock exchange has omitted/failed to dispose off within the time specified in Section 73(1-A) of the Companies Act its application for permission for dealings of its securities, within 15 days from the date of expiry of the specified time/within such extended period not exceeding one month allowed by the Securities Appellate Tribunal (SAT) may appeal to the SAT.

It may **(i)** vary/set aside the decision of the stock exchange or **(ii)** grant/refuse permission for dealing in the securities. A copy of the SAT's order would also be sent to the SEBI. Any person aggrieved by any decision/order of the SAT may file an appeal at the Supreme Court on any question of fact/law arising from such an order.

Penalties and Procedures

Any offence committed by any person, company/director/manager/secretary/other officer under the specified provisions of SCRA is punishable with imprisonment up to 10 year, or with a fine up to ₹25 crore or with both. Such offence is deemed to be a cognisable offence.

The penalty for specific violations/failures is as follows:

- For failure to furnish information/return etc. to a recognised stock exchange: not less than ₹1 lakh but may extend ₹1 lakh for each day during which the failure continues subject to a maximum of ₹1 crore;
- For failure to maintain books of accounts/records as per the listing agreement/bye-laws of the stock exchange: as above;
- For failure by any person to enter into an aggrement with clients: as above;
- For failure to redress investors grievances by a stockbroker/sub-broker: as above;
- For failure in case of stockbrokers/sub-brokers to segregate securities/money(ies) of the client(s) or use of security(ies)/money(ies) of a clients(s) for self or other client: not less than ₹1 lakh but may extend up to ₹1 crore;
- Failure to comply with provisions of listing agreement/delisting norms by a company/ person/collective investment scheme/mutual fund: not less than ₹5 lakh but may extend up to ₹25 crore;
- For excess dematerialisation/delivery of unlisted securities: not less than ₹5 lakh but may extend up to ₹25 crore;
- For failure to furnish periodical returns by a recognised stock exchange/to amend its rules or bye-laws as directed by the SEBI/to comply with SEBI directions: not less than ₹5 lakh but may extend up to ₹25 crore;
- For contravention where no penalty has been provided: not less than ₹5 lakh but may extend up to ₹1 crore.

The SEBI may appoint an adjudicating officer for imposing any penalty. It may enhance the quantum of penalty in the interest of the securities market. The concerned party may propose for settlement of alleged defaults. Taking into account the nature, gravity and impact of defaults, the SEBI may agree for settlement on payment of the specified amount or other terms.

If a person fails to **(i)** pay the penalty imposed by the adjudicating officer, **(ii)** comply with the direction of disgorgement order, **(iii)** pay any fee due to the SEBI, a recovery officer would recover the specified amount by one/more of the following modes: **(a)** attachment/ sale of movable/immovable property, **(b)** attachment of bank accounts, **(c)** assert/detention in prison, and **(d)** appointment of a receiver for management of movable/immovable properties. The due amount would be deemed to be arrears of income tax. The recovery officer would be empowered to seek the assistance of the local district administration, and the recovery amount would have precedence over any other claim against the defaulter. Any person aggrieved by the order/decision of the stock exchange/judicating officer/SEBI may prefer an appeal before the Securities Appellate Tribunal.

Offences by Companies For offence(s) committed by a company, every person who was in change of/responsible for the conduct of its business as well as the company would be deemed guilty and liable to the proceeded against/punished unless he proves that the offence was committed without his knowledge/he exercised all due diligence to prevent the commission of the offence. If proved that the offence has been committed with the consent/convenience of or is attributable to any gross negligence on their part, a director/manager/secretary/other officers of the company would also be deemed guilty liable to be punished.

Establishment of Special Courts For speedy trial, the government with the concurrence of the Chief Justice of the concerned High Court may establish/designate special courts(s) consisting of a single judge of the rank of a senior/additional session judge. The concerned High Court would exercise all its powers as if the special court(s) were a court of session within the local limits of its jurisdiction.

Power to Delegate

The Government can delegate its powers, except those relating to making rules, to the RBI/SEBI.

Power to Make Rules

The Central Government is empowered to make rules for carrying out the objectives of the SCRA to provide, in particular, for:

- Manner and contents of application for registration and fee payable;
- Manner of enquiry for recognition of stock exchange, conditions to be imposed and form of recognition;
- Contents of periodical returns and annual reports to be furnished to the Government;
- Maintenance and preservation of documents;
- Manner of enquiry by Governing Board of stock exchanges;
- Manner of making/amendment of bye-laws;
- Manner of licensing of dealers in securities, fee payable, period of licence, conditions, maintenance of documents, filing of periodical returns and so on;
- Requirements to be complied with by public companies/collective investment schemes for listing securities/units on stock exchanges;
- Form of filing an appeal before the SAT; and
- Any others specified matter.

Special Provisions Related to Commodity Derivatives

The provisions of the SCR Act do not apply to **non-transferable specific delivery contracts** (i.e. a specific delivery contract the rights/liabilities under which or under any delivery order/ railway receipt/bill of lading/warehouse receipt/any other documents of title are not transferable). **A specific delivery contract** means a commodity derivative which provides for actual delivery of specific qualities/types of goods during a specified future period at a price fixed/ to be fixed in the agreed manner and in which the names of both the buyers and sellers are mentioned. **Goods** mean every kind of movable property other than actionable claims/money/ securities. The Government may also notify the non-application of the SCR Act to **transferable specific delivery contracts**, that is a delivery contract which is subject to conditions relating to its transferability specified by the Government.

Power of SEBI to Make Regulations

The SEBI can make regulations consistent with the provisions of the SCRA to carry out the purposes of the SCRA. In particular, regulations may provide for **(a)** the manner in which at least 51 per cent of the equity share capital of a recognised stock exchange is held within 12 months from the date of publication of a scheme of corporatisation and demutualisation by the public other than the shareholders who have trading rights, **(b)** the form and manner in which a special purpose entity would apply for the issue and trading of the certificates/instruments, their contents and the manner of their disclosure in the instruments/certificates.

SECURITIES CONTRACTS (REGULATIONS) RULES [SCRRs]

The main elements of the SCRRs are summarised below.

Recognition of a Stock Exchange (SE)

The application for recognition of a SE in the prescribed form should be made to the SEBI. A company would also be eligible to be elected as a member of a SE if **(i)** it undertakes to comply with any financial requirement and norms specified by the SEBI for registration with it, **(ii)** the majority of its directors are its shareholders and a minimum of 40 per cent of its paid-up capital is held by them/the body corporate appointing them as directors, **(iii)** the directors are not disqualified from being members of a SE (in terms of prescribed qualifications discussed subsequently and they had not been director of a company which had been declared defaulted/ expelled as a member of a SE and **(iv)** at least two directors posses a maximum of two years' experience **(a)** in dealing in securities or **(b)** as portfolio managers or **(c)** as investment consultants. The application should be accompanied by a fee of ₹500 and four copies of the rules (including the Memorandum and Articles of Association if the applicant—SE is a body corporate) and bye-laws of the SE. The recognition of a SE may be **(a)** for one renewable year or **(b)** on permanent basis. The recognition of a SE can be withdrawn. Three months before the expiry of the period of recognition, a recognised SE has to apply to the SEBI for renewal of recognition, together with a fee of ₹200.

Qualification for Membership

The rules relating to admission of members of a stock exchange seeking recognition, *inter-alia*, provide that:

(1) No person would be eligible to be elected as a member if he:

- **(a)** is less than 21 years of age;
- **(b)** is not a citizen of India; however, the governing body may, in suitable cases, relax this condition with the prior approval of the SEBI;
- **(c)** has been adjudged bankrupt or a receiving order in bankruptcy has been made against him or he has been proved to be insolvent even though he has obtained his final discharge;
- **(d)** has been convicted of an offence involving fraud or dishonesty;
- **(e)** is engaged as principal or employee in any business other than that of securities or commodity derivatives except as a broker or agent, not involving any personal financial liability unless he undertakes, on admission, to sever his connection with such businesses. However, members of recognised SEs which are corporations/body corporates/

companies/institutions/board of trustees of EPF/registered person fund/stand alone primary dealer would not be affected;

(f) has been at anytime expelled or declared a defaulter by any other SE;

(g) has been previously refused admission to membership, unless a period of one year has elapsed since the date of such rejection:

(2) No person eligible for admission as a member under sub-rule **(1)** above would be admitted as a member unless he:

(a) has worked for at least two years as a partner with, or an authorised assistant, authorised clerk, remisier or apprentice to a member; or

(b) agrees to work for a minimum period of two years as a partner or representative member with another member, and enter into bargains on the floor of the stock exchange, not in his own name but in the name of such other members or

(c) succeeds to the established business of a deceased or retiring member who is his father, uncle, brother or any other person who is, in the opinion of the governing body, a close relative. However, the rules of the SE may authorise the governing body to waive compliance with any of the foregoing conditions if the person seeking admission is in respect of means, position, integrity, knowledge and experience of business in securities considered by it to be otherwise qualified for membership.

(3) No person who is a member at the time of application for recognition or subsequently admitted as a member would continue as such if he:

(a) ceases to be a citizen of India [except those who became members under rule 1(b) above];

(b) is a adjudged bankrupt or a receiving order in bankruptcy is made against him or he is proved to be insolvent;

(c) is convicted of an offence involving fraud or dishonesty;

(d) engages either as principal or employee in any business other than that of securities or commodity derivatives except as a broker or agent, not involving any personal financial liability, provided that the governing body may, for reasons to be recorded in writing, permit a member to engage himself as principal or employee in any such business, if the member in question ceases to carry on business on the SE either as an individual or as a partner in a firm. To conduct business in commodity derivatives, he would have to set up a separate company which would comply with the regulatory requirements (e.g. network, capital adequacy, margin and exposure norms specified by the Forward Markets Commission.

(4) A company is eligible to be elected as a member of a stock exchange if:

(i) it is formed in compliance with the provisions of Section 322 of the Companies Act;

(ii) a majority of its directors are its shareholders and also members of that SE and

(iii) its directors, who are members of that SE have the ultimate liability in such a company. However, on the recommendations of the SEBI, the governing body of a SE would in relaxation of the requirements of this clause, admit as member the following corporations, body corporates companies or institutions, namely, **(a)** the IFCI Ltd, **(b)** the IDBI, **(c)** any insurance company, **(d)** the Unit Trust of India, **(e)** the subsidiaries of any of the corporations or companies specified and any subsidiary of the State Bank of India or any public sector bank set up for providing merchant banking services, buying and selling securities and other similar activities, any bank, EXIM Bank of India, NABARD and NHB, **(f)** Central Board of Trustees of EPF/pension fund/stand alone primary dealer.

(4A) A company would also be eligible to be elected as a member of a stock exchange if:

(i) it is formed in compliance with the provisions of Section 12 of the Companies Act;

(ii) it undertakes to comply with such financial requirements and norms as may be specified by SEBI for its registration.

(iii) its directors are not disqualified from being members of a SE and they had not held the offices of the Directors in any company which had been a member of the SE and had been declared defaulter or expelled by the SE and

(iv) not less than two directors of the company are persons who possess a minimum two years' experience **(a)** in dealing in securities; or **(b)** as portfolio managers or **(c)** as investment consultants.

(5) Where any member of a SE is a firm, the provisions of sub-rules **(1)**, **(3)** and **(4)** above would, so far as they can, apply to the admission or continuation of any partner in such firm.

(6) Any limited liability partnership if **(i)** it undertakes to comply with the SEBI-prescribed financial requirements, **(ii)** its designated partners are not disqualified from being members, and **(iii)** at least two members have a minimum experience of two years in dialing in securities/as portfolio managers/investment consultants.

(7) Any provident fund represented by its trustees of an exempted establishment under the EPF Act.

Contracts Between Members of Recognised Stock Exchange

All contracts between the members of a recognised SE should be confirmed in writing and enforced in accordance with its rules and bye-laws.

Nominees of SEBI

The SEBI may nominate upto three persons as members of the governing body of every recognised SE. Such members would enjoy the same status and powers as other members of the governing body.

Obligation of the Governing Body

After receiving the report of the result of an enquiry, the SEBI may take such action as they deem proper and, in particular, may direct the governing body of the SE to take such disciplinary action against the offending member, including fine, expulsion, suspension or any other penalty of a like nature, not involving the payment of money, as may be specified by it. The governing body should give effect to the directions of the SEBI in this behalf and not in any manner commute, revoke or modify the action taken in pursuance of such directions without its prior approval. It may, however, either of its own motion or on the representation of the member concerned, modify or withdraw its direction to the governing body.

Audit of Accounts of Members

Every member should get his accounts audited by a chartered accountant whenever required by the SEBI.

Books of Account and Other Documents

Every recognised SE should maintain and preserve the following books of accounts and documents for a period of five years: **(1)** Minute books of meetings of **(a)** the members, **(b)** the governing body, **(c)** any standing committee(s) of the governing body or of the general body of members **(2)** Register of members showing their full names and addresses, where any member of the SE is a firm, full names and addresses of all partners should be shown **(3)** Register of authorised clerks **(4)** Register of remisiers of authorised assistants **(5)** Record of security deposits **(6)** Margin deposits book **(7)** Ledgers **(8)** Journals **(9)** Cash book and **(10)** Bank pass book.

Books of Account and Other Documents

Every member of a recognised SE should maintain and preserve the following books of accounts and documents for a period of five years: **(a)** Register of transactions (*sauda* book) **(b)** Clients' ledger **(c)** General ledger **(d)** Journals **(e)** Cash book **(f)** Bank pass book and **(g)** Documents register showing full particulars of shares and securities received and delivered. They should also maintain and preserve the following documents for a period of two years: **(a)** Member's contract books showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to them **(b)** Counterfoils or duplicates of contract notes issued to clients and **(c)** Written consent of clients with respect to contracts entered into, by them as principal.

Manner of Inquiry

The person(s) appointed by the SEBI to make inquiries related to the affairs of the governing body of a recognised SE, or/any member related to the SE, would be referred to as the inquiry officer/authority. The inquiring authority would hand over a statement of issues to be inquired into to the governing body/the member concerned, who would be given a reasonable opportunity to state their/his side of the case. If any witness is called for examination, an opportunity would be provided to the governing body/the member whose affairs are being inquired into, to cross-examine him. Where the inquiring authority consists of more than one person, the views of the majority would be deemed to represent the findings of such authority and, in the event of an equality of votes, the chairman or senior member would have a casting vote. The inquiry authority would submit its report in writing to the SEBI in the period specified within the order of appointment. Where the SEBI has directed the governing body of a SE to make an inquiry, it would appoint one or more of its members to make the inquiry and the above provisions would apply *mutatis mutandis* to such an inquiry.

Submission of Annual Report

Every recognised SE should, before January 31 each year or within such extended time as the SEBI may allow from time to time, annually furnish the SEBI with a report about its activities during the preceding calendar year, which should, *inter-alia*, contain detailed information about the following matters: **(a)** changes in rules and bye-laws, if any; **(b)** changes in the composition of the governing body; **(c)** any new sub-committees set up and changes in the composition of existing ones; **(d)** admissions, re-admissions, deaths or resignations of members; **(e)** disciplinary action against members; **(f)** arbitration of disputes (nature and number) between members and non-members; **(g)** defaults; **(h)** action taken to combat any emergency in trade; **(i)** securities listed and de-listed and **(j)** securities brought on or removed from the forward list. Within one month of the date of its annual general meeting, it should also furnish the SEBI with a copy of its audited balance sheet, and profit and loss account for the preceding financial year.

Submission of Periodical Returns

Every recognised SE should furnish the SEBI with periodical returns relating to **(i)** the official rates for the securities enlisted thereon; **(ii)** the number of shares delivered through the clearing house; **(iii)** the making-up prices; **(iv)** the clearing house programmes; **(v)** the number of securities listed and de-listed during the previous three months; **(vi)** the number of securities brought on or removed from the forward list during the previous three months; and **(vii)** any other matter specified by the SEBI.

Requirements with Respect to the Listing of Securities on a Recognised Stock Exchange

1. A public company desirous of getting its securities listed at the SE should apply to it and forward along with its application the following documents and particulars:
   - **(a)** Memorandum and Articles of association and, in the case of a debenture issue, a copy of the trust deed.
   - **(b)** Copies of all prospectuses/statements in lieu of prospectuses issued by the company at any time.
   - **(c)** Copies of offers for sale and circulars/advertisements offering any securities for subscription/sale during the last five years.
   - **(d)** Copies of balance sheets and audited accounts for the last five years, or in the case of new companies, for such shorter periods for which accounts have been made up.
   - **(e)** A statement showing: **(i)** dividends and cash bonuses, if any, paid during the last ten years (or for such shorter periods as the company has been in existence, whether as a private or public company), **(ii)** dividends or interest in arrears, if any.
   - **(f)** Certified copies of agreements or other documents relating to arrangements with or between **(i)** vendors and/or promoters, **(ii)** underwriters and sub-underwriters, and **(iii)** brokers and sub-brokers.
   - **(g)** Certified copies of agreement with **(i)** selling agents, **(ii)** managing directors and technical directors and **(iii)** general manager, sales manager, manager or secretary.
   - **(h)** Certified copy of every letter, report, balance sheet, valuation contract, court order or other document, part of which is reproduced or referred to in any prospectus, offer for sale, circular/advertisement offering securities for subscription/sale, during the last five years.
   - **(i)** A statement containing particulars of the dates of, and parties to, all material contracts, agreements (including agreements for technical advice and collaboration), concessions and similar other documents (except those entered into in the ordinary course of business carried on/intended to be carried on by the company) together with a brief description of the terms, subject matter and general nature of the documents.
   - **(j)** A brief history of the company, since its incorporation, giving details of its activities including any reorganisation, reconstruction/amalgamation, changes in its capital structure, (authorised, issued and subscribed) and debenture borrowings, if any.

(k) Particulars of shares and debentures issued: **(i)** for consideration other than cash, whether in whole or part, **(ii)** at a premium or discount, **(iii)** in pursuance of an option.

(l) A statement containing particulars of any commission, brokerage, discount/other special terms including an option for the issue of any kind of the securities granted to any person.

(m) Certified copies of **(i)** acknowledgement card/the receipt of filing the offer document with the SEBI and **(ii)** agreements, if any, with the IFCI and similar bodies.

(n) Particulars of shares forfeited.

(o) A list of highest ten holders of each class/kind of securities of the company as on the date of application, along with particulars about the number of shares/debentures held by, and the address of, each such holder.

(p) Particulars of shares or debentures for which permission to deal is applied for. A recognised SE may, either generally by its bye-laws or in any particular case, call for such further particulars or documents as it deems proper.

2. Apart from complying with such other terms and conditions as may be laid down by a recognised SE, an applicant-company should satisfy it that:

(a) Its articles of association provide for the following; among others:

(i) the company would use a common form of transfer,

(ii) the fully paid shares would be free from all lien, while in the case of partly paid shares, the company's lien, if any, would be restricted to moneys called or payable at a fixed time in respect of such shares,

(iii) any amount paid-up in advance of calls on any share may carry interest but would not entitle the holder to participate in a dividend subsequently declared,

(iv) there would be no forfeiture of unclaimed dividends before the claim becomes barred by law,

(v) options/right to call shares would not be given to any person except with the sanction of the company in general meeting.

However, a recognised SE may provisionally admit to dealing the securities of a company that undertakes to amend its articles of association at its next general meeting so as to fulfil the foregoing requirements, and agrees to act in the meantime strictly in accordance with the provisions of this clause.

(b) At least **(1)** 25 per cent of each class/kind of equity shares/debentures convertible into equity shares issued by the company if its post-issue capital calculated at offer price is upto ₹1,600 crore; **(2)** at least such percentage of its issued shares/convertible debentures equivalent to ₹400 crore if the post-issue capital is more than ₹1,600 crore but less than/equal to ₹4,000 crore, **(3)** at least 10 per cent of its issued shares/convertible debentures if the post-issue capital exceeds ₹4,000 crore. The companies falling in categories (2) and (3) should increase their public shareholding to at least 25 per cent within three years of listing of their securities.

3. A company applying for listing should as a condition precedent, undertake, *inter-alia*:

(a) **(i)** Letters of allotment would be issued simultaneously and in the event of its being impossible to issue letters of regret at the same time, a notice to that effect would be inserted in the press so that it would appear on the morning after the letters of allotment have been posted; **(ii)** letters of right would be issued simultaneously; **(iii)** letters of allotment, acceptance/rights would be serially numbered, printed on good quality paper and examined and signed by a responsible officer of the company and, whenever possible, they would contain the distinctive numbers of the securities to which they relate; **(iv)** letters of allotment and renounceable letters of right would contain a provisio for splitting and, when so required by the SE, the form of renunciation would be printed on the back of/attached to the letters of allotment and letters of right; **(v)** letters of allotment/right would state how the next payment of interest or dividend on the securities would be calculated.

(b) To issue, when so required, receipts of all securities deposited with it whether for registration, sub-division, exchange or for other purposes; and not to charge any fees for registration of transfers/sub-division and consolidation of certificates/sub-division of letters of allotment, renounceable letters of right, and split consolidation, renewal and transfer receipts into denominations of the market unit of trading;

(bb) To issue, when so required, consolidation/renewal certificates in denominations of the market unit of trading to split certificates, letters of allotment, letters of right; and transfer renewal, consolidation and split receipts into smaller units; to split call notices; issue duplicates thereof and not require any discharge on call receipts and to accept the discharge of members of stock exchange on split, consolidation and renewal receipts as good and sufficient without insisting on the discharge of the registered holders;

(c) When documents are lodged for sub-division or consolidation or renewal through the clearing house of the exchange:

- **(i)** to accept the discharge of an official of the stock exchange clearing house on the company's split/consolidation/renewal receipts as good and sufficient discharge without insisting on the discharge of the registered holders, and
- **(ii)** to verify when the company is unable to issue certificates or split/consolidation/renewal receipts immediately on lodgement, whether the discharge of the registered holders on the documents lodged for sub-division/consolidation/renewal and their signatures on the relative transfers are in order;

(d) On production of the necessary documents by shareholders or by members of the SE, to make endorsements on transfers to the effect that the power of attorney, probate, letters of administration, death certificate, certificate of the Controller of Estate Duty or other similar documents have been duly exhibited to and registered by the company;

(e) To issue certificates with respect to debentures lodged for transfer within a period from one month of the date of lodgement of transfer and to issue the balance certificates within the same period when the transfer is accompanied by a larger certificate;

(f) To advise the SE of the date of the board meeting at which the declaration or recommendation of a dividend, the issue of rights or bonus share would be considered;

(g) To recommend or declare all dividends and/or cash bonuses at least five days before the commencement of the closure of its transfer books, or the record date fixed for the purpose, and to advise the SE in writing of all dividends and/or cash bonuses recommended or declared immediately after a meeting of the board of the company has been held to finalise the same;

(h) To notify the SE of any material change in the general character or nature of the company's business;

(i) To notify the SE of any change **(i)** in the company's directorate by death, resignation, removal or otherwise, **(ii)** of the managing director, **(iii)** of auditors appointed to audit the books of accounts of the company;

(j) To forward to the SE copies of statutory and annual reports and audited accounts as soon as they are issued, including director's report;

(k) To forward to the SE, as soon as they are issued, copies of all other notices and circulars sent to the shareholders, including proceedings of ordinary and extraordinary general meetings of the company, and to file with the stock exchange certified copies of the resolution of the company as soon as such resolutions become effective;

(l) To notify the SE prior to intimating the shareholders of any new issue of securities, whether by way of rights, privilege bonus or otherwise, and the manner in which it is proposed to offer or allot the same;

(m) To notify the SE in the event of re-issue of any forfeited securities or the issue of securities held in reserve for future issue;

(n) To notify the SE of any other alteration of capital including calls;

(o) To close the transfer books only for the purpose of declaration of dividend or issue of rights or bonus shares or for such other purposes as the SE may agree, and to give notice to it as many days in advance as it may from time to time reasonably prescribe, stating the dates of closure of its transfer books (or, when the transfer books are not to be closed, the date fixed for taking a record of its shareholders or debentureholders) and specifying the purpose(s) for which the transfer books are to be closed (or the record is to be taken); and in the case of a rights or bonus issue to so close the transfer books or fix a record date only after the sanctions of the competent authority subject to which the issue is proposed to be made have been duly obtained, unless the SE agrees otherwise;

(p) To forward to the SE an annual return immediately after each annual general meeting of at least ten principal holders, of each class of security of the company along with particulars of the number of shares or debentures held by, and address of, each such holder;

(q) To grant to shareholders the right of renunciation in all cases of issue of rights, privileges and benefits and to allow them reasonable time, not less than four weeks, within which to record, exercise, or renounce such rights, privileges and benefits and to issue, where necessary, coupons or fractional certificates or provide for the payment of the equivalent of the value of the fractional right in cash, unless the company in a general meeting or the SE agrees otherwise;

(r) To promptly notify the SE:

- **(i)** of any action which would result in the redemption, cancellation or retirement in whole or in part of any securities listed on the exchange,
- **(ii)** of the intention to make a drawing of such securities, intimating at the same time the date of the drawing and the period of the closing of the transfer books (or the date of the striking of the balance) for the drawing,
- **(iii)** of the amount of securities outstanding after any drawing has been made;

(s) To intimate to the SE any other information necessary to enable the shareholders to appraise the position of the company and to avoid the establishment of a false market in the shares of the company;

(t) In the event of the application for listing being granted, such listing would be subject to the rules and bye-laws of the SE in force from time to time and the company would comply within a reasonable time, with such further listing requirements as may be promulgated by the SE as a general condition for new listings.

4. An application for listing would be necessary in respect of all **(i)** new issues of any class/kind of security offered to the public, **(ii)** further issues if the class/kind of securities are already listed on a recognised stock exchange.
5. A recognised SE may suspend or withdraw admission to dealings in the securities of a company/body corporate either for a breach of, or non-compliance with, any of the conditions of admission to dealings or for any other reason, to be recorded in writing, which in the opinion of the SE justifies such action. However, no such action would be taken by a SE without affording the company or body corporate concerned a reasonable opportunity by a notice in writing, stating the reasons, to show cause against the proposed action. Further, where a recognised SE has withdrawn admission to dealings in any security, or where suspension of admission to dealings has continued for a period exceeding three months, the company/body corporate concerned may prefer appealing to the Securities Appellate Tribunal (SAT). The SAT may, after giving the SE an opportunity of being heard, vary or set aside the decision of the SE and its order would have to be carried out by the SE.
6. A recognised SE may, either at its own discretion or should in accordance with the orders of the SAT restore or re-admit to dealings any securities suspended or withdrawn from the list.

6A. All the requirements with respect to listing, so far as they may, would also apply to a public sector company.

7. The SEBI may, at its own discretion or on the recommendation of a recognised SE, waive or relax the strict enforcement of any or all of the requirements with respect to listing prescribed by these rules.

Continuous Listing Requirements

Every listed company should maintain a minimum public shareholding of 25 per cent. In case of a fall in such holding below 25 per cent, the 25 per cent level should be brought within 12 months in a manner specified by the SEBI.

SECURITIES CONTRACT REGULATION (STOCK EXCHANGES AND CLEARING CORPORATIONS) REGULATIONS, 2012

The main elements of the SEBI regulations are **(i)** recognition of stock exchanges and clearing corporations, **(ii)** their networth, **(iii)** their ownership, **(iv)** governance, **(v)** general obligations, **(vi)** listing of securities, and **(vii)** power/directions. They are discussed in this Section.

Recognition of Stock Exchanges and Clearing Corporations

A recognition should be obtained from the SEBI to conduct/organise or assist in organising a stock exchange (SE)/clearing corporation (CC). the prescribed application form together with the prescribed fee of ₹500 should be submitted to the SEBI. The application should be accompanied by copies of memorandum/articles of association/bye-laws and other documents as well as the agreement(s) entered into with the SEs and depositories. It should comply with the following conditions. It is **(i)** a company limited by shares, **(ii)** is **demutualised** (i.e. ownership and management is segregated from trading/clearing rights), **(iii)** its directors/shareholders are fit and proper persons, **(iv)** satisfies requirements relating to the specified ownership and governance structure/networth requirements/requisite capability including its financial capacity, functional expertise and infrastructure.

The applicant should also comply with the following conditions, namely, has **(a)** the necessary infrastructure for orderly execution of trades, **(b)** an online screen-based trading system, **(c)** online surveillance capability which monitors positions, prices and volumes in real time so as to ensure market integrity, **(d)** adequate infrastructure to list securities for trading on its platform, **(e)** necessary capability to have a nationwide network of trading members and adequate facility to admit and regulate its members, **(f)** made necessary arrangements to establish connectivity with its trading members and clearing corporation, **(g)** has adequate investor protection fund and investor services fund, **(h)** adequate investor grievances redressal/arbitration mechanisms to resolve disputes arising out of trades and its settlement, **(i)** the facility to disseminate information about trades, quantities and quotes in real time to at least two information vending networks which are accessible to investors in the country; **(j)** adequate systems' capacity supported by a business continuity plan including a disaster recovery site, **(k)** in its employment, sufficient number of persons having adequate professional and other relevant experience, **(l)** the business feasibility plan has been appraised by a reputed agency having expertise in securities market; and **(m)** any other conditions specified by the SEBI.

On being satisfied with the capability of the applicant to comply with the specified conditions, the SEBI would grant an in-principle approval valid for one year. It may make inquiries and require further information/document to be furnished deemed necessary and grant recognition to the applicant in the interest of the securities market. The recognised stock exchange/clearing corporation should comply with other SEBI imposed conditions, including those with regard to the nature of securities to be dealt with. The period of recognition unless granted on a permanent basis, would be at least one year. Every recognised stock exchange would pay the regulatory fee. The fee for renewal of recognition would be ₹200.

Networth of Stock Exchange and Clearing Corporation

Every recognised stock exchange/clearing corporation should have a minimum networth of ₹100 crore at all times. The clearing corporation should achieve a minimum networth of ₹300 crore within three years from the date of recognition. It would not distribute profits in any manner to its shareholders until the specified networth is achieved. The **networth of a stock exchange** means the aggregate value of paid-up equity share capital plus free reserves (excluding statutory/benefit funds and reserves created out of revaluation) reduced by the related/unrelated investments in businesses, aggregate value of accumulated losses and deferred expenditure including miscellaneous expenses not written off. The **networth** of a clearing corporation means the aggregate value of its liquid asset calculated in the specified manner by the SEBI.

Ownership of Stock Exchange and Clearing Corporations

Their shareholding would include any instrument directly/indirectly owned/controlled that provides for entitlements of equity/rights over equity at any future date.

- At least 51 per cent of the paid-up equity share capital of a recognised stock exchange should be held by public. No person resident in/out India would at any time, directly or indirectly, either individually or together with persons acting in concert, acquire/hold more than 5 per cent of its paid-up equity share capital. However, a **(i)** stock exchange, **(ii)** depository, **(iii)** banking company, **(iv)** an insurance company, and **(v)** public financial institution may acquire upto 15 per cent. The combined holding of all persons resident outside India should not exceed 49 per cent. A foreign portfolio investor (FPI) should acquire the shares only through the secondary market. It should acquire them through the stock exchange where they are listed. In case of unlisted stock exchange, it may acquire them through a transactions outside of a stock exchange but it should not be an initial allotment of shares. Any clearing corporation should not hold any right/stake/interest in any recognised stock exchange.

- At least 51 per cent of the paid-up share capital of a recognised clearing corporation should be held by recognised stock exchange(s). However, any recognised stock exchange cannot, acquire/hold more than 15 per cent in more than one recognised clearing corporation. The shareholding of any resident/non-resident person except a stock exchange, depository/bank/insurance company and PFI would be similar to the stock exchanges. The stipulations relating to the combined holdings of all persons resident outside India applicable to stock exchanges is also applicable to clearing corporations.
- Any person who acquires/holds equity shares of a recognised stock exchange/clearing corporation should be a fit and proper person. He should seek the SEBI's approval within 15 days of acquisition if his shareholding exceeds 2 per cent and file a declaration within 15 days from the date of every financial year that he complies with the fit and proper criteria. The person eligible to acquire/hold more than 5 per cent should also have the SEBI's approval.
- A person would be deemed to be a fit and proper person if he has **(a)** a general reputation and record of fairness and integrity, including but not limited to **(i)** financial integrity, **(ii)** good reputation and character, an **(iii)** honesty; **(b)** not incurred any of the following disqualifications: **(i)** he/any of his whole-time director/managing partner has been convicted by a court for any offence involving moral turpitude/economic offence/offence against the securities laws, **(ii)** an order for winding-up has been passed against him, **(iii)** he/or any of his whole-time directors/managing partners, has been declared insolvent and has not been discharged, **(iv)** an order, restraining/prohibiting/debarring him/any of his whole time directors or managing partners, from dealing in securities/accessing the securities market, has been passed by the SEBI/any other regulatory authority, and a period of 3 years from the date of the expiry of the period specified in the order has not elapsed, **(v)** any other order against him, or any of its whole time directors or managing partners, which has a bearing on the securities market, has been passed by the SEBI or any other regulatory authority, and a period of 3 years from the date of the order has not elapsed, **(vi)** he has been found to be of unsound mind by a court of competent jurisdiction and the finding is in force, and **(vii)** he is financially not sound. If any question arises as to whether a person is a fit and proper person, the SEBI's decision would be final.
- The recognised stock exchange(s)/clearing corporation(s) should disclose to the SEBI, in the specified format, their shareholding pattern on a quarterly basis within 15 days from the end of each quarter, including therein the following: **(a)** the names of the **(i)** 10 largest shareholders along with the number and percentage of shares held by them, **(ii)** shareholders who had acquired shares in that quarter.

- In addition to the requirements under the laws in force, a recognised stock exchange/clearing corporation should maintain and preserve all the books, registers, other documents and records relating to the issue or transfer of its securities for at least 10 years.

Governance of Stock Exchanges and Clearing Corporations

- The governing board of every recognised stock exchange/clearing corporation should include: **(a)** shareholder directors, **(b)** public interest directors, and **(c)** managing director. **Public** includes any member/section of the public excluding trading/clearing member/their associates/agents. A public sector bank/public financial institution/insurance company/mutual fund/alternative investment fund in public sector whose associates are trading/clearing members would be deemed as public.

  Subject to the prior approval of the SEBI, the chairperson should be elected by the governing board from amongst the **public interest directors** (i.e. an independent director representing the interest of the investors and not having any direct/indirect association in conflict with his role). Their number should not be less than that of shareholders directors in a recognised stock exchange. Their respective numbers should be two-thirds and one-third. The managing director should be an ***ex-officio*** director on the governing board and should not be included in either category. Any of their employees may be appointed on the governing board in addition to the managing director who would be deemed to be a shareholder director. No trading/clearing member/their associates/agents should be on the governing board. At least one public interest director should be present in the meetings of the governing board to constitute the quorum. No FPI should have any representation in the governing board. An **associate** of a person would include another person who **(i)** directly/indirectly by himself/in combination with others exercises control over him, **(ii)** holds more than 15 per cent of his capital, **(iii)** is its holding/subsidiary company or a company under the same management, **(iv)** his relative, **(v)** a Hindu Undivided Family of which he is a member, **(vi)** other cases where the SEBI is of the view that a person should be considered an associate based on facts/factors including the extent of control/independence/conflict of interest.
- The appointment/re-appointment of all shareholders directors on their governing board would be with the prior approval of the SEBI. The public interest directors would be nominated by the SEBI for a fixed term of 3 years/extended period approved by it. They may be renominated after a cooling-off period of one year or a period as the SEBI may deem fit in the interest of the securities market. They would be paid only sitting fee.
- The appointment/renewal of the managing director would be subject to the prior approval of the SEBI. Subject to the SEBI guidelines, they would determine the qualification, manner of appointment, terms and conditions of appointment and other procedural formalities associated with their selection/appointment. It should be for a tenure of at least 3 years and not exceeding 5 years. The managing director should not: **(a)** be a shareholder/an associate of a shareholder of a recognised stock exchange/clearing corporation or their associate, **(b)** be a trading/clearing member, or his associate and agent, or shareholder or their associate and agent, or **(c)** hold any position concurrently in their subsidiary, or in any other entity associated with them. He may be appointed on the governing board, but not of the subsidiary. He would liable for removal/termination of service by their govern-

ing boards with the prior approval of the SEBI for failure to give effect to the directions/ guidelines/other orders issued by the it, or other rules, the articles of association, bye-laws and regulations. The SEBI may ***suo moto*** remove/terminate the appointment of the managing director if deemed fit in the interest of securities market.

Code of Conduct for Directors an Key Management Personnel Every director of a recognised exchange/clearing corporation should abide by the SEBI-specified code of conduct. **This is available in Appendix 5-A on the website. The website address is: http://www.mhhe.com//khanifs10e**

Every director and key management personnel should abide by the SEBI-specified code of ethics. **This is available in Appendix 5-B on the website. The website address is: http://www.mhhe.com//khanifs10e**

They should be a fit and proper person. The SEBI may, for any failure by the directors to abide by regulations/code of conduct/ethics or in case of any conflict of ethics/interest, either upon a reference from the recognised stock exchange/clearing corporation or, ***suo moto***, take appropriate action including removal/termination of the appointment of any director, after providing him a reasonable opportunity of being heard.

- A recognised stock exchange/clearing corporation should constitute a compensation committee comprising a majority of public interest directors and chaired by a public interest director. It should determine the compensation of key management personnel in terms of a compensation policy, which should be in accordance with the SEBI-specified norms. The compensation payable to the managing director should be as approved by the SEBI and the terms and conditions of their compensation not be changed without its prior approval. The compensation should be disclosed in their reports. The tenure of a key management personnel, other than a director, should be for a fixed period, as may be decided by the compensation committee.
- They should segregate their regulatory departments from other departments in the specified manner.
- They should constitute independent oversight committee of the governing board, each chaired by a public interest director, in order to address the conflicts of interest in respect of **(a)** member regulation, **(b)** listing and **(c)** trading and surveillance function. It should follow the minimum SEBI-specified listing standards. The heads of departments handling the above matters should report directly to the respective committee and also to the managing director. Any action of a recognised stock exchange against a head of a regulatory department would be subject to an appeal to the respective committee within the period determined by the governing board. These provisions would ***mutatis mutandis*** apply to a recognised clearing corporation.
- An advisory committee should be constituted by the governing board of every recognised stock exchange/clearing corporation to advise it on non-regulatory and operational matters including product design, technology, charges and levies. It would comprise of its trading/ clearing members. The chairperson of the governing board should be the head of the advisory committee and the managing director a permanent invitee to its every meeting. It should meet at least four times a year with a maximum gap of three months between two meetings. Its recommendations should be placed in the ensuing meeting of the governing board for consideration and appropriate decision, and this recommendations along with the decision of the governing board should be disclosed on their respective websites. The trading/clearing members should not be a part of any other committee.

- Every recognised clearing corporation should constitute a risk management committee, comprising its public interest directors and independent external experts, which should report to the governing board. It should formulate a detailed risk management policy to be approved by the governing board. The head of the risk management committee would be responsible for its implementation and report to the risk management committee/the managing director. The committee should monitor implementation of the policy and keep the SEBI/governing board informed about its implementation and deviation.
- Every recognised stock exchange/clearing corporation should appoint a compliance officer responsible for monitoring the compliance of the Securities Contracts (Regulation)/ Companies/SEBI Act/rules/regulations/directions for the redressal of investor's grievances. He should, immediately and independently, report to the SEBI any non-compliance of any provision observed by him.
- Every recognised stock exchange/clearing corporation/member should contribute to the Settlement Guarantee Fund **(discussed later)** in the SEBI-specified manner. They should similarly replenish to the threshold level in case of a shortfall.
- Penalties levied by a recognised stock exchange/clearing corporation should be credited to their Investor Protection Fund or the Specified Fund to guarantee settlement of trades (**discussed later**).
- The disclosure requirements and corporate governance norms specified for listed companies would ***mutatis mutandis*** apply to a recognised stock exchange/clearing corporation.

General Obligations

- Every recognised stock exchange should use the services of recognised clearing corporation(s) for clearing and settlement of its trades pursuant to an agreement in writing between them stipulating their rights and obligations, the conditions for admission of securities for clearing and settlement, risk management measures, charges for clearing and settlement and other incidental an consequential matters. It should extend its arbitration mechanism for settlement of disputes/claims arising out of clearing and settlement of trades executed on it.
- A recognised clearing corporation should seek approval of the SEBI before **(i)** extending its services to any segment of a recognised stock exchange, **(ii)** admitting any securities for clearing and settlement.
- It should establish and maintain a fund for each segment, to guarantee the settlement of trades executed in respective segment. The Settlement Guarantee Fund/Trade Guarantee Fund of existing recognised stock exchange should be transferred to the clearing corporation to which its clearing) and settlement functions are transferred. An existing clearing corporation would continue to utilise its Settlement Guarantee Fund or Trade Guarantee Fund after its recognition. In the event of a clearing member failing to honour his settlement obligations, the Fund should be utilised to complete the settlement. The corpus of the Fund should be adequate to meet the settlement obligations arising on account of their failure. Its sufficiency should be tested by in the SEBI-specified manner way of periodic stress tests. The utilisation of the fund should be in accordance with the norms specified by the SEBI.
- The utilisation of profits and investments by recognised clearing corporation should be in accordance with the SEBI-specified norms.

- The recognised clearing corporation should lay down a transparent policy framework for ensuring that there is no discrimination while rendering clearing and settlement services in settlement of trades on shareholders stock exchange(s) and non-shareholder stock exchange(s). They should ensure equal, unrestricted, transparent and fair access to all persons without any bias towards its associates and related entities and not engage in activities that are unrelated or not incidental to its activity as a stock exchange or clearing corporation except through a separate SEBI-permitted legal entity.
- Every recognised stock exchange/clearing corporation should maintain and preserve the following books of accounts and documents for a minimum period of ten years: **(a)** Minute books of the meetings of: **(i)** governing board; **(ii)** any committees of the governing board, **(b)** Record of clearing members showing their full names, address and details of bank and depository accounts for settlement purposes, **(c)** Transaction records, **(d)** Record of security deposit, **(e)** Margin deposit book, **(f)** Client margin collection details, **(g)** Ledgers, **(h)** Journals, **(i)** Cash book, **(j)** Bank account statement, **(k)** Other SEBI-specified books of accounts and documents. They should furnish to the SEBI its annual financial statements and returns with respect to preceding financial year by the 30th day of September of every year. With the previous approval of the SEBI, they should make bye-laws for the regulation of contracts and clearing and settlement. No memorandum/articles of association/any other constitution document should be amended except with its prior approval.
- The payment and settlement of a transaction in a recognised stock exchange should be determined in accordance with the **netting** or gross procedure as specified in their bye-laws with the prior approval of the SEBI. **Netting** means the determination of net payment/delivery obligations of the clearing member by setting-off/adjustment of ***inter se*** obligations/claims arising out of buying/selling of securities including the claims/obligations arising out of termination of transactions admitted for settlement at future date so that only a net claim be demanded/net obligation be used. Payment and settlement in respect of a transaction between parties under the bye-laws would be final, irrevocable and binding on them. When a settlement has become final and irrevocable, their right to appropriate any collaterals/deposits/margins contributed by the trading/clearing member/client towards its settlement/other obligations would take priority over any other liability of or claim against them. The settlement is final and irrevocable as soon as the money/securities/other transactions payable as a result of such settlement is determined, whether or not actually paid. The right of recognised clearing corporation(s) to recover the dues from its clearing members, arising from the discharge of their clearing and settlement functions, from the collaterals, deposits and the assets of the clearing members, would have priority over any other liability of or claim against them.
- A recognised stock exchange including commodity derivative exchange (CDE) can add a new segment with the SEBI's prior approval only. Every CDE should comply with all the provisions for the stock exchanges in the manner and within time limits specified by the SEBI. Any CDE should not, without the SEBI's prior permission, engage in any activity other than that of assisting/regulating/controlling the business of buying/dealing in commodity derivatives. Every national CDE should credit the settlement-related penalties to its Settlement Guarantee Fund (SGF) and other penalties to its investor protection fund and regional CDEs should credit all penalties to its GSF. They should guarantee the settlement of trades including good delivery. A **national CDE** is a CDE which is demutualised and has electronic trading platform to assist/regulate/control buying/selling/dealing derivatives on all commodities.

Listing

Subject to the provisions of applicable laws in force, a recognised stock exchange may apply for listing of its securities on any recognised stock exchange, other than itself and its associated stock exchange, if it **(a)** is compliant with the provisions of the SEBI regulations particularly those relating to ownership and governance; **(b)** has completed three years of continuous trading operations immediately preceding the date of application of listing; and **(c)** has obtained approval of the SEBI which may specify conditions as it may deem fit in the interest of the securities market including those in relation to transfer of shares held by any person. It would not list any securities of its associates. The securities of a recognised clearing corporation would also not be listed on the stock exchange and they should be in dematerialised form.

Powers of Inspection/Directions by SEBI

- The SEBI may from time to time call for any information/documents/records from the recognised stock exchange/clearing corporation/their governing board/any shareholder.
- It may at any time undertake their inspection, conduct inquiries and audit/any associate/any shareholder/any associate and agent of shareholder. The recognised stock exchange/clearing corporation/shareholder/associate and every manager, director, managing director, chairperson or officer and their other employee should co-operate with the SEBI.
- Without prejudice to exercise of its powers under the provisions of the SCRA/SEBI Acts/rules/regulations, the SEBI may, either ***suo moto*** or on receipt of any information or during pendency of any inspection, inquiry or investigation or on completion, in the interest of public or trade or investors of the securities market, issue such directions as it deems fit, including but not limited to any or all of the following: **(a)** directing person holding equity shares/rights over equity shares in contravention of these regulations to divest his holding in the specified manner, **(b)** directing transfer of any proceeds/securities to the Investor Protection Fund/Settlement Guarantee Fund, and **(c)** debarring them from accessing the securities market or dealing in securities for a specified period.

SEBI LISTING OBLIGATIONS AND DISCLOSURES REQUIREMENTS REGULATIONS (LISTING REGULATIONS) 2015

These regulations apply to the **listed entity** who has listed the following **designated securities** on recognised stock exchange(s): **(a) specified securities** listed on main Board/SME exchange/institutional trading platform, **(b)** non-convertible debt securities/redeemable preference shares/perpetual debt instruments, perpetual non-cumulative preference shares, **(c)** Indian depository receipts, **(d)** securitised debt instruments, **(e)** units issued by mutual funds, and **(f)** other SEBI-specified securities. A **listed entity** means an entity which has listed, on a recognised stock exchange, the designate securities issued/managed by it in accordance with the **listing agreement**, that is, an agreement between a stock exchange and an entity on its application undertaking to employ with conditions for listing of the designated securities. The main elements of the regulations are: **(i)** principles governing disclosures and obligations of listed entity, **(ii)** common obligations of listed entities, **(iii)** obligation of listed entity which has listed **(a)** non-convertible debt securities/redeemable preference shares or both, **(b)** specified securities and non-convertible debt securities/redeemable preference shares or both, **(c)** Indian depository receipts, **(d)** securitised debt instruments, **(e)** mutual fund units, **(iv)** duties/obligations of the stock exchange(s) and **(v)** procedure for action in case of default.

Principles Governing Disclosures and Obligations of Listed Entity

- The listed entity should make disclosures and abide by its obligations in accordance with the following principles: **(a)** Information should be prepared/disclosed in accordance with the applicable standards of accounting and financial disclosures; **(b)** It should **(i)** implement the prescribed accounting standards in letter and spirit in the preparation of financial statements taking into consideration the interest of all stakeholders and also ensure that the annual audit is conducted by an independent, competent and qualified auditor, **(ii)** refrain from misrepresentation and ensure that the information provided to recognised stock exchange(s) and investors is not misleading, **(iii)** provide adequate and timely information to them, **(iv)** ensure that disseminations/circulars are adequate, accurate, explicit, timely and presented in a simple language; **(c)** The channels for disseminating information should provide for equal, timely and cost efficient access to relevant information by investors; **(d)** The listed entity should **(i)** abide by all the provisions of the applicable laws including the **securities laws** (i.e. SEBI/SCR/Depositories/Companies Act/rules/regulations/ circulars/ guidelines), other guidelines issued by the SEBI/recognised stock exchange(s) in this regard **(ii)** make the specified disclosures and follow its obligations in letter and spirit taking into consideration the interest of all stakeholders; **(e)** Filings, reports, statements, documents and information which are event-based/filed periodically should contain the relevant information. They should contain information that enable investors to track the performance of the listed entity over regular intervals of time and provide sufficient information to enable them to assess its current status.
- The listed entity should comply with the corporate governance provisions (**discussed later in this Section**) which should be implemented in a manner so as to achieve the objectives of the principles as mentioned below.

Rights of Shareholders It should seek to protect and facilitate the exercise of the following rights of shareholders: **(i)** right to participate in, and to be sufficiently informed of, decisions concerning fundamental corporate changes, **(ii)** opportunity to participate effectively and vote in general shareholder meetings. **(iii)** being informed of the rules, including voting procedures governing general shareholder meetings, **(iv)** opportunity to ask questions to the Board of Directors/place items on the agenda of general meetings/propose resolutions, **(v)** effective shareholder participation in key corporate governance decisions, such as the nomination/election of members of the Board of Directors, **(vi)** exercise of ownership rights by all shareholders, including institutional investors, **(vii)** adequate mechanism to address their grievances, **(viii)** protection of minority shareholders from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and effective means of redress.

Timely Information It should provide adequate/timely information to shareholders, including the following: **(i)** date/location/agenda of general meetings/full and timely information regarding the issues to be discussed at the meeting, **(ii)** capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership, **(iii)** rights attached to all series/classes of shares to be disclosed to investors before they acquire them.

Equitable Treatment It should ensure equitable treatment of all shareholders, including minority/foreign shareholders, in the following manner: **(i)** all shareholders of the same series of a class treated equally, **(ii)** effective shareholder participation in key corporate governance decisions, such as the nomination/election of members of Board of Directors facilitated, **(iii)** exercise of voting rights by foreign shareholders facilitated, **(iv)** devise a framework to avoid insider trading and abusive self-dealing, **(v)** processes/procedures for general shareholder meetings should allow for equitable treatment of all shareholders, and **(vi)** procedures should not make it unduly difficult/expensive to cast votes.

Role of Stakeholders in Corporate Governance It should recognise the rights of its stakeholders and encourage co-operation with them and respect their rights established by law/through mutual agreements. They should have **(i)** the opportunity to obtain effective redress for violation of their rights, **(ii)** access to relevant/sufficient/reliable information on a timely and regular basis. It should devise an effective whistle blower mechanism enabling stakeholders, including individual employees and their representative bodies, to freely communicate their concerns about illegal/unethical practices.

Disclosure and Transparency The listed entity should ensure timely and accurate disclosure on all material matters including its financial situation, performance, ownership, and governance. Information should be prepared/disclosed in accordance with the prescribed standards of accounting, financial/non-financial disclosure. The channels for disseminating information should provide for equal, timely and cost efficient access to relevant information by the users. The minutes of the meeting should be maintained explicitly recording dissenting opinions.

Responsibilities of the Board of Directors The Board of Directors of the listed entity should have the following responsibilities:

(i) Disclosure of Information: The members of Board of Directors and key managerial personnel should disclose whether they, directly/indirectly, or on behalf of third parties, have a material interest in any transaction/matter directly affecting the listed entity. They should conduct themselves so as to meet the expectations of operational transparency to stakeholders while at the same time maintaining confidentiality of information in order to foster a culture of good decision-making.

(ii) Key Functions of the Board of Directors (a) reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans, setting performance objectives, monitoring implementation and corporate performance, and overseeing major capital expenditures, acquisitions and divestments, **(b)** monitoring the effectiveness of its governance practices and making changes as needed, **(c)** selecting, compensating, monitoring, replacing key managerial personnel and overseeing succession planning, **(d)** aligning key managerial personnel and remuneration of the Board of Directors with the longer term interests of the listed entity and its shareholders, **(e)** ensuring a transparent nomination process with the diversity of thought, experience, knowledge, perspective and gender in the Board of Directors, **(f)** monitoring and managing potential conflicts of interest of management, members of the Board of Directors and shareholders, including misuse of corporate assets and abuse in related party transactions, **(g)** ensuring the integrity of its accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards, and **(h)** overseeing the process of disclosure and communications, and **(i)** monitoring and reviewing the Board of Director's evaluation framework.

(iii) Other Responsibilities The Board of Directors should provide strategic guidance, ensure effective monitoring of the management and be accountable to the listed entity and the shareholders. It should set a corporate culture and the values by which executives throughout a group behave. Its members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the listed entity and the shareholders. They should encourage continuing directors training to ensure that they are kept up to date. Where their decisions may affect different shareholder groups differently, they should treat all shareholders fairly and maintain high ethical standards and take into account the interests of stakeholders. They should **(i)** exercise objective independent judgement on corporate affairs, **(ii)** consider assigning a sufficient number of nonexecutive members of the Board of Directors capable of exercising independent judgement to tasks where there is a potential for conflict of interest, **(iii)** ensure that, while rightly encouraging positive thinking, these do not result in over-optimism that either leads to significant risks not being recognised or exposes the listed entity to excessive risk, **(iv)** have ability to 'step back' to assist executive management by challenging the assumptions underlying: strategy, strategic initiatives (such as acquisitions), risk appetite, exposures and the key areas of its focus. The mandate, composition and working procedures of the committees of the Board of Directors should be well defined and disclosed. Their members should be able to commit themselves effectively to their responsibilities for which they should have access to accurate, relevant and timely information. They should facilitate the independent directors to perform their role effectively.

In case of any ambiguity/incongruity between the principles and relevant regulations, the above principles would prevail.

Common Obligations of Listed Entities

The main elements of the regulations are: **(i)** general obligations of compliance, **(ii)** compliance officer and his obligations, **(iii)** share transfer agent, **(iv)** cooperation with intermediaries, **(v)** preservation of documents, **(vi)** filing of information, **(vii)** scheme of arrangement, **(viii)** payment of dividend/interest/redemption/repayment, **(ix)** grievances redressal mechanism and **(x)** fee/other charges payable to the stock exchanges. The listed entity should:

- ensure that key managerial personnel, directors, promoters or any other person dealing with it, complies with responsibilities/obligations assigned to them.
- appoint a qualified company secretary as the compliance officer who would be responsible for **(a)** ensuring conformity with the applicable regulatory provisions in letter and spirit, **(b)** co-ordination with and reporting to the SEBI recognised stock exchange(s)/depositories with respect to compliance with rules/regulations/other directives in the specified manner, **(c)** ensuring that the correct procedures have been followed that would result in the correctness, authenticity and comprehensiveness of the information/statements/reports filed by it, **(d)** monitoring **email** address of grievance redressal division for registering complaints by investors.
- appoint **(i)** a share transfer agent or manage the share transfer facility in-house, **(ii)** ensure that all activities in relation to both physical and electronic share transfer facility are

maintained either in-house or by SEBI-registered registrar to an issue and share transfer agent, **(iii)** submit a compliance certificate to the concerned stock exchange, duly signed by both the compliance officer and the authorised representative of the share transfer agent within one month of end of each half of the financial year, certifying compliance with the above requirements, **(iv)** enter into a tripartite agreement between the existing/new share transfer agent/listed entity, in the SEBI-specified manner and intimate their appointment to the stock exchange(s) within seven days of entering into the agreement which should be placed in the subsequent meeting of the Board of Directors.

- co-operate with, and submit correct/adequate information to, the SEBI-registered intermediaries such as credit rating agencies/registrar to an issue and share transfer agents/ debenture trustees etc., within timelines and procedures specified under the SEBI-Act, regulations/circulars.
- have a policy for preservation of documents including in electronic mode, classifying them as **(a)** whose preservation would be permanent in nature, **(b)** with preservation period of minimum 8 years after completion of the relevant transactions.
- file the specified reports/statements/documents/filings/other information with the recognised stock exchange(s) on the electronic platform, and put in place the required infrastructure for its compliance.
- ensure that any scheme of arrangement/amalgamation/merger/ reconstruction/reduction of capital to be presented to any court/tribunal does not violate/override/limit the provisions of securities laws/requirements of the stock exchange(s).
- use an electronic mode of the RBI-approved payment facility in the specified manner for the payment of **(a)** dividends, **(b)** interest, **(c)** redemption/repayment amounts.
- ensure that **(i)** adequate steps are taken for expeditious redressal of investor complaints, **(ii)** it is registered on the SCORES/other SEBI-mandated electronic platform/system in order to handle investor complaints, **(iii)** file with the recognised stock exchange(s) on a quarterly basis, within 21 days from the end of each quarter, a statement giving the number of investor complaints pending/received/disposed of during the quarter/remaining unresolved at the end of the quarter.
- pay all applicable fee/charges to the recognised stock exchange(s) in the specified manner.

Obligations of Listed Entity Which has Listed its Specified Securities

These provisions are applicable to a listed entity which has listed its **specified securities**, that is, equity shares and convertible securities in terms of the SEBI ICDR regulations (**discussed in Chapter 7**) on any recognised stock exchange(s) on the main board/SME exchange/institutional trading platform. However, the compliance with the corporate governance provision (**discussed subsequently)** would not apply to the listed entity **(i)** having paid-up equity share capital and net worth not exceeding ₹10 crore and ₹25 crore respectively, **(ii)** which has listed its specified securities on the SME exchange. The main elements of the regulations are: **(i)** board of directors, **(ii)** audit committee, **(iii)** nomination and remuneration committee, **(iv)** stakeholders relationship committee, **(v)** risk management committee, **(vi)** vigil mechanism, **(vii)** related party transactions, **(viii)** corporate governance requirements with respect to subsidiary of listed/entity, **(ix)** obligations with respect to independent directors, **(x)** obligations with respect to employees and senior management, **(xi)** other corporate governance requirements, **(xii)** in-principle approval of recognised stock exchange(s), **(xiii)** prior intimations, **(xiv)** disclosure of events or information, **(xv)** holding of specified securities and shareholding pattern, **(xvi)** disclosure of class of shareholders and conditions for reclassification, **(xvii)** statement of deviation(s)/variation(s), **(xviii)** financial results, **(xix)** annual report, **(xx)** draft scheme of arrangement and scheme of arrangement, **(xxi)** minimum public shareholding, **(xxii)** issuance of certificates/receipts/letters/advices for securities and dealing with unclaimed securities, **(xxiii)** transfer or transmission or transposition of securities, **(xxiv)** other provisions relating to securities, **(xxv)** record date/date of closure of transfer books, **(xxvi)** dividends, **(xxvii)** dividend distribution policy, **(xxviii)** voting by shareholders, **(xxix)** voting by shareholders, **(xxx)** change in name of the listed entity, **(xxxi)** website, **(xxxii)** advertisements in newspapers, and **(xxxiii)** accounting standards.

Board of Directors The composition of its Board of Directors should have an optimum combination of executive and nonexecutive directors with at least one woman director and 50 per cent non-executive directors. Where the chairperson is a non-executive director, at least one-third should comprise of independent directors and where there is no regular non-executive chairperson, at least 50 per cent of the board of directors should comprise of independent directors. Where the regular non-executive chairperson is a promoter/related to any promoter/person occupying management positions at the level of the director or at one level below, at least 50 per cent of the directors should consist of independent directors. The term **"related to any promoter"** means **(i)** directors other than the independent directors/employees/nominees of listed company, **(ii)** directors/employees/nominees of a listed company be deemed to be related to it. An "**independent director"** means a non-executive director, other than a nominee director of the listed entity who **(i)** is a person of integrity and possesses relevant expertise and experience; **(ii)** who is or was not a promoter of the listed entity/its holding/subsidiary/associate company; **(iii)** who is not related to promoters/directors in the listed entity, its holding, subsidiary or associate company; **(iv)** apart from receiving director's remuneration, has/had no material pecuniary relationship with the listed entity, its holding, subsidiary or associate company, or their promoters/directors during the two immediately preceding current financial year; **(v)** none of whose relatives has/had pecuniary relationship/transaction with the listed entity, its holding, subsidiary or associate company, or their promoters, or directors, amounting to at least 2 per cent of its gross turnover/total income or ₹50,00,000/such higher amount as may be prescribed from time to time, whichever is lower, during the two immediately preceding current financial year; **(vi)** who, neither himself, nor whose relative(s) **(A)** holds/has held the position of a key managerial personnel or is/has been an employee of the listed entity or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, **(B)** is or has been an employee/proprietor/partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of **(1)** a firm of auditors/company secretaries in practice/cost auditors of the listed entity or its holding, subsidiary or associate company, **(2)** any legal/consulting firm that has or had any transaction with the listed entity, its holding, subsidiary or associate company amounting to 10 per cent or more of the gross turnover of such firm, **(C)** holds together with his relatives 2 per cent or more of the total voting power of the listed entity, **(D)** is a chief executive/director of any non-profit organisation that receives 25 per cent or more of its receipts/corpus from the listed entity, any of its promoters, directors or its holding, subsidiary or associate company or that holds 2 per cent or more of the total voting power of the listed entity, **(E)** is a material supplier, service provider or customer or a lessor or lessee of the listed entity; and **(vii)** who is not less than 21 years of age.

The Board of Directors should **(i)** meet at least four times a year, with a maximum time gap of 120 days between two meetings, **(ii)** periodically review compliance reports pertaining to all applicable laws, prepared by the listed entity as well as steps taken by it to rectify instances of non-compliances, **(iii)** satisfy itself that plans are in place for orderly succession for appointment to the Board of Directors and senior management. **Senior management** means officers/personnel who are members of core management team excluding directors and normally comprising of all members of management one level below the executive directors including all functional heads, **(iv)** lay down a code of conduct suitably incorporating the duties of independent directors as laid down in the Companies Act, for all directors/senior management, **(v)** recommend fees/compensation paid to non-executive directors, including independent directors with the approval of shareholders in general meeting; the approval of the shareholders should specify the limits for the maximum number of stock options that may be granted to non-executive directors, in any financial year and in aggregate; independent directors would not be entitled to any stock option; the chief executive/financial officer should provide the specified compliance certificate to the Board of Directors, **(vi)** should lay down procedures to inform the directors about risk assessment and minimisation procedures would be responsible for framing/implementing/monitoring the risk management plan. The performance evaluation of independent directors should be done by the entire Board of Directors. The directors who are subject to evaluation should not participate in the evaluation.

Audit Committee Every listed entity should constitute a qualified and independent audit committee having minimum three directors as members, two-thirds being independent directors. All the members should be **financially literate** (i.e. the ability to read and understand basic financial statements, namely, balance sheet, profit and loss account, and statement of cash flows) and at least one member should have accounting/related financial management expertise. The chairperson should be an independent director and present at annual general meeting to answer shareholder queries. The company secretary should act as the secretary to the audit committee which at its discretion may invite the finance director/head of the finance function of internal audit and a representative of the statutory auditor and any other executives to be present at the meetings. The audit committee should meet at least four times in a year and not more than 120 days should elapse between two meetings. The quorum for meeting would either be two members or one third of the members of the audit committee, whichever is greater, with at least 2 independent directors. It should have powers to investigate any activity within its terms of reference, seek information from any employee, obtain outside legal or other professional advice and secure attendance of outsiders with relevant expertise, if considered necessary.

Nomination and Remuneration Committee The Board of Directors should constitute the nomination and remuneration committee comprising of atleast three directors, all of whom should be non-executive directors; and at least 50 per cent should be independent directors. The chairperson should be an independent director. He may be present at the annual general meeting, to answer the shareholders' queries.

Stakeholders Relationship Committee A stakeholders relationship committee should specifically look into the mechanism of redressal of grievances of share/debenture/other security holders. The chairperson of this committee should be a non-executive director. The Board of Directors should decide other members of this committee.

Risk Management Committee The majority of the members of risk management committee should consist of members of the Board of Directors. The chairperson should be a member of the Board of Directors and senior executives may be members. The Board of Directors should define the role and responsibility of the committee and may delegate to the committee monitoring and reviewing of the risk management plan and other functions as it may deem fit. **These provisions are applicable to top 100 listed entities, determined on the basis of market capitalisation, as at the end of the immediate previous financial year.**

Vigil Mechanism The listed entity should formulate a vigil mechanism for directors and employees to report genuine concerns. It should provide for adequate safeguards against victimisation of director(s)/employee(s)/other person(s) who avail the mechanism and also provide for direct access to the chairperson of the audit committee in appropriate/exceptional cases.

Related Party Transactions A **related party transaction** means transfer of resources/services/obligations between a listed entity and a related party regardless of charging of price and would include a single/group of transaction(s) in a contract. The listed entity should formulate a policy on materiality of related party transactions. It would be considered material if the transaction(s) individually or taken together with previous transactions during a financial year exceeds 10 per cent of its annual consolidated turnover.

All related party transactions would require prior approval of the audit committee. It may grant omnibus approval for them subject to the following conditions:**(a)** the audit committee would **(i)** lay down the criteria for granting the omnibus approval, **(ii)** satisfy itself, that it is in its interest, **(b)** the omnibus approval should specify: **(i)** name(s) of the related party, nature/period/maximum amount of transactions, **(ii)** indicative base current contracted price and the formula for variation in the price, and **(iii)** other conditions as deems fit, **(c)** the audit committee should review, atleast on a quarterly basis, the details of related party transactions pursuant to each omnibus approvals, **(d)** the approvals would be valid for a maximum of one year. All material related party transactions would require approval of the shareholders and the related parties should abstain from voting on such resolutions.

Corporate Governance Requirements with Respect to Subsidiary of Listed Entity At least one independent director of the listed entity should be a director of an unlisted **material subsidiary** (i.e. a subsidiary whose income/networth exceeds 20 per cent of the consolidated income/networth of the listed entity/subsidiaries in the immediately preceding year) incorporated in India. The audit committee should also review the financial statements, in particular, the investments made by the unlisted subsidiary. The minutes of the meetings of the Board of Directors of the unlisted subsidiary should be placed at the meeting of the Board of Directors of the listed entity. The management of the unlisted subsidiary should periodically bring to the notice of the Board of Directors of the listed entity, a statement of all significant transactions and arrangements entered into by it. A **significant transaction/arrangement** would mean any individual transaction/arrangement that exceeds/is likely to exceed 10 per cent of the total revenues/expenses/assets/liabilities of the unlisted material subsidiary for the immediately preceding accounting year. The listed entity should not dispose of shares in its material subsidiary resulting in reduction of its shareholding to less than 50 per cent or cease the exercise of control over it without passing a special resolution in its general meeting except in cases where the divestment is made under a scheme of arrangement duly approved by a court/tribunal. Selling/disposing/leasing of more than 20 per cent of the assets of the material subsidiary on an aggregate basis during a financial year would require prior approval of shareholders by way of special resolution, unless it is made under a scheme of arrangement duly approved by a court/tribunal. **Where a listed entity has a listed subsidiary, which is itself a holding company, these provisions would apply to the listed subsidiary in so far as its subsidiaries are concerned.**

Obligations with Respect to Independent Directors A person should not serve as an independent director in more than 7 listed entities. A whole time director in any listed entity can serve as an independent director in only three listed entities. Their maximum tenure would be in accordance with the Companies Act/ rules. They should hold at least one meeting in a year without the presence of non-independent directors and members of the management. They should, *inter-alia,* **(a)** review the performance of **(i)** non-independent directors and the Board of Directors as a whole, **(ii)** chairperson of the listed entity, taking into account the views of executive/ non-executive directors, **(b)** assess the quality, quantity and timeliness of flow of information between the management and the Board of Directors necessary for it to effectively and reasonably perform their duties.

An independent director would be held liable, only in respect of acts of omission/commission by the listed entity, which had occurred with his knowledge, attributable through processes of Board of Directors, and with his consent/connivance or where he had not acted diligently. An independent director who resigns or is removed should be replaced by a new independent director before the immediate next meeting of the Board of Directors or three months from the date of the vacancy, whichever is later. The listed entity should familiarise the independent directors through various programmes including the following: **(a)** nature of the industry in which the listed entity operates, **(b)** its business model, **(c)** roles, rights, responsibilities of independent directors, and **(d)** any other relevant information.

Obligations with Respect to Employees and Senior Management A director can be a member of upto 10 committees or act as chairperson of upto 5 committees across all listed entities. He should inform the listed entity about the committee positions he or she occupies in other listed entities and notify changes as and when they take place. All the directors and senior management personnel should affirm compliance with their code of conduct on an annual basis. The non-executive directors should disclose their shareholding, held by them or on a beneficial basis for any other persons in the listed entity, in the notice to the general meeting called for their appointment. The senior management should make disclosures to the Board of Directors relating to all material, financial and commercial transactions, where they have personal interest that may have a **potential conflict** (relating to dealing in the shares of listed entity, commercial dealings with bodies, which have shareholding of management and their relatives etc.) with the interest of the listed entity at large.

Other Corporate Governance Requirements The listed entity should submit a quarterly compliance report signed either by the compliance officer or the chief executive office on corporate governance in the SEBI-specified format to the recognised stock exchange(s) within 15 days from the close of the quarter. The details of all material transactions with related parties should also be disclosed.

In-principle Approval of Recognised Stock Exchange(s) The listed entity, before issuing securities, should obtain an **in-principle** approval from recognised stock exchange(s) where **(a)** listed only on recognised stock exchange(s) having nationwide trading terminals, from all, **(b)** listed on any recognised stock exchange not having nationwide trading terminals, from all stock exchange(s) in which proposed to be listed, **(c)** where listed on both, from all having nationwide trading terminals.

Prior Intimations The listed entity should give prior intimation (at least 2 days in advance excluding the date of intimation/meeting) to stock exchange about the meeting of its Board of Directors in which the following proposals are due to be considered: (a) quarterly, half yearly/ annual, financial results, (b) buyback of securities, voluntary delisting, (c) fund raising by way of further public offer/rights issue/GDRs/ADRs/QIP/FCCBs/debt issue/preferential issue/any other method and for determination of issue price. The intimation should also be given in case of any annual/extraordinary general meeting/postal ballot proposed to be held for obtaining shareholder approval for further fund raising indicating type of issuance, (d) declaration/recommendation of dividend, issue of convertible securities including convertible debentures/debentures carrying a right to subscribe to equity shares or the passing over of dividend, (e) proposal for declaration of bonus securities. It should give intimation to the stock exchange(s) at least 11 working days before proposal is placed before the Board of Directors for any alteration in the (i) form or nature of any of its securities listed on the stock exchange or in the rights or privileges of their holders, (ii) date on which the interest on debentures /bonds, or the redemption amount of redeemable shares/debentures/bonds would be payable.

Disclosure of Events or Information Every listed entity should make disclosures of the SEBI-specified **material events/information**. It should consider the following criteria for determination of their materiality **(a)** omission of an event/information, likely to result in **(i)** discontinuity/alteration of event or information already available publicly, **(ii)** significant market reaction if the omission came to light at a later date, **(b)** in the opinion of the Board of Directors it is considered material. It should frame a policy for determination of materiality, based on the above criteria duly approved by its Board of Directors and disclosed on its website. It Board of Directors should authorise the key managerial personnel(s) for determining materiality for making disclosures to stock exchange(s) within 24 hours from occurrence and his contact details should also be disclosed to the stock exchange(s) as well as on the listed entity's website. The listed entity should disclose on its website all the events/information disclosed to the stock exchange(s) and hosted on its website for minimum 5 years and as per its archival policy disclosed on its website. It should also disclose all material events/information with respect to its subsidiaries. In case where an event occurs/an information is available which has not been indicated, but which may have material effect on it, it should make adequate disclosures.

Holding of Specified Securities and Shareholding Pattern A statement should be submitted to the stock exchange(s) showing holding of securities and shareholding pattern separately for each class of securities in the SEBI-specified format **(a)** one day prior to their listing, **(b)** on a quarterly basis, within 21 days from the end of each quarter, and, **(c)** within 10 days of any capital restructuring resulting in a change exceeding 2 per cent of the total paid-up share capital. It should **(i)** ensure that 100 per cent of shareholding of promoter(s)/promoter group is in dematerialised form and maintained on a continuous basis in the SEBI-specified manner, **(ii)** comply with SEBI circulars/ directions with respect to maintenance of shareholding in the dematerialised form.

Disclosure of Class of Shareholders and Conditions for Reclassification All entities falling under promoter/promoter group should be disclosed separately in the shareholding pattern appearing on the website of the concerned stock exchange(s) in accordance with the SEBI-specified formats. The concerned stock exchange (s) should allow modification/reclassification of the status of the shareholders, only upon a request from the concerned listed entity/shareholders along with all relevant evidence and on being satisfied with the compliance of required conditions. In case of transmission/succession/inheritance, the inheritor should be classified as promoter. When a new promoter replaces the previous promoter subsequent to an open offer or in any other manner, a re-classification may be permitted subject to the approval of shareholders in the general meeting and compliance of the following conditions: **(a)** they **(i)** do not hold more than 10 per cent of its paid-up capital, **(ii)** would continue to have any special rights through formal or informal arrangements, and they/relatives would not act as key managerial person(s) for more than 3 years from the date of the shareholders' approval. Where an entity becomes professionally managed and does not have any identifiable promoter, the existing promoters may be re-classified as public shareholders subject to approval of the shareholders in a general meeting. It may be considered as **professionally managed**, if **(i)** no person/group along with persons acting in concert hold more than one per cent paid-up equity capital of including holding of convertibles/outstanding warrants/depository receipts, **(ii)** promoters/relatives may act as key managerial personnel only subject to shareholders' approval for a period not exceeding three years, **(iii)** promoter along with his promoter group entities/persons acting in concert should not have any special right through formal or informal arrangements.

The re-classification of promoter as public shareholders would be subject to the following conditions: **(a)** He should not, directly or indirectly, exercise control, over the affairs of the entity, **(b)** Increase in the level of public shareholding would not be counted towards achieving compliance with the minimum public shareholding requirement under 19-A of the Securities Contracts (Regulation) Rules, **(c)** The event of re-classification should be disclosed to the stock exchange(s) as a material event, **(d)** The SEBI may relax any condition for re-classification in specific cases, if satisfied about the non-exercise of control by the outgoing promoter/persons acting in concert. Any public shareholder who seeks to re-classify itself as promoter, should make an open offer in accordance with the provisions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations.

Statement of Deviation(s)/Variation(s) The listed entity should submit to the stock exchange(s) statement(s) on a quarterly basis for public/rights/preferential issues indicating **(i)** deviations in the use of proceeds from the objects stated in the offer document/explanatory statement to the notice for the general meeting, **(ii)** category-wise variation (capital expenditure, sales and marketing, working capital etc.) between projected utilisation of funds in its offer document/explanatory statement to the notice for the general meeting and their actual utilisation till the time the issue proceeds have been fully utilised or the purpose for which these proceeds were raised has been achieved. They should be placed before the audit committee for review and submitted to the stock exchange(s). The listed entity should furnish an explanation for the specified variation in the directors' report in its annual report.

It should prepare an annual statement of funds utilised for purposes other than those stated in the offer document/prospectus/notice, certified by its statutory auditors and place it before the audit committee till such time the full money raised through the issue has been fully utilised. Where it has appointed a monitoring agency to monitor the utilisation of proceeds of a public/rights issue, it should submit to the stock exchange(s) any comments/report received from the monitoring agency and promptly place it before the audit committee on an annual basis.

Financial Results The financial results should be prepared on the basis of accrual accounting policy in accordance with the uniform accounting practices adopted for all the periods. The quarterly and year-to-date results should be prepared in accordance with the recognition and measurement principles in terms of the (Indian Accounting Standard) **Ind AS-25/ –Ind AS-31/Ind AS-34 specified** in **(i)** Section 133 of the Companies Act/rules **(ii)** by the Institute of Chartered Accountants of India. The stand-alone/consolidated financial results should be prepared as per the generally accepted accounting principles in India. The listed entity may also submit its financial results as per the international financial reporting standards notified by the International Accounting Standards Board. It should ensure that the limited review/audit reports submitted to the stock exchange(s) on a quarterly/annual basis are to be given only by an auditor who has subjected himself to the peer review process of and holds a valid certificate issued by the Peer Review Board of the Institute of Chartered Accountants of India. It should also make the specified disclosures.

The approval/authentication of the financial results should be done by listed entity in the following manner. The quarterly financial results should be approved by its Board of Directors. The chief executive/financial officer should certify that they not contain any false/misleading statement/figures and do not omit any material fact making them misleading. They should be signed by the chairperson/managing director/whole time director/other director duly authorised by the Board of Directors. The limited review report should be approved by the Board of Directors before being submitted to the stock exchange(s).

The financial results should be submitted in the following manner: **(a)** quarterly and year-to-date standalone financial results to the stock exchange within 45 days of end of each quarter, other than the last quarter, **(b)** in case of subsidiaries, submit quarterly/year-to-date consolidated financial results subject to following: **(i)** intimate to the stock exchange, whether it opts to additionally submit quarterly/year-to-date consolidated financial results in the first quarter of the financial year and this option should not be changed during the financial year, **(ii)** in case of change of its option, comparable figures for the previous year in accordance with the exercised option.

The quarterly and year-to-date financial results may be audited/unaudited subject to the following: **(i)** the unaudited financial results would be subject to limited review by the statutory auditors and accompanied by the limited review report. The audited financial results, should be accompanied by the audit report.

The listed entity should submit annual audited standalone financial results within 60 days from the end of the financial year along with the audit report and ***Statement on Impact of Audit Qualifications***. While submitting annual audited standalone financial results, it should also submit annual audited consolidated financial results along with the audit report and ***Statement on Impact of Audit Qualifications***. In case of audit reports with unmodified opinion(s), it should furnish a declaration to that effect to the stock exchange(s) while publishing the annual audited financial results. It should also submit the audited financial results in respect of the last quarter alongwith the results for the entire financial year, with a note stating that the figures of the last quarter are the balancing figures between the audited figures in respect of the full financial year and the published year-to-date figures upto the third quarter of the current financial year. It should also submit, by way of a note, a statement of assets and liabilities as at the end of the half-year. The applicable formats of the financial results and ***Statement on Impact of Audit Qualifications*** should be in the SEBI-specified manner. The ***Statement on Impact of Audit Qualifications*** and the accompanying annual audit report would be reviewed by the stock exchange(s).

Annual Report The annual report should be submitted to the stock exchange(s) within 21 working days of it being approved and adopted in the annual general meeting as per the provisions of the Companies Act. It should contain: **(a)** audited financial statements, that is, balance sheets, profit and loss accounts ***Statement on Impact of Audit Qualifications***, **(b)** consolidated financial statements audited by its statutory auditors, **(c)** cash flow statement presented only under the indirect method as prescribed in Accounting Standard-3 or Indian Accounting Standard 7, specified in Section 133 of the Companies Act or as specified by the Institute of Chartered Accountants of India, **(d)** directors report, **(e)** management discussion and analysis report, **(f)** for the top 500 listed entities based on market capitalisation (calculated as on March 31 of every financial year), business responsibility report describing the initiatives taken by them from an environmental, social and governance perspective, in the SEBI-specified format. Other companies may include these business responsibility reports on a voluntary basis. The annual report should contain any other disclosures specified in the Companies Act along with other SEBI-specified requirements.

Annual Information Memorandum The listed entity should submit to the stock exchange(s) an annual information memorandum in the SEBI-specified manner.

Documents and Information to Shareholders The listed entity should send the annual report at least 21 days before annual general meeting to the shareholders: **(a)** soft copies of full annual report to all those shareholder(s) who have registered their email address(es) for the purpose, **(b)** copy of statement containing the salient features of all the documents, as prescribed in Section 136 of Companies Act or rules to those shareholder(s) who have not registered, **(c)** copies of full annual reports to shareholders on request. In case the appointment of a new director/re-appointment of a director, the shareholders must be provided with the following information: **(a)** a brief resume of the director; **(b)** nature of his expertise in specific functional areas; **(c)** disclosure of relationship between directors *inter se*; **(d)** names of listed entities in which he also holds the directorship and the membership of committees of the Board; and **(e)** shareholding of non-executive directors.

Draft Scheme of Arrangement and Scheme of Arrangement A listed entity desirous of undertaking/ involved in a scheme of arrangement, should file its draft proposed under the Companies Act with the stock exchange(s) for obtaining observation/no-objection letter, before filing it with any court/tribunal in terms of the SEBI/stock exchange-specified requirements. The validity of the observation/no-objection would be six months from the date of issuance. It should also ensure compliance with the other SEBI-prescribed requirements. Upon sanction of the scheme by the court/tribunal, it should submit the SEBI/stock exchange prescribed the documents to the stock exchange(s).

Minimum Public Shareholding The listed entity should comply with the minimum public shareholding requirements specified in Rule 19(2) and Rule 19-A of the Securities Contracts (Regulation) Rules, in the SEBI-specified manner (**discussed in Chapter 5 of this book**).

Issuance of Certificates/Receipts/Letters/Advices for Securities and Dealing with Unclaimed Securities The listed entity should comply with Rule 19(3) of Securities Contract Rules in respect of letter/advices of allotment, acceptance/rights, transfers, subdivision, consolidation, renewal, exchanges, issuance of duplicates or any other purpose and issue the new certificate within 30 days of lodgement. It should submit the information regarding loss and issue of the duplicate share certificates to the stock exchange(s) within 2 days of its getting information. It should also comply with the specified procedural requirements while dealing with securities issued pursuant to the public/other issue, physical or otherwise, which remain unclaimed and/or are lying in the escrow account.

Transfer or Transmission or Transposition of Securities Subject to the specified provisions of securities laws/companies act/rules, the listed entity should also comply with the specified requirements for effecting transfer of securities. Its Board of Directors may delegate the power of transfer of securities to a committee/compliance officer/the registrar to an issue and/or share transfer agent(s). The Board of Directors and/or the delegated authority should attend to the formalities pertaining to transfer of securities at least once in a fortnight and report it to the Board of Directors in each meeting. On receipt of proper documentation, the listed entity should register transfers of its securities in the name of the transferee(s) and issue certificates/receipts/advices of transfers or issue any valid objection/intimation to the transferee/transferor within 15 days from the date of the receipt of request for transfer. It should ensure that transmission requests are processed for securities held in dematerialised/physical mode within 7 days and 21 days respectively. Proper verifiable dated records of all correspondence with the investor(s) should be maintained by it. It should not register transfer when **(i)** any statutory prohibition/attachment/ prohibitory order of a competent authority restrains it, **(ii)** the transferor(s) object. It should comply with all the specified procedural requirements with respect to transfer of securities. On failure to transfer of securities, it should communicate to the transferee(s) any valid objection to the transfer, within 15 days and compensate the aggrieved party for the opportunity losses caused during the period of the delay. During the intervening period on account of delay in transfer, the listed entity should provide all the accrued benefits to the holder of securities in terms of provisions of the Companies/Securities Contracts (Regulation) Act. It should be ensured that the share transfer agent and/or the in-house share transfer facility produces a certificate from a practicing company secretary within one month of the end of each half of the financial year to the effect that all the certificates have been issued within 30 days of the date of lodgement for transfer/subdivision/consolidation/renewal/exchange/ endorsement of calls/allotment monies and filed with the stock exchange(s) simultaneously. In addition to transfer of securities, the above provisions would also apply to the following: **(a)** deletion of name of the deceased holder(s) of securities, **(b)** transmission of securities to the legal heir(s), **(c)** transposition of securities, when there is a change in the order of names in which physical securities are held jointly in the names of two or more holders of securities.

Other Provisions Relating to Securities The listed entity should **(a)** not exercise a lien on its fully/ partly paid shares except in respect of moneys called/payable at a fixed time in respect of partly-paid shares, **(b)** in case of any amount to be paid in advance of calls on any shares stipulating that it may carry interest but should not in this respect confer a right to dividend or to participate in profits, **(c)** not issue shares in any manner which may confer on any person superior rights as to voting/dividend vis-à-vis the rights on equity shares that are already listed, **(d)** issue/offer in the first instance all shares (including forfeited shares), securities, rights, privileges and benefits to subscribe ***pro rata*** basis, to its equity shareholders unless the shareholders in the general meeting decide otherwise, and **(e)** not select any listed security for redemption otherwise than on ***pro-rata*** basis or by lot unless the terms of the issue otherwise provide.

Record Date/Date of Closure of Transfer Books The listed entity should **(i)** intimate the record date to all the concerned stock exchange(s) for **(a)** declaration of dividend, **(b)** issue of right/ bonus shares, **(c)** issue of shares for conversion of debentures/other convertible security; **(d)** shares arising out of rights attached to debentures/other convertible security, **(e)** corporate actions like mergers, de-mergers, splits and bonus shares, where stock derivatives are available on its stock or where stocks form part of an index on which derivatives are available, **(f)** other purposes specified by the stock exchange(s), **(ii)** give notice in advance of atleast 7 working days (excluding the date of intimation and the record date) to stock exchange(s) specifying the purpose of the record date, **(iii)** recommend/declare all dividend and/or cash bonuses at least five working days (excluding the date of intimation and the record date) before the record date fixed, **(iv)** ensure the time gap of at least 30 days between two record dates. It may announce dates of closure of its transfer books in place of record date for complying with the above for securities held in physical form. It should also ensure that there is a time gap of atleast 30 days between two dates of closure of its transfer books.

Dividends The listed entity should **(i)** declare/disclose the dividend on per share basis only, **(ii)** not forfeit unclaimed dividends before the claim becomes barred by law and any forfeiture should be annulled in appropriate cases.

Dividend Distribution Policy The top 500 listed entities based on market capitalisation (calculated as on March 31 of every financial year) should formulate a dividend distribution policy which should be disclosed in their annual reports and on their websites. It should include the following parameters: **(a)** circumstances under which the shareholders may/may not expect dividend, **(b)** financial parameters to be considered while declaring dividend, **(c)** internal and external factors to be considered for declaration of dividend, **(d)** policy as to how the retained earnings would be utilised, and **(e)** parameters to be adopted with regard to various classes of shares. If it proposes to **(i)** declare dividend on the basis of parameters in addition to the above, **(ii)** change the additional parameters/dividend distribution policy contained in any/parameter, it should disclose them along with their rationale in its annual report and on its website. Other listed entities may disclose their dividend distribution policies on a voluntary basis in their annual reports and on their websites.

Voting by Shareholders The listed entity should **(i)** provide the facility of remote **e-voting** facility to its shareholders in respect of all their resolutions, **(ii)** submit to the stock exchange(s), within 48 hours of conclusion of its general meeting, details regarding the voting results in the SEBI-specified format, and **(iii)** send proxy forms to holders of securities in all cases mentioning that he may vote either for or against each resolution.

Change in Name of the Listed Entity The listed entity can change its name subject to compliance with the following conditions: **(a)** a time period of at least one year has elapsed from the last name change, **(b)** at least 50 per cent of the total revenue in the preceding one year period has been accounted for by the new activity suggested by the new name, **(c)** the amount invested in the new activity/project is atleast 50 per cent of its assets. If any listed entity has changed its activities which are not reflected in its name, it should change its name in line with its activities within six months from the change of activities in compliance of the provisions as applicable to the change of name prescribed under the Companies Act. While **assets** means the sum of fixed assets/advances/works in progress/inventories/ investments/trade receivables, cash/cash equivalents, **advances** include only those amounts extended to contractors/suppliers towards execution of project, specific to new activity as reflected in the new name.

Website The listed entity should **(i)** maintain a functional website containing the basic information about it, **(ii)** disseminate the following information on its website: **(a)** details of its business, **(b)** terms/conditions of appointment of independent directors, **(c)** composition of various committees of its Board of Directors, **(d)** code of conduct of Board of Directors and senior management personnel, **(e)** details of establishment of vigil mechanism/whistle blower policy, **(f)** criteria of making payments to non-executive directors, if not disclosed in annual report, **(g)** policy on dealing with related party transactions, **(h)** policy for determining **material subsidiaries**, **(i)** details of familiarisation programmes imparted to independent directors including the following details: **(1)** number of programmes attended/hours spent by independent directors in such programmes (during the year and on cumulative basis till date), and **(2)** other relevant details, **(j)** the email address for grievance redressal and other relevant details, **(k)** contact information of its designated officials who are responsible for assisting and handling investor grievances, **(l)** financial information including: **(1)** notice of meeting of the Board of Directors where financial results would be discussed; **(2)** financial results, on conclusion of the meeting of the Board of Directors where the financial results were approved; **(3)** complete copy of the annual report including balance sheet/profit and loss account/directors report/corporate governance report etc.; **(m)** shareholding pattern, **(n)** details of agreements entered into with the media companies and/or their associates; **(o)** schedule of analyst/institutional investor meet and presentations made to them simultaneously with submission to stock exchange, **(p)** its new/old name for a continuous period of one year, from the date of the last name change; and **(q)** items of information in newspaper advertisement **(discussed subsequently)**. It should be ensured that the contents of the website are correct and change in the content of its website updated within 2 working days from the date of the change in the content.

Advertisements in Newspapers The listed entity should publish the following information in the newspapers: **(a)** notice of meeting of the Board of Directors where financial results would be discussed **(b)** financial results, along-with the modified opinion(s)/reservation(s), expressed by the auditor. If it has submitted both standalone and the consolidated financial results, it should publish the consolidated financial results alongwith **(1)** turnover, **(2)** profit before tax and **(3)** profit after tax, on a stand-alone basis, as a foot note; and a reference to the places, such as its website and stock exchange(s), where its standalone results are available, **(c)** statements of deviation(s)/variation(s) on quarterly basis, after review by the audit committee and its explanation in Directors' report in annual report, and **(d)** notices given to shareholders by the advertisement. It should give a reference in the newspaper publication to link its website and stock exchange(s), where further details are available. It should publish the above information in the newspaper simultaneously with its submission to the stock exchange(s). However, the financial results should be published within 48 hours of the conclusion of the meeting of Board of Directors at which the financial results were approved. The above information should be published in at least one English language national daily newspaper circulating in the whole/substantially the whole of India and in one daily newspaper published in the language of the region, where its registered office is situated.

Accounting Standards The listed entity should comply with all the applicable and notified accounting standards from time to time.

Obligations of Listed Entity Which Has Listed its Non-convertible Debt Securities/Redeemable Preference Shares or Both

These provisions apply only to a listed entity which has listed its non-convertible debt securities and/or redeemable preference shares on a recognised stock exchange in accordance with the SEBI Issue and Listing of Debt Securities Regulations/Issue and Listing of Non-Convertible Redeemable Preference Shares Regulations respectively (**discussed in Chapter 7 of this book**). They are also applicable to perpetual debt instrument/non-cumulative preference share listed by banks. However, the provisions concerning debenture trustees and security creation (or asset cover/charge on assets) would not be applicable for non-convertible redeemable preference shares. The main elements of the regulation are: **(1)** intimation to stock exchanges, **(2)** financial results, **(3)** annual reports, **(4)** asset covers, **(5)** credit rating, **(6)** documents/intimation to debenture trustees, **(7)** other submissions to the stock exchanges, **(8)** documents/intimation to holders, **(9)** structure, **(10)** record date, **(11)** terms and **(12)** website.

Intimation to Stock Exchange(s) The listed identity should:

- give prior intimation to the stock exchange(s) at least 11 working days before the date on, and from which the interest on debentures and bonds/redemption amount of redeemable shares/debentures and bonds would be payable,
- intimate to the stock exchange(s) **(a)** its intention to raise funds through them it proposes to list either through a public issue or on private placement basis, prior to their issuance, **(b)** at least two working days in advance, excluding the date of the intimation and date of the meeting, regarding the meeting of its Board of Directors, at which the recommendation/declaration of their issue or any other matter affecting the rights/interests of their holders is proposed to be considered,
- **promptly** inform (i.e. as soon as practicable and without delay first to them before any third party) the stock exchange(s) of all information having bearing on its performance/operation, price sensitive information or any action that would affect payment of interest/dividend. It should also make all the specified disclosures.

Financial Results The listed entity should:

- prepare and submit un-audited/audited financial results on a half yearly basis in the SEBI-specified format within 45 days from the end of the half year to the recognised stock exchange(s).
- comply with the following requirements with respect to preparation/approval/ authentication/publication of annual and half-yearly financial results: **(a)** Unaudited financial results accompanied by limited review report in the SEBI-specified format by its statutory auditors/any practising chartered accountant in case of public sector undertaking, **(b)** Half-yearly results should be taken on record by the Board of Directors and signed by the Managing Director/Executive Director, **(c)** The audited results should be submitted in the same format as is applicable for half-yearly financial results, **(d)** Modified opinion(s) in audit reports having a bearing on the interest/dividend payment/redemption or principal repayment capacity should be appropriately/adequately addressed by the Board of Directors while publishing the accounts. The annual audited financial results should be submitted along with the annual audit report and ***Statement on Impact of Audit Qualifications*** for audit report with modified opinion. In case of audit reports with unmodified opinion, it should furnish a declaration to that effect to the stock exchange(s) while publishing the annual audited financial results. The ***Statement on Impact of Audit Qualifications*** and the accompanying annual audit report should be reviewed by the stock exchange(s).

- While submitting half yearly/annual financial results, disclose the following line items **(a)** credit rating and change in credit rating, **(b)** asset cover available in case of non-convertible debt securities, **(c)** debt-equity ratio, **(d)** previous due date for the payment of interest/ dividend/repayment of principal and whether the same has been paid or not, **(e)** next due for their payment, **(f)** debt service coverage ratio, **(g)** interest service coverage ratio, **(h)** outstanding redeemable preference shares (quantity and value), **(i)** capital/debenture redemption reserve, **(j)** net worth, **(k)** net profit after tax, and **(l)** earnings per share.

The above requirement would not be applicable in case of unsecured debt instruments issued by regulated financial sector entities eligible for meeting capital requirements as specified by the respective regulators. The above information should also be accompanied by a certificate signed by debenture trustee that it has taken note of the contents. The following additional disclosures as notes to financials should also be made: **(a)** profit for the half year and cumulative profits for the year, **(b)** free reserve as on the end of half year, **(c)** securities premium account balance (if redemption of redeemable preference share is to be done at a premium, such premium may be appropriated from securities premium account) in the year in which non-convertible redeemable preference shares are due for redemption, **(d)** track record of dividend payment, **(e)** breach of any covenants under the terms of the non convertible redeemable preference shares.

The listed entity should submit to the stock exchange on a half yearly basis along with the half yearly financial results, a statement indicating any material deviations in the use of proceeds of their issue from the objects stated in the offer document. It should within two calendar days of the conclusion of the meeting of the Board of Directors publish the financial results and the required statement in at least one English national daily newspaper circulating in the whole or substantially the whole of India.

Annual Report The annual report should contain disclosures as specified in the Companies Act, along with the following: **(a)** audited financial statements, that is, balance sheets/profit and loss accounts and ***Statement on Impact of Audit Qualifications***, **(b)** cash flow statement presented only under the indirect method as prescribed in the Ind AS-3/ Ind AS-7, **(c)** auditors report, **(d)** directors report, **(e)** name of the debenture trustees with full contact details, and **(f)** related party SEBI-specified disclosures.

Asset Cover The listed entity should maintain 100 per cent asset cover sufficient to discharge the principal amount at all times for the non-convertible debt securities issued. It should disclose to the stock exchanges in quarterly/half-yearly/year-to-date and annual financial statements, the extent and nature of security created and maintained with respect to them. The above requirement would not be applicable in case of unsecured debt securities issued by regulated financial sector entities eligible for meeting capital requirements as specified by the respective regulators.

Credit Rating Each rating obtained by it with respect to the non-convertible debt securities should be reviewed at least once a year by a SEBI-registered credit rating agency.

Documents and Intimation to Debenture Trustees The listed entity should forward the following to the debenture trustee promptly:

(a) a copy of the annual report at the same time as it is issued along with a copy of certificate from the auditors in respect of utilisation of funds during the implementation period of the project for which the funds have been raised,

(b) a copy of all notices/resolutions/circulars relating to **(i)** new issue of non-convertible debt securities at the same time as they are sent to shareholders/ holders of non-convertible debt securities, **(ii)** the meetings of holders of non-convertible debt securities at the same time as they are sent to the holders of non-convertible debt securities or advertised in the media including those relating to proceedings of the meetings,

(c) intimations regarding **(i)** revision in the rating, **(ii)** default in timely payment of interest/ redemption/both in respect of the non-convertible debt securities, **(iii)** failure to create charge on the assets,

(d) a half-yearly certificate regarding maintenance of 100 per cent asset cover by a practicing company secretary/chartered accountant, along with the half yearly financial results. It should also forward to the debenture trustee any information sought and provide access to the relevant books of accounts as required by them. It may, subject to the consent of the debenture trustee, send the required information in electronic form/fax.

Other Submissions to Stock Exchange(s) The listed entity should submit a certificate to the stock exchange(s) within two days of becoming due that it has made timely payment of interests/ principal obligations/both. It should **(i)** provide an undertaking on annual basis stating that all documents/intimations required to be submitted to debenture trustees in terms of trust deed and the SEBI Issue and Listing of Debt Securities Regulations **(discussed in Chapter 7)** have been complied with, **(ii)** forward any other information in the SEBI-specified manner and format.

Documents and Information to Holders of Non-convertible Debt Securities/Preference Shares The listed entity should send the following documents: **(a)** Soft copies of full annual reports to all the holders share who have registered their email address(es), **(b)** Hard copy of statement containing the salient features of all the documents specified by the Companies Act, to those holders who have not so registered, **(c)** Hard copies of full annual reports to those holders, who request for the same, **(d)** Half-yearly specified communication regulation to all holders. It should send **(i)** the notice of all meetings of their holders specifically stating that the provisions for appointment of proxy would be applicable, **(ii)** proxy forms to the holders which should be worded in such a manner that they may vote either for or against each resolution.

Structure of Non-convertible Debt Securities/Redeemable Preference Shares The listed entity should not make material modification without the prior approval of the concerned stock exchange(s) to the structure of **(a)** the debentures in terms of coupon/conversion/redemption/ otherwise, **(b)** non-convertible redeemable preference shares in terms of dividend/conversion/ redemption/ otherwise. The approval of the stock exchange should be made only after: **(a)** approval of the Board of Directors/debenture trustee, **(b)** after complying with the provisions of the Companies Act, including approval of the consent of requisite majority of holders of that class of securities.

Record Date The listed entity should fix a record date for payment of interest/dividend/ redemption/repayment amount or for other stock exchange-specified purposes. It should give notice in advance of atleast 7 working days (excluding the date of intimation and the record date) to the recognised stock exchange(s) of the record date or of as many days as the stock exchange(s) may agree to or require specifying the purpose of the record date.

Terms of Nonconvertible Debt Securities/ Redeemable Preference Shares The listed entity should:

- ensure timely payment of interest/dividend/redemption payment. It should not declare/ distribute dividend if it has defaulted in payment of interest/redemption on debt securities or in creation of security as per the terms of their issue. This requirement would not be applicable in case of unsecured debt securities issued by regulated financial sector entities eligible for meeting capital requirements as specified by the respective regulators,

- not forfeit unclaimed interest/dividend which should be transferred to the **Investor Education and Protection Fund** set up as per Section 125 of the Companies Act,
- not select any listed securities for redemption otherwise than on ***pro rata*** basis or by lot,
- comply with the specified requirements for transfer of securities including the specified procedural requirements.

Website The listed entity should maintain a functional website containing the following information: **(a)** details of its business, **(b)** financial information including complete copy of the annual report including balance sheet/profit and loss account/directors report etc., **(c)** contact information of the designated officials who are responsible for assisting/handling investor grievances, **(d)** *email* address for grievance redressal and other relevant details, **(e)** name of the debenture trustees with full contact details, **(f)** the information, report, notices, call letters/ circulars/proceedings/concerning non-convertible redeemable preference shares/debt securities, **(g)** all information and reports including compliance reports filed by it, **(h)** information with respect to the following events: **(i)** default by issuer to pay interest on or redemption amount, **(ii)** failure to create a charge on the assets, **(iii)** revision of rating assigned to the non convertible debt securities. It may also issue a press release with respect to the above specified events and ensure that the contents of the website are correct and updated at any given point of time.

Obligations of Listed Entity Which Has Listed its Specified Securities and Either Non-Convertible Debt Securities/Preference Shares or Both

An entity, which has listed its specified securities and non-convertible debt securities/redeemable preference shares or both on any recognised stock exchange, would be bound by the provisions applicable to a listed entity which has listed its specified securities **(discussed in an earlier Section).** It should additionally comply with the following regulations applicable to listed entity which has listed its non-convertible debt securities/redeemable preference shares or both (**discussed in an earlier Section**): **(a)** information to stock exchanges with reference to intention to raise funds and meeting of the Board of Director to recommending the issue, **(b)** disclosure of information having a bearing on the performance/operation of the listed entity and/or price sensitive information, **(c)** financial results with reference to the audited financial results along with the audit report, line items, certificate by debenture trustees and additional disclosures as notes to financials results, **(d)** annual report, **(e)** asset cover, **(f)** credit rating, **(g)** documents and intimation to debenture trustees, **(h)** other submission to stock exchanges, **(i)** documents and information to holders of non-convertible debt securities/preference shares, **(j)** structure of convertible securities, **(k)** record date, **(l)** terms of convertible securities. However, the listed entity which has submitted any information to the stock exchange in compliance with the disclosure requirements with reference to listing of its specified securities need not re-submit them. Similarly, if it has satisfied certain other compliance obligations, it may not satisfy the same conditions again. In the event the specified securities are delisted from the stock exchange(s), it should comply with all the provisions applicable to the listed non-convertible securities. In the event the non-convertible debt securities/preference shares do not remain listed, it should comply with all the provisions applicable to the listing of the specified securities.

Obligations of Listed Entity Which Has Listed its Indian Depository Receipts

These provisions would apply to listed entity issuing Indian depository receipts (IDRs) (**discussed in Chapter 7 of this book**). The main elements of the regulation are: **(i)** general obligations, **(ii)** disclosure of material information/events, **(iii)** holding pattern/shareholders details, **(iv)** periodical financial results, **(v)** annual report, **(vi)** corporate governance, **(vii)** documents/information to IDR-holder, **(viii)** equitable treatment of IDR-holders, **(ix)** terms of IDRs, **(x)** newspaper advertisement, **(xi)** structure of IDRs, **(xii)** record date, **(xiii)** voting, and **(xiv)** delisting.

General Obligations All correspondences filed with the stock exchange(s)/sent to the IDR holders should be in English. The listed entity should **(i)** comply with the rules/regulations/laws of the **country of origin** (i.e. country/parent country where it is incorporated/listed), **(ii)** undertake that the competent courts/tribunals/regulatory authorities in India would have jurisdiction in the event of any dispute concerning the IDRs offered/subscribed/bought in India, **(iii)** forward, on a continuous basis, any information requested by the stock exchange(s), in the interest of investors. Any claim/difference/dispute would be referred to, and decided by, arbitration as provided in the bye-laws and regulations of the stock exchange(s).

Disclosure of Material Events/Information The listed entity should promptly inform to the stock exchange(s) of all the specified material events/information which is price sensitive and/or have bearing on its performance/operation. It should also make all the other disclosures.

IDR Holding Pattern/Shareholding Details. It should file with the stock exchange(s) the IDR **(i)** holding pattern on a quarterly basis within 15 days of end of the quarter in the SEBI-specified format, **(ii)** file the following details in compliance with the disclosure requirements of the listing authority/stock exchange in its home country or any other jurisdiction where its securities are listed: **(a)** shareholding pattern, **(b)** pre- and post-arrangement shareholding pattern and capital structure in case of any corporate restructuring like mergers/amalgamations.

Periodical Financial Results It should **(i)** file periodical financial results with the stock exchange(s) in the manner and within the time and to the extent required as per the listing requirements of the home country, **(ii)** comply with the requirements with respect to the preparation and specified disclosures in financial results.

Annual Report It should **(i)** submit to stock exchange(s) an annual report at the same time as it is disclosed to the securityholders in its home country or in other jurisdictions where they are listed, containing the following: **(a)** report of Board of Directors, **(b)** balance sheet, **(c)** profit and loss account, **(d)** auditors report, **(e)** all applicable periodical and special reports, **(f)** any other required report to be sent to securityholders annually, **(ii)** comply with the requirements with respect to the preparation and the specified disclosures in financial results in the annual report.

Corporate Governance The listed entity should **(i)** comply with the applicable corporate governance provisions in its home country and other jurisdictions in which its equity shares are listed, **(ii)** submit to stock exchange(s) a comparative analysis of the corporate governance provisions applicable in its home country and in the other jurisdictions along with the compliance of the same vis-à-vis the corporate governance requirements applicable to the other listed entities.

Documents and Information to IDR-holder The listed entity should disclose/send the following documents to IDR-holders, at the same time and to the extent that it discloses to securityholders in its home country or in other jurisdictions: **(a)** soft copies of the annual report to all the IDR holders who have registered their email address(es) for the purpose, **(b)** hard copy of the annual report to those who request for the same either through domestic depository or compliance officer, **(c)** the pre- and post-arrangement capital structure and shareholding pattern in case of any corporate restructuring like mergers/amalgamations/other schemes

Equitable Treatment to IDR-holders If the listed entity's equity shares/other securities representing equity shares are also listed on the stock exchange(s) in countries other than its home country, it should ensure that they are treated in a manner equitable with securityholders in home country. It should also ensure that for all corporate actions, except those which are not permitted by Indian laws, it would treat IDR holders in a manner equitable with securityholders in the home country. In case of take-over/delisting/buy-back of its equity shares, it should, while following the laws applicable in its home country, give equitable treatment to IDR holders *vis-à-vis* security holders in home country. It should also ensure protection of interests of the IDRholders particularly with respect to all corporate benefits permissible under the Indian laws and the laws of its home country and address all investor grievances adequately.

Advertisements in Newspapers It should publish the following information in the newspapers: **(a)** required periodical financial results, **(b)** notices given to its IDR holders by advertisement. It should be issued in at one English national daily newspaper circulating in the whole or substantially the whole of India and in one Hindi national daily newspaper in India.

Terms of Indian Depository Receipts The listed entity should **(i)** pay the dividend as per the timeframe applicable in its home country or other jurisdictions whichever is earlier, so as to reach the IDR holders on or before the date fixed for payment of dividend to holders of its equity share or other securities, **(ii)** not forfeit unclaimed dividends before the claim becomes barred by law in its home country and it should be annulled in appropriate cases. The IDRs should have two-way fungibility in the SEBI-specified manner.

Structure The listed entity should **(i)** ensure that the underlying shares of IDRs would rank *paripassu* with the existing shares of the same class and the fact of having different classes of shares based on different criteria should be disclosed in its annual report, **(ii)** not exercise a lien on the fully/partly-paid underlying shares, against which the IDRs are issued and also not exercise any lien except in respect of moneys called/payable at a fixed time in respect of the underlying shares, **(iii)** stipulate that any amount paid-up in advance of calls on any underlying shares against the IDRs are issued may carry interest but would not confer a right to dividend or to participate in profits.

Record Date Where required in its home country/other jurisdictions, the listed entity should **(i)** fix the record date for payment of dividends/distribution of any other corporate benefits to the IDR holders, **(ii)** give notice in advance of atleast four working days to the recognised stock exchange(s) of record date specifying its purpose.

Voting The listed entity should, either directly or through an agent, send out proxy forms to the IDR holders in all cases mentioning that he may vote for or against each resolution. The voting rights should be exercised in accordance with the **depository agreement** (i.e. agreement between the listed entity and domestic depository).

Delisting The listed entity should, if it decides to delist IDRs, give fair and reasonable treatment to its holders. It should comply with the SEBI/stock exchange-specified norms and conditions for their delisting. It should also, in case the underlying shares are listed, delist/cancel the IDRs.

Obligations of Listed Entity Which Has Listed its Securitised Debt Instruments

These provisions apply to special purpose distinct entity (SPDE) issuing securitised debt instruments (SDIs) and its trustees should ensure compliance them. The expressions asset pool, clean-up call option, credit enhancement, debt or receivables, investor, liquidity provider, obligor, originator, regulated activity, scheme, securitisation, securitised debt instrument, servicer, special purpose distinct entity, sponsor and trustee have the same meaning as assigned to them under the SEBI Public Offer and Listing of Securitised Debt Instruments Regulations (**discussed in Chapter 4 of this book**). The main elements of the regulations **(i)** intimation/filing with stock exchanges, **(ii)** disclosure of information having bearing on performance/operation of the listed entity and/or price sensitive information, **(iii)** credit rating, **(iv)** information to investors, **(v)** terms of securitised debt instruments and **(vi)** record date are discussed below. The listed entity should

- **(i) (a)** intimate the stock exchange(s), of its intention to issue new SDIs through a public issue or on private placement basis (if it proposes to list them) prior to issuing them, **(b)** at least two working days in advance, excluding the date of the intimation/meeting, regarding the meeting of its Board of Trustees, at which the recommendation/declaration of the issue or any other matter affecting the rights/interests of their holders is proposed to be considered, **(ii)** submit in the SEBI-specified format statements/reports/information including financial information within seven days from the end of the month/actual payment date, either by itself or through the servicer, on a monthly basis, **(iii)** provide in the specified manner either by itself or through the servicer, loan level information, without disclosing the particulars of individual borrowers;
- **promptly** (i.e. as soon as practically possible and without any delay and that the information should be given first to the stock exchange(s) before providing the same to any third party) inform the stock exchange(s) of all the specified information having bearing on its performance/operation and price sensitive information. The rating obtained by it with respect to the SDIs should be periodically reviewed, preferably once a year, by a SEBI-registered credit rating agency and disseminated by them;
- **(i)** provide either by itself or through the servicer, loan level information without disclosing particulars of individual borrower to its investors/information regarding any revision in rating in electronic form, **(ii)** display the *email* address of the grievance redressal division and other relevant details prominently on its website and in the various materials/pamphlets/advertisement campaigns initiated by it for creating investor awareness;
- ensure **(a)** that no material modification would be made to the structure of the SDIs in terms of coupon, conversion, redemption, or otherwise without their prior approval and make the application to the recognised stock exchange(s) only after the approval by trustees, **(b)** timely interest/redemption payment, **(c)** make credit enhancement available for the listed SDIs at all times, **(d)** not forfeit unclaimed interest and principal and transfer them after seven years to the Investor Protection and Education Fund, **(e)** also not select any of its listed SDIs for redemption otherwise than on *pro rata* basis or by lot and promptly submit the details to the stock exchange(s), **(f)** remain listed till their maturity/redemption or delisting;
- **(i)** fix a record date for payment of interest/redemption/repayment amount or for other stock exchange-specified purposes, **(ii)** give notice in advance of atleast seven working

days to the stock exchange(s) of the record date or of as many days as it may agree to/require specifying the purpose of the record date.

Obligations of Listed Entity Which has Listed its Mutual Fund Units

These provisions would apply to the asset management company managing the mutual fund scheme whose units are listed on the stock exchange(s). The provisions of the SEBI Mutual Funds Regulations/directions (**discussed in detail in Chapter 15 of this book**) would apply on the listed entity and to the schemes. The two elements of the regulations, namely, submission of documents and dissemination on the website of the stock exchanges, are discussed below. The listed entity should

- intimate to the stock exchange(s) **(a)** the information relating to daily net asset value, monthly portfolio, half-yearly portfolio of those schemes whose units are listed in the specified format under the SEBI Mutual Fund Regulations/directions **(b)** movement in unit capital of the listed schemes, **(c)** their rating and any changes in the rating, **(d)** imposition of penalties and material litigations against the listed entity and mutual fund, **(e)** any prohibitory orders restraining it from transferring units registered in the name of the unitholders.
- submit the required information and documents, on its website in terms of SEBI Mutual Fund Regulations/directions to the recognised stockexchange for dissemination.

Duties and Obligations of the Recognised Stock Exchange(s)

The main elements of the regulations are: **(i)** dissemination, **(ii)** transferability, **(iii)** draft scheme of arrangement and scheme arrangement, **(iv)** statement on impact of audit qualifications on annual audit report, **(v)** grievances redressal and **(vi)** monitoring of compliance/non-compliance and adequacy/accuracy of disclosures.

- Upon receipt of relevant intimations/information/filings/reports/statements/documents/other submissions from the listed entity, the recognised stock exchange(s) should immediately disseminate them on its website in organised, user-friendly and easily-referable manner including by providing hyperlinks for easy accessibility.
- It should coordinate with the depositories to ensure compliance with the applicable SEBI laws/directions or any competent court with regard to freezing/unfreezing, lock-in/release of lock-in with respect to the securities issued/managed by it.
- Upon receipt of draft schemes of arrangement and the SEBI-prescribed documents, it should forward them to the SEBI in the prescribed manner. It should also submit to the SEBI its objection/no objection letter on the draft scheme of arrangement after, *inter-alia,* ascertaining whether it is in compliance with securities laws within 30 days of its receipt or within 7 days of date of receipt of satisfactory reply on clarifications from the listed entity and/or opinion from independent chartered accountant, sought by it. It should **(i)** issue observation letter or no-objection letter to the listed entity within seven days of receipt of comments from the SEBI, after suitably incorporating its comments, **(ii)** bring the observations or objections to the notice of court or tribunal at the time of approval of the scheme of arrangement. Upon sanction of the scheme by the court or tribunal, it should forward its recommendations to the SEBI on the documents submitted by the listed entity.

- It should review **(i)** the submitted statement on impact of audit qualifications and the accompanying annual audit report, **(ii)** redress/facilitate redressal of complaints of holders of listed securities, **(iii)** monitor compliance by the listed entity/adequacy/accuracy of the disclosures made, **(iv)** submit a report to the SEBI, with respect to the SEBI-specified obligations in the specified manner, **(v)** put in place appropriate framework including adequate manpower and required infrastructure to comply with the provisions of the regulations.

Procedure for Action in Case of Default

The listed entity or any other person who contravenes any of the provisions of these regulations, would, in addition to liability for action in terms of the securities laws, be liable for the following actions by the respective stock exchange(s), in the SEBI-specified manner: **(a)** imposition of fines, **(b)** suspension of trading, **(c)** freezing of promoter/promoter group holding of designated securities in coordination with the depositories, **(d)** any other action specified by the SEBI. The revocation of the above actions would be in terms of SEBI-specified circulars/guidelines. If listed entity fails to pay any fine imposed on it within the stock exchange-specified period, after a notice in writing, it may initiate action.

SEBI DELISTING OF EQUITY SHARES REGULATION

The main elements of the SEBI regulations are: **(i)** delisting of equity shares, **(ii)** voluntary delisting, **(iii)** exit opportunity, **(iv)** compulsory delisting, **(v)** special provisions for small companies and delisting by operations of law and **(vi)** miscellaneous.

Delisting of Equity Shares

These regulations apply to delisting of equity shares of a listed company from all/any stock exchange. They, however, do not apply to securities listed without making a public issue on the institutional trading platform of a stock exchange. Delisting of shares would not be permitted by a sock exchange **(a)** pursuant to a **(i)** buy-back of shares, **(ii)** preferential allotment, **(b)** unless a period of 3 years has elapsed since their listing, **(c)** if any convertible instrument issued by the company are outstanding. Delisting of convertible securities would also not be permitted. No promoter should directly/indirectly employ the funds of the company to finance an exit opportunity (**discussed later**) or an acquisition of shares from public shareholders. No acquirer/promoter/promoter group/their relatives should: **(a) (i)** employ any device/scheme/artifice, **(ii)** engage in any transaction/practice that operates as a fraud/deceit upon any shareholder/other person, and **(b)** engage in any act/practice that is fraudulent/deceptive/manipulative in connection with any delisting sought/permitted or exit opportunity given or acquisition of shares made. A **public shareholder** means shareholder(s) other than **(i)** promoters, **(ii)** holders of depository receipts issued overseas against shares with a custodian as well as the custodian. A promoter/other person should not **(a)** employ any device/scheme/artifice to defraud any shareholder/other person, **(b)** engage in any transaction/practice that operates as a fraud/deceit upon any shareholder/other person, **(c)** engage in any act/practice that is fraudulent, deceptive or manipulative, in connection with any delisting sought/permitted or exit opportunity given or other acquisition of shares.

Voluntary Delisting

Voluntary delisting means delisting of shares voluntarily on the application of the concerned company. A company may delist its equity shares if all public shareholders are given an exit opportunity (discussed later). However, a company may delist its equity shares from a stock exchange(s) and continue their listing on other stock exchanges subject to the following: (a) if after the proposed delisting, the equity shares would remain listed on any stock exchange which has nationwide trading terminals, no exit opportunity needs to be given to the public shareholders and (b) if they would not like-wise remain listed, exit opportunity should be given to all the public shareholders.

Delisting without Exit Opportunity

The proposed delisting should be approved by a resolution of the Board of Directors of the company. It should give a public notice of the proposed delisting in at least one English national daily with wide circulation, one Hindi national daily with wide circulation and one regional language newspaper of the region where the concerned stock exchange(s) are located and make an application to the concerned stock exchange for delisting its equity shares. The fact of delisting should be disclosed in the first annual report of the company after the delisting. The public notice should mention the names of the stock exchanges from which the equity shares are intended to be delisted, the reasons, the fact of continuation of listing on stock exchange having nationwide trading terminals. An application for delisting should be disposed of by the concerned stock exchange within 30 working days from the date of its receipt complete in all respects.

Delisting with Exit Opportunity

Any company desirous of delisting its equity shares, in case they would not remain listed on a stock exchange with nationwide trading terminals, should: **(a)** obtain the prior approval of its Board of Directors, **(b)** two-thirds public shareholders of the company by special resolution passed through postal ballot, after disclosure of all material facts in the explanatory statement sent to them; **(c)** make an application to the concerned stock exchange for in-principle approval of the proposed delisting in the specified form; and **(d)** within one year of passing the special resolution, make the final application in specified form.

Prior to granting the approval, the Board of Directors of the company should: **(i)** make a disclosure to the concerned stock exchange that the promoter/acquirers have proposed to delist, **(ii)** appoint a merchant banker to carry out due diligence and make disclosures to this effect, **(iii)** obtain details of trading on the shares of the company for 2 years prior to the Board meeting by the top 25 per cent shareholders from the concerned stock exchange(s) and details of their off-market transactions for 2 years and furnish the information to the merchant banker for carrying out due diligence, **(iii)** obtain further details and furnish it to the merchant banker. While approving the proposal, they should certify that the **(a)** company is in compliance with the applicable provisions of the securities laws, **(b)** acquirer/promoter group/their relatives are in compliance with requirement that they would not **(i)** employ any device/scheme/artifice to defraud/engage in any transaction/practice that acts as a fraud/deceit on any shareholder/person **(ii)** engage in any fraudulent/deceptive/manipulative act/practice and **(c)** delisting is in the interest of the shareholders. For certification in respect of these matters, they should also take into account the specified report of the merchant bankers, certifying that **(1)** the trading of shares by the entities belonging to the promoter/promoter group/their relatives was in compliance with the applicable provisions of the securities laws, **(2)** these entities have/have not carried out any transaction to facilitate the success of the delisting offer which is not in compliance with the requirement not to employ any device, scheme/artifice to defraud/engage in fraudulent/deceptive/manipulative act/practice.

The application seeking in-principle approval for delisting should be accompanied by an audit report covering a period of 6 months prior to the date of application. It should be disposed of by the concerned stock exchange within 5 working days from the date of its receipt complete in all respects. While considering the application, the stock exchange should not unfairly withhold the application, but may require the company to satisfy it as to **(a)** compliance with the requisite Board approval/public shareholders resolution, **(b)** the resolution of investor grievances by the company, **(c)** payment of listing fees to the stock exchange, **(d)** the compliance with any condition of the listing agreement having a material bearing on the interests of its equity shareholders, **(e)** any litigation/action pending against the company pertaining to its activities in the securities market or any other matter having a material bearing on the interests of its equity shareholders, and **(f)** any other relevant matter as the stock exchange may deem fit to verify. The final application for delisting should be accompanied with such proof of having given the exit opportunity to the public shareholders.

Exit Opportunity The promoters/acquirers of the company should, within one working day from the date of receipt of in-principle approval for delisting from the stock exchange, make a public announcement in at least one English national daily with wide circulation, one Hindi national daily with wide circulation and one regional language newspaper of the region where the concerned stock exchange is located, containing all material information including the information specified by the SEBI and not contain any false or misleading statement. It should also announce a **specified date** (i.e. a day within 30 days from the date of announcement) for determining the names of the eligible shareholders. Before making the public announcement, the promoter/acquirer should appoint a merchant banker and/other necessary intermediaries. The promoter/acquirer and the merchant banker should ensure compliance with all the requirements. The merchant banker should not be an associate of the promoter/acquirer.

Before making the public announcement, the promoter should deposit the total estimated amount of consideration calculated on the basis of floor price and number of equity shares outstanding with the public shareholders in an escrow account. On determination of final price and making of public announcement, the promoter/acquirer should forthwith deposit in the escrow account sufficient/additional sum to make up the entire sum due and payable as consideration in respect of equity shares outstanding with the public shareholders. The escrow account should consist of cash deposited with bank/a bank guarantee in favour of the merchant banker, or a combination of both. The promoter should, while opening the account, empower the merchant banker to instruct the bank to issue banker's cheque/demand draft for the amount lying to the credit of the escrow account and the amount in such deposit, if any, remaining after full payment of consideration for equity shares tendered in the offer and those tendered should be released to the promoter. The bank guarantee should be valid till payments are made in respect of all tendered shares.

The promoter/acquirer should dispatch the letter of offer to all the public shareholders not later than 2 working days from the date of the public announcement. It should contain all the disclosures made in the public announcement and other necessary disclosures for the shareholders to take an informed decision and accompanied with a bidding form for use and a form to be used by them for tendering shares.

The date of opening of the offer should not be later than 7 working days from the date of public announcement. The acquirer/promoter should facilitate tendering of shares and its settlement through the SEBI-specified stock exchange mechanism. It should remain open for a minimum period of three working days and maximum period of five working days.

All public shareholders of the equity shares which are sought to be delisted should be entitled to participate in the book-building process in the specified manner. An acquirer/promoter/a person acting in concert with any of them should not make a bid in the offer and the merchant banker should take necessary steps to ensure compliance. Any holder of depository receipts issued on the basis of underlying shares held by a custodian and any such custodian would also not be entitled to participate in the offer, unless the holder of depository receipts exchanges them with shares of the class that are proposed to be delisted.

Offer Price The offer price should be determined through book-building in the specified manner after fixation of floor price and disclosure of the same in the public announcement and the letter of offer. The floor price would be determined in terms of the provisions of the SEBI Substantial Acquisition of Shares and Takeover Regulations.**

Promoter Not to Accept Offer Price The promoter/acquirer would not be bound to accept the equity shares at the offer price determined by the book-building process. Where he does not accept the offer price, he should not acquire any equity shares **(i)** tendered pursuant to the offer and **(ii)** deposited/pledged by a shareholder pursuant to exit route should be returned/released to him within 10 working days of closure of the bidding period. The company should also not make the final application to the exchange for delisting of the equity shares. The acquirer/promoter may close the escrow account.

An offer should be deemed to be successful if post-offer, the shareholding of the promoter (along with the persons acting in concert) taken together with the shares accepted through eligible bids at the final price determined reaches **(a)** 90 per cent of the total issued shares of that class excluding the shares which are held by a custodian and against which depository receipts have been issued overseas; and **(b)** atleast 25 per cent of the public shareholders holding shares in demat mode had participated in the book building process.

Closure of Offer Within 5 working days of closure of the offer, the promoter/merchant banker should make a public announcement in the same newspaper in which the public announcement was made regarding **(i)** the success of the offer along with the final price accepted by the acquirer, **(ii)** the failure of the offer, **(iii)** rejection of the final price by the promoter.

Failure of Offer Where the offer is rejected/is not successful, it would be deemed to have failed and no equity shares should be acquired. Where the offer fails, the equity shares deposited/pledged by a shareholder pursuant to an exit route should be returned/ released to him within 10 working days from the end of the bidding period and no final application should be made to the exchange for delisting of the equity shares, and the escrow account opened should be closed.

****Available in Khan, M Y, *Financial Services*, MHE, 2017, Chapter 13.**

Payment of Consideration The promoter should immediately on ascertaining success of the offer, open a special account with a SEBI-registered banker to an issue and transfer to the entire amount due and payable as consideration in respect of equity shares tendered in the offer, from the escrow account. All the shareholders whose equity shares are verified to be genuine should be paid the final price within 10 working days from the closure of the offer. The equity shares deposited/pledged by a shareholder pursuant to an exit route should be returned/released to him, within ten working days from the closure of the offer, in cases where the bids have not been accepted.

Where the equity shares are delisted, any remaining public shareholders of equity shares may tender them to the promoter upto at least one year from the date of delisting and the promoter should accept the same final price. The payment of consideration for accepted shares should be made out of the balance amount lying in the escrow account. The amount in the escrow account or the bank guarantee would not be released to the promoter unless all payments are made in respect of the tendered shares.

Compulsory Delisting

A recognised stock exchange may delist any equity shares of a company on any ground prescribed in the rules under Section 21-A of the Securities Contracts (Regulation) Act. The decision regarding compulsory delisting should be taken by a panel to be constituted by the stock exchange consisting of **(a)** two directors of the exchange (one of whom should be a public representative), **(b)** one representative of the investors, **(c)** one representative of the Ministry of Corporate Affairs/Registrar of Companies, and **(d)** the Executive Director/Secretary of the concerned exchange.

The stock exchange should give a notice in one English national daily with wide circulation and one regional language newspaper of the region where the concerned stock exchange is located, of the proposed delisting, giving a time period of at least 15 working days from the notice, within which representations may be made by any aggrieved person and also display the notice on its trading systems and websites. Where the stock exchange passes an order, it should **(a)** forthwith publish a notice in one English national daily with wide circulation and one regional language newspaper of the region where the concerned stock exchange is located, of the fact of such delisting, disclosing therein the name and address of the company, the fair value of the delisted equity shares and the names and addresses of the promoters of the company, and **(b)** inform all other concerned stock exchanges about the delisting and the surrounding circumstances.

Rights of Public Shareholders The recognised stock exchange should appoint an independent valuer(s) from a panel of experts (i.e. a chartered accountant/merchant banker) to determine the fair value of the delisted shares having regard to the factors having a bearing on the offer price (**discussed earlier**). The promoter of the company should acquire the delisted equity shares from the public shareholders by paying them the value determined by the valuer, subject to their option of retaining their shares.

Where a company has been compulsorily delisted, the company, its whole time directors/promoters/companies promoted by any of them should not directly/indirectly access the securities market/seek listing for any equity shares for 10 years from the date of the delisting.

Powers of the SEBI The SEBI may grant relaxation from strict enforcement of any of the above requirements if satisfied that it is in the interest of the investors/securities market. The application for exemption should be supported by an affidavit detailing exemptions/grounds of exemption together with the non-refundable fee of ₹50,000. The applicant would be given an opportunity to be heard before grant/rejection of its application. Without prejudice to provisions of the SEBI/ Securities Contracts (Regulation) Act, the SEBI may, in case of any violation of these regulations and in the interests of the investors and the securities market, give directions as it deems fit after giving an opportunity of hearing to the concerned person.

Special Provisions for Small Companies and Delisting by Operation of Law

Where the equity shares of a company having a paid-up capital upto ₹1 crore were not traded in the one year immediately preceding may be delisted without an exit option. Similarly, shares may be delisted where a company has upto 300 public shareholders and the paid-up value of the shares held by them is not more than ₹1 crore without an exit option. The delisting may be made only if, the following additional conditions are fulfilled: **(a)** the promoter **(i)** appoints a merchant banker and decides an exit price in consultation with him, **(ii)** exit price should not be less than the floor price; **(iii)** writes individually to all public shareholders informing them of his intention to get the equity shares delisted, indicating the exit price together with the justification for and seeking their consent of the proposal for delisting, **(b)** at least 90 per cent of the public shareholders give their positive consent in writing to the proposal and have consented either to sell their equity shares at the price offered by the promoter or to remain holders even if they are delisted, **(c)** the promoter completes **(i)** the process of inviting the positive consent and finalisation of the proposal within 75 working days of the first communication, **(ii)** makes payment of consideration in cash within 15 working days from the date of expiry of the 75 working days.

The communication made to the public shareholders should contain justification for the offer price with particular reference to the applicable parameters and specifically mention that consent for the proposal would include consent for dispensing with the exit price discovery through book-building method. The concerned stock exchange may delist the equity shares upon satisfying itself of compliance with this regulation.

In case of winding-up proceedings of a listed company, the rights of its shareholders should be in accordance with the laws applicable to those proceedings.

Where the SEBI withdraws recognition granted to a stock exchange or refuses a renewal of its recognition to it may, in the interest of investors, pass appropriate order in respect of the status of equity shares of the companies listed on the exchange.

Miscellaneous

The respective recognised stock exchanges should comply with and monitor compliance with the provisions of these regulations and should report to the SEBI any instance of non-compliance which comes to their notice. No application for listing should be made in respect of any equity shares, which have been delisted for a period of ten years from the delisting. While considering an application for listing of any delisted equity shares due regard would be given to facts and circumstances under which the delisting was made. An application for listing of delisted equity shares would be deemed to be an application for fresh listing and would be subject to the provisions of law relating to the listing of equity shares of unlisted companies.

CONCLUDING OBSERVATIONS

- The object of SCRA is to prevent undesirable transactions in securities. It sets up a general framework of control that makes the influence of Government /SEBI all pervasive. At the same time, as an enabling legislative measure, it provides the SEBI with a flexible apparatus for the regulation of the stock market in India.
- Securities include: **(i)** shares, scrips, stocks, bonds/debentures, other marketable securities; **(ii)** derivatives which include **(a)** a security derived from another security and **(b)** a contract which derives its value from the prices/index of prices of underlying securities; **(iii)** units of mutual funds; **(iv)** Government securities; **(v)** such other instruments as may be decided by Government/SEBI to be security, **(vi)** rights or interests in securities; **(vii)** security receipts issued by asset reconstruction companies; and certifcates/instruments issued by securitisation companies.
- Stock exchanges require SEBI's recognition to the carry on the business of dealing in securities. All recognised stock exchanges should be companies (corporation) and ownership, management and trading rights of members should be segregated (demutulaisation). In the interest of trade or in public interest, Government/SEBI may withdraw recognition.
- Recognised stock exchanges have to furnish to the SEBI with periodical returns relating to their affairs. The SEBI has power to direct an inquiry into the affairs of the governing body/any member, in relation to the affairs of the stock exchange. Every recognised stock exchange has to furnish to the SEBI, a copy of its annual report. The SEBI can make/amend any rule or direct the stock exchange(s) to do so.
- A recognised stock exchange may transfer the duties and functions of clearing and settlement to a Clearing Corporation, for periodical statement of contracts and differences, delivery of and payment for securities and so on. It may, with the prior approval of SEBI, make bye-laws for the regulation and control of contracts. The SEBI has the power to make as well as amend the bye-laws. It can also supersede the governing body of the stock exchange and appoint person(s) to exercise and perform all the powers and duties of the governing body. It may also issue directions in the interest of the investors and the securities market.
- Listing denotes registration of a security as officially approved for dealing/trading on a stock exchange. The principal objectives of listing are to provide easy marketability and impart liquidity and free negotiability to securities, ensure proper supervision and control of dealings in them and protect the interests of the investors. A recognised stock exchange may delist securities.
- Any offence committed by a person/company/manager/secretary/other officer under the specific provisions of the SCRA, is punishable with imprisonment upto ten years or with a fine upto a maximum of ₹25 crore or with both. Such offence is deemed to be a cognizable offence. The penalty for failure to furnish information to a stock exchange/maintain books and records as per the listing agreement/to enter into an agreement with clients/redress investor grievances by brokers, is ₹ one lakh for each day of failure or ₹ one crore, whichever is less. The penalty for a failure to comply with provisions of the listing agreement and delisting norms/furnish periodical returns/amend bye laws/comply with SEBI regulations can be upto ₹25 crore.
- The Government/SEBI can make rules/regulations for carrying out the objectives of the SCRA consistent with the provisions of the SCRA so as to carry out the purposes of the SCRA.
- The main elements of the Securities Contracts (Regulations) Rule are: recognition of a stock exchange; qualification of membership; contracts between members of a recognised stock exchange; nominees of SEBI, obligations of the governing body; audit of accounts of members, books of accounts and other documents of a recognised stock exchange; manner of

inquiry, submission of annual report/periodical returns and requirements with respect to listing of securities on a recognised stock exchange and continuous listing of securities.

- The main elements of the SEBI Securities Contracts Regulation (Stock Exchange and Clearing Corporations) Regulations are **(i)** recognition of stock exchanges and clearing corporations, **(ii)** their networth, **(iii)** their ownership, **(iv)** governance, **(v)** general obligations, **(vi)** listing of securities, and **(vii)** power/directions. They are discussed in this Section.
- A recognition should be obtained from the SEBI to conduct/organise or assist in organising a stock exchange (SE)/clearing corporation (CC). It should comply with the following conditions: it is **(a)** a company limited by shares, **(ii)** is **demutualised** (i.e. ownership and management is segregated from trading/clearing rights), **(iii)** its directors/shareholders are fit and proper persons, **(iv)** satisfies requirements relating to the specified ownership and governance structure/networth requirements/requisite capability including its financial capacity, functional expertise and infrastructure. The applicant should also comply with the following conditions, namely, has **(a)** the necessary infrastructure for orderly execution of trades, **(b)** an online screen-based trading system, **(c)** online surveillance capability which monitors positions, prices and volumes in real time so as to ensure market integrity, **(d)** adequate infrastructure to list securities for trading on its platform, **(e)** necessary capability to have a nationwide network of trading members and adequate facility to admit and regulate its members, **(f)** made necessary arrangements to establish connectivity with its trading members and clearing corporation, **(g)** has adequate investor protection fund and investor services fund, **(h)** adequate investor grievances redressal/arbitration mechanisms to resolve disputes arising out of trades and its settlement, **(i)** the facility to disseminate information about trades, quantities and quotes in real time to at least two information vending networks which are accessible to investors in the country; **(j)** adequate systems' capacity supported by a business continuity plan including a disaster recovery site, **(k)** in its employment, sufficient number of persons having adequate professional and other relevant experience, **(l)** the business feasibility plan has been appraised by a reputed agency having expertise in securities market; and **(m)** any other conditions specified by the SEBI.
- Every recognised stock exchange/clearing corporation should have a minimum networth of ₹100 crore at all times. The clearing corporation should achieve a minimum networth of ₹300 crore within three years from the date of recognition. It would not distribute profits in any manner to its shareholders until the specified networth is achieved.
- Their shareholding would include any instrument directly/indirectly owned/controlled that provides for entitlements of equity/rights over equity at any future date. At least 51 per cent of the paid-up equity share capital of a recognised stock exchange should be held by public. No person resident in/out India would at any time, directly or indirectly, either individually or together with persons acting in concert, acquire/hold more than 5 per cent of its paid-up equity share capital. The combined holdings of persons resident outside India should not exceed 49 per cent. Any clearing corporation should not hold any right/stake/interest in any recognised stock exchange. At least 51 per cent of the paid-up share capital of a recognised clearing corporation should be held by recognised stock exchange(s). However, any recognised stock exchange cannot, acquire/hold more than 15 per cent in more than one recognised clearing corporation. The shareholding of any resident/non-resident person except a stock exchange, depository/bank/insurance company and PFI would be similar to the stock exchanges. The stipulations relating to the combined holdings of all persons resident outside India applicable to stock exchanges is also applicable to clearing corporations. Any person who acquires/holds equity shares of a recognised stock exchange/clearing corporation should be a fit and proper person. He should seek the SEBI's approval within 15 days of acquisition if his shareholding exceeds 2 per cent and file a declaration within 15 days from the date of every financial year

that he complies with the fit and proper criteria. The person eligible to acquire/hold more than 5 per cent should also have the SEBI's approval. The recognised stock exchange(s)/clearing corporation(s) should disclose to the SEBI, in the specified format, their shareholding pattern on a quarterly basis within 15 days from the end of each quarter, including therein the following: (a) the names of the (i) 10 largest shareholders along with the number and percentage of shares held by them, (ii) shareholders who had acquired shares in that quarter.

- The governing board of every recognised stock exchange/clearing corporation should include: **(a)** shareholder directors, **(b)** public interest directors, and **(c)** managing director. Subject to the prior approval of the SEBI, the chairperson should be elected by the governing board from amongst the **public interest directors**. Their number should not be less than that of shareholders directors in a recognised stock exchange. Their respective numbers should be two-thirds and one-third. The managing director should be an ***ex-officio*** director on the governing board and should not be included in either category. No trading/clearing member/ their associates/agents should be on the governing board. At least one public interest director should be present in the meetings of the governing board to constitute the quorum. No FPI should have any representation in the governing board.
- Every director of a recognised exchange/clearing corporation should abide by the SEBI-specified code of conduct. Every director and key management personnel should abide by the SEBI-specified code of ethics. They should be a fit and proper person. A recognised stock exchange/clearing corporation should constitute a compensation committee comprising a majority of public interest directors and chaired by a public interest director. They should segregate its regulatory departments from other departments in the specified manner. They should constitute independent oversight committee of the governing board, each chaired by a public interest director, in order to address the conflicts of interest in respect of **(a)** member regulation, **(b)** listing and **(c)** trading and surveillance function. An advisory committee should be constituted by the governing board of every recognised stock exchange/clearing corporation to advise it on non-regulatory and operational matters including product design, technology, charges and levies. Every recognised clearing corporation should constitute a risk management committee, comprising its public interest directors and independent external experts, which should report to the governing board. Every recognised stock exchange/clearing corporation should appoint a compliance officer responsible for monitoring the compliance of the Securities Contracts (Regulation)/Companies/SEBI Act/rules/regulations/directions for the redressal of investor's grievances.
- Every recognised stock exchange should use the services of recognised clearing corporation(s) for clearing and settlement of its trades. The recognised clearing corporation should seek approval of the SEBI before **(i)** extending its services to any segment of a recognised stock exchange, **(ii)** admitting any securities for clearing and settlement. It should establish and maintain a fund for each segment, to guarantee the settlement of trades executed in respective segment. The payment and settlement of a transaction in a recognised stock exchange should be determined in accordance with the **netting** or gross procedure as specified in their bye-laws with the prior approval of the SEBI.
- Subject to the provisions of applicable laws in force, a recognised stock exchange may apply for listing of its securities on any recognised stock exchange, other than itself and its associated stock exchange. It would not list any securities of its associates. The securities of a recognised clearing corporation would also not be listed on the stock exchange.
- The listing regulations apply to the **listed entity** who has listed the following **designated securities** on recognised stock exchange(s): **(a) specified securities** listed on main Board/ SME exchange/institutional trading platform, **(b)** non-convertible debt securities/redeemable

preference shares/perpetual debt instruments, perpetual non-cumulative preference shares, **(c)** Indian depository receipts, **(d)** securitised debt instruments, **(e)** units issued by mutual funds, and **(f)** other SEBI-specified securities. A **listed entity** means an entity which has listed, on a recognised stock exchange, the designate securities issued/managed by it in accordance with the **listing agreement**, that is, an agreement between a stock exchange and an entity on its application undertaking to employ with conditions for listing of the designated securities. The main elements of the regulations are: **(i)** principles governing disclosures and obligations of listed entity, **(ii)** common obligations of listed entities, **(iii)** obligation of listed entity which has listed **(a)** non-convertible debt securities/redeemable preference shares or both, **(b)** specified securities and non-convertible debt securities/redeemable preference shares or both, **(c)** Indian depository receipts, **(d)** securitised debt instruments, **(e)** mutual fund units, **(iv)** duties/obligations of the stock exchange(s) and **(v)** procedure for action in case of default.

- The main elements of the regulations relating to common obligations of listed entities are: **(i)** general obligations of compliance, **(ii)** compliance officer and his obligations, **(iii)** share transfer agent, **(iv)** cooperation with intermediaries, **(v)** preservation of documents, **(vi)** filing of information, **(vii)** scheme of arrangement, **(viii)** payment of dividend/interest/redemption/repayment, **(ix)** grievances redressal mechanism and **(x)** fee/other charges payable to the stock exchanges.
- The main elements of the regulations relating to obligations of listed entity which has listed its specified securities are: **(i)** board of directors, **(ii)** audit committee, **(iii)** nomination and remuneration committee, **(iv)** stakeholders relationship committee, **(v)** risk management committee, **(vi)** vigil mechanism, **(vii)** related party transactions, **(viii)** corporate governance requirements with respect to subsidiary of listed/entity, **(ix)** obligations with respect to independent directors, **(x)** obligations with respect to employees and senior management, **(xi)** other corporate governance requirements, **(xii)** in-principle approval of recognised stock exchange(s), **(xiii)** prior intimations, **(xiv)** disclosure of events or information, **(xv)** holding of specified securities and shareholding pattern, **(xvi)** disclosure of class of shareholders and conditions for reclassification, **(xvii)** statement of deviation(s)/variation(s), **(xviii)** financial results, **(xix)** annual report, **(xx)** draft scheme of arrangement and scheme of arrangement, **(xxi)** minimum public shareholding, **(xxii)** issuance of certificates/receipts/letters/advices for securities and dealing with unclaimed securities, **(xxiii)** transfer or transmission or transposition of securities, **(xxiv)** other provisions relating to securities, **(xxv)** record date/date of closure of transfer books, **(xxvi)** dividends, **(xxvii)** dividend distribution policy, **(xxviii)** voting by shareholders, **(xxix)** voting by shareholders, **(xxx)** change in name of the listed entity, **(xxxi)** website, **(xxxi)** advertisements in newspapers, and **(xxxii)** accounting standards.
- These provisions apply only to a listed entity which has listed its non-convertible debt securities and/or redeemable preference shares on a recognised stock exchange in accordance with the SEBI Issue and Listing of Debt Securities Regulations/Issue and Listing of Non-Convertible Redeemable Preference Shares Regulations respectively (**discussed in Chapter 7 of this book**). They are also applicable to perpetual debt instrument/non-cumulative preference share listed by banks. However, the provisions concerning debenture trustees and security creation (or asset cover/charge on assets) would not be applicable for non-convertible redeemable preference shares. The main elements of the regulation are: **(1)** intimation to stock exchanges, **(2)** financial results, **(3)** annual reports, **(4)** asset covers, **(5)** credit rating, **(6)** documents/intimation to debenture trustees, **(7)** other submissions to the stock exchanges, **(8)** documents/intimation to holders, **(9)** structure, **(10)** record date, **(11)** terms and **(12)** website.
- The main elements of the regulation relating to the obligations of a listed entity issuing Indian depository receipts (IDRs) are: **(i)** general obligations, **(ii)** disclosure of material information/

events, **(iii)** holding pattern/shareholders details, **(iv)** periodical financial results, **(v)** annual report, **(vi)** corporate governance, **(vii)** documents/information to IDR-holder, **(viii)** equitable treatment of IDR-holders, **(ix)** terms of IDRs, **(x)** newspaper advertisement, **(xi)** structure of IDRs, **(xii)** record date, **(xiii)** voting, and **(xiv)** delisting.

- The main elements of the regulations relating to the obligations of a listed entity which has listed its SDIs, **(i)** intimation/filing with stock exchanges, **(ii)** disclosure of information having bearing on performance/operation of the listed entity and/or price sensitive information, **(iii)** credit rating, **(iv)** information to investors, **(v)** terms of securitised debt instruments and **(vi)** record date are discussed below. The listed entity should
- The two elements of the regulations relating to mutual fund units are: submission of documents and dissemination on the website of the stock exchanges.
- The main elements of the regulations relating to obligations of the recognised stock exchanges are: **(i)** dissemination, **(ii)** transferability, **(iii)** draft scheme of arrangement and scheme arrangement, **(iv)** statement on impact of audit qualifications on annual audit report, **(v)** grievances redressal and **(vi)** monitoring of compliance/non-compliance and adequacy/accuracy of disclosures.
- The listed entity or any other person who contravenes any of the provisions of these regulations, would, in addition to liability for action in terms of the securities laws, be liable for the following actions by the respective stock exchange(s), in the SEBI-specified manner: **(a)** imposition of fines, **(b)** suspension of trading, **(c)** freezing of promoter/promoter group holding of designated securities in coordination with the depositories, **(d)** any other action specified by the SEBI. The revocation of the above actions would be in terms of SEBI-specified circulars/guidelines. If listed entity fails to pay any fine imposed on it within the stock exchange-specified period, after a notice in writing, it may initiate action.
- The main elements of the SEBI delisting of equity shares regulations are: delisting of equity shares, voluntary delisting, exit opportunity, company delisting, special provisions for small companies and delisting by operation of law, and miscellaneous.
- Voluntary delisting means delisting on the basis of application of the concerned company. It may be with or without exit opportunity to all the public shareholders.
- The main elements of the exit opportunity are offer price, promoter may not accept the offer price, closure of offer, failure of offer and payment of consideration.
- A recognised stock exchange may compulsorily delist shares of a company on grounds prescribed in the rules under Section 21-A of the Securities Contracts (Regulation Act).
- The SEBI is empowered to issue directions to the concerned persons in case of violation of the regulations and in the interest of investors/securities market.

CHAPTER 6

Primary Market Organisation: Intermediaries

INTRODUCTION

The scenario in the primary/new issue market changed very fast after the mid-eighties and its organisation underwent a transformation beyond recognition. The market has, since then, come to occupy the centre-stage in the emerging financial system in India.

The organisation of the new issue market a decade earlier also suffered from structural lacunae. It was synonymous with the underwriting mechanism, of which the Development Finance Institutions (DFIs) constituted the backbone. There was practically no specialist institutional arrangement for the origination of issues of capital. True, the Industrial Credit and Investment Corporation of India (ICICI) and a few commercial banks, such as the State Bank of India and the ANZ Grindlays Bank, did set up merchant banking divisions and as managers to the issues of capital, provided advisory and other procedural services to their clients in connection with new issues. But they had not made any significant impact because the sponsors, banks for instance, had either limited experience of long-term financing of industry or they were finance-oriented as in the case of the ICICI. In addition, underwriting facility, though pervasive and fairly widespread, was rather of a limited complexion in the sense that it was synonymous with an amount of money which each underwriter was prepared to guarantee in case of unsatisfactory public response. A serious drawback of the system was the absence of an in-built provision for distributing the securities to the investing public. This was in sharp contrast to the prevailing practice in the developed new issues markets. For instance, in terms of the procedure of investment banking mechanism, through which securities are floated in the USA, the investment bankers provide a unified and comprehensive package of service. They not only investigate and sponsor issues of capital but also arrange for underwriting as well as retail distribution. To strengthen the organisation of the market and exercise salutary effect on the quality of new issues, and the standard and efficiency of the market itself, the primary market in India, as a solution to the foregoing deficiencies, had to set up merchant banking institutions, with skill and expertise being their main source.

Yet another organisational weakness of the primary market in India in the mid-eighties was the obstacle in the the floating of small issues. The difficulty of small issues was partly the result of institutional obstacles and partly due to the operational obstacles inherent in such issues themselves in the form of prohibitively high cost of capital. An urgent requirement of the market was the introduction of a method of flotation to raise capital at a reasonable cost. The development of institutional facility for the placement of securities was called for to overcome this lacuna in the organisation of the market.

Finally, there was no genuine investment demand for the new issues as shown by the substantial amount devolving on the underwriters because of tardy public response. There was a need to lay more stress on the creation of institutional demand for industrial securities. This underlied the need for encouraging the growth of a diversified structure of mutual funds, and liberalisation of the regulations governing the investments of institutional investors like the LIC, GIC, and pension and provident funds.

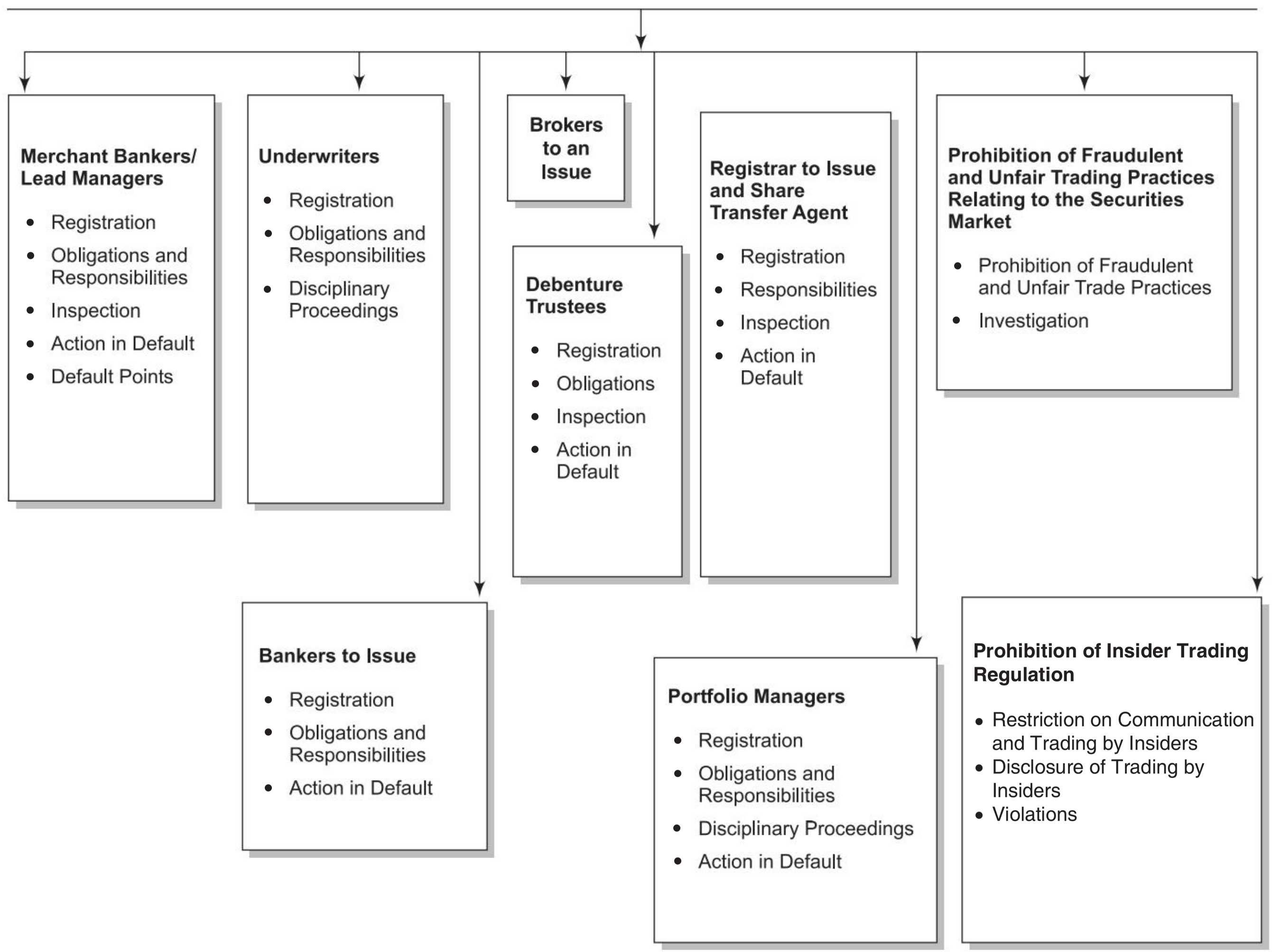
The new issue market/activity was regulated by the Controller of Capital Issues (CCIs) under the provisions of the *Capital Issues (Control) Act, 1947* and the exemption orders and rules made under it. With the repeal of the Act and the consequent abolition of the office of the CCI in 1992, the protection of the interest of the investors in securities market and promotion of the development and regulation of the market/activity became the responsibility of the SEBI. To tone up the operations of the new issues in the country, it has put in place rigorous measures. These cover both the major intermediaries as well as the activities. The SEBI framework regulating the intermediaries is comprehensively examined in this chapter. They have to conform to regulations prescribed by the SEBI. The operational framework of the primary market in terms of activities is discussed in detail in the next chapter.

A significant organisational development in the Indian primary market has been the emergence of an array of intermediaries which play a critical role in the process of selling new issues. The legal framework for their operations has been prescribed by the SEBI. **It is depicted in Exhibit 6.1.** The framework in terms of guidelines provides the ground rules for the intermediaries. The major new issue market intermediaries are covered in Sections 1-7. The discussions focus on the lead managers, underwriters, bankers to an issue, registrars and share transfer agents, debenture trustees, and portfolio managers. While the fraudulent and unfair trade practices regulation is described in Section 8, a brief outline of the insider trading regulation is given in Section 9. Some concluding observations are given in the last Section.

MERCHANT BANKERS/LEAD MANAGERS

A **merchant banker** means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager/consultant/advisors or rendering corporate advisory service in relation to such issue management. **Issues** means an offer for sale/purchase of securities by any body corporate/other person or group of persons on its/his/their behalf to, or from the public or from the holders of their securities, through a merchant banker. The importance of merchant bankers as sponsors of capital issues is reflected in their major services/functions such as, determining the composition of the capital structure (type of securities to be issued), draft of prospectus (offer documents) and application forms, compliance with procedural formalities, appointment of registrars to

Exhibit 6.1 Issue Management: Intermediaries



deal with the share application and transfers, listing of securities, arrangement of underwriting/sub-underwriting, placing of issues, selection of brokers and bankers to the issue, publicity and advertising agents, printers, and so on. In view of the overwhelming importance of merchant bankers in the process of capital issues, it is now mandatory that all public issues should be managed by merchant banker(s) functioning as the lead manager(s). In the case of rights issues not exceeding ₹50 lakh, such appointments may not be necessary. The salient features of the SEBI framework of their operations are summarised in this Section.

Registration

Compulsory Registration Merchant bankers require compulsory registration with the SEBI to carry out their activities. Application for initial registration should be made to the SEBI in the prescribed form accompanied by non-refundable fee. They fall under four categories. Category I merchant bankers can carry on any activity related to issue management, that is, the preparation of prospectus and other information relating to the issue, determining the financial structure, tie-up of financiers, final allotment of securities, refund of the subscription and so on. They could also act as advisors, consultants, managers, underwriters or portfolio managers. Category II merchant bankers can act as advisors, consultants, co-managers, underwriters and portfolio managers; and Category III merchant bankers can act as underwriters, advisors, and consultants to an issue; Category IV merchant bankers can act only as adviser or consultant to an issue. Thus, only Category I merchant bankers could act as lead managers to an issue. With effect from December 9, 1997, however, only Category I merchant bankers are registered by the SEBI. To carry on activities as portfolio managers, they have to obtain separate certificates of registration from the SEBI.

Grant of Certificate The SEBI grants a certificate of registration on consideration of all matters that are relevant to the activities related to the merchant banker: **(a)** merchant bankers should also be a body corporate other than a non-banking financial company. However, a merchant banker who has been granted registration by the RBI to act as Primary Dealer may carry on such activity subject to the condition that it would not accept/hold public deposit, **(b)** they are expected to have the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge their activities; **(c)** they should have employed at least two persons with experience to conduct merchant banking business; **(d)** any person directly or indirectly connected with the applicant, that is, an associate/subsidiary/interconnected or group company, does not have a certificate of registration from the SEBI; **(e)** they fulfil the capital adequacy requirement of a minimum networth (i.e. paid-up capital and reserves) of ₹5 crore; **(f)** they/partners/directors/principal offices should not be involved in any litigation connected with the securities market, which has an adverse effect on their business; **(g)** have recognised professional qualification in finance, law or business management and or their registration is in the interest of the investors; **(gg)** grant of certificate is in the interest of investors; and **(h)** the applicant is a fit and proper person. **For determining whether an applicant/merchant banker is a fit and proper person, the SEBI would take into account the criteria specified in the SEBI Intermediaries Regulation 2008**.

On being satisfied that the applicant is eligible, the SEBI would grant on payment of the prescribed fee a certificate of initial registration which should be valid for five years. Three months before the expiry of the period of initial registration, an application in the prescribed form accompanied by the prescribed non-refundable fee should be made for permanent registration.

It should be accompanied by details of the changes that have taken place in the information submitted while seeking initial registration and a declaration that no changes other than those mentioned in such details have taken place. On being satisfied, the SEBI should grant permanent registration on payment of the requisite fee.

Fee A marchant banker has to pay **(i)** registration fee for initial registration, ₹2,00,000,within 15 days from the date of intimation from the SEBI; **(ii)** to keep permanent registration in force, ₹9,00,000 every three years from the sixth year from the date of initial registration within 15 days from the date of intimation from the SEBI and thereafter three months before the expiry of the block for which fee has been paid; **(iii)** non-refundable fee for initial/permanent registration, ₹50,000.

Conditions of Registration The registration/renewal of certificate of a merchant banker would be subject to the following conditions:

- Prior approval of the SEBI would be necessary to continue to act as a merchant banker after change in control. **Change in control** means **(i)** if its shares are listed, change of control in terms of stipulations of the SEBI Takeover Regulations, **(ii)** change in its controlling interest in any other case. In case of a non-body corporate, it would be construed as any change in its legal formation ownership. **Controlling interest** means direct/indirect interest to the extent of at least 51 per cent of voting rights.
- Enter into a legally binding contract with the issuer specifying their mutual duties and responsibilities.
- Pay the initial and permanent registration fee in the prescribed manner.
- Take adequate steps for redressal of investors grievances within one month of the complaint and keep the SEBI informed about the number, nature and other particulars of such complaints together with the manner of their redressal.
- Abide by the relevant regulations under the SEBI Act.

Obligations and Responsibilities

Code of Conduct for Merchant Bankers A merchant banker should:

1. Make all efforts to protect the interests of investors.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Fulfill its obligations in a prompt, ethical, and professional manner.
4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
5. Endeavour to ensure that: **(a)** inquiries from investors are adequately dealt with; **(b)** grievances of investors are redressed in a timely and appropriate manner; **(c)** where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to him under the regulatory system.
6. Ensure that adequate disclosures are made to the investors in a timely manner in accordance with the applicable regulations and guidelines so as to enable them to make a balanced and informed decision.
7. Endeavour to ensure that the investors are provided with true and adequate information without making any misleading or exaggerated claims or any misrepresentation and are made aware of the attendant risk before taking any investment decision.
8. Endeavour to ensure that copies of the prospectus, offer document, letter of offer or any other related literature is made available to the investors at the time of issue or the offer.

9. Not discriminate amongst its clients, save and except on ethical and commercial considerations.

10. Not make any statement, either oral or written, which would misrepresent the services that the merchant banker is capable of performing for any client or has rendered to any client.

11. Avoid conflict of interest and make adequate disclosure of its interest.

12. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.

13. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as merchant banker which would impair its ability to render fair, objective and unbiased services.

14. Always endeavour to render the best possible advice to the clients having regard to their needs.

15. Not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.

16. Ensure that any change in registration status/any penal action taken by the SEBI or any material change in the merchant banker's financial status, which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.

17. Not indulge in any unfair competition, such as weaning away the clients on assurance of higher premium or advantageous offer price or which is likely to harm the interests of other merchant bankers or investors or is likely to place such other merchant bankers in a disadvantageous position while competing for or executing any assignment.

18. Maintain arms length relationship between its merchant banking activity and any other activity.

19. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

20. Not make untrue statement or suppress any material fact in any documents, reports or information furnished to the SEBI.

21. Maintain an appropriate level of knowledge and competence and abide by the provisions of the SEBI Act/regulations/circulars and guidelines, which may be applicable and relevant to the activities carried on by it. They should also comply with the award of the Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.

22. Ensure that the SEBI is promptly informed about any action, legal proceedings, etc., initiated against it in respect of material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.

23. **(a)** Not render, directly or indirectly, any investment advice about any security in any publicly accessible media, whether real-time or non real-time, unless a disclosure of his interest including a long or short position, in the security has been made, while rendering such advice; **(b)** In the event of an employee of the merchant banker rendering such advice, the merchant banker should ensure that such employee should also disclose the interests, if any, of himself, his dependent family members and the employer merchant banker, including their long or short position in the security, while rendering such advice.

24. Demarcate the responsibilities of the various intermediaries appointed by it clearly so as to avoid any conflict or confusion in their job description.

25. Provide adequate freedom and powers of its compliance officer for the effective discharge of his duties.

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

27. Ensure that good corporate policies and corporate governance are in place.

28. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

29. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it in the conduct of its business, in respect of dealings in securities market.

30. That the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

31. Not be a party to or instrument for: **(a)** creation of false market; **(b)** price rigging or manipulation or; **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary in the securities market.

Restriction on Business No merchant banker, other than a bank/public financial institution (PFI) is permitted to carry on business other than that in the securities market. In other words, he is prohibited from carrying on fund/asset-based business such as leasing and so on. However, a merchant banker who is registered with RBI as a Primary Dealer/Satellite Dealer may carry on such business as may be permitted by the RBI. A merchant banker may also ensure market making in respect of issue of specified securities by small and medium enterprises (**discussed in Chapter 7**)

Responsibilities of Lead Managers Every lead manager has to enter into an agreement with the issuing companies, setting out their mutual rights, liabilities and obligations relating to such issues, and in particular to disclosures allotment and refund. A statement specifying these is to be furnished to the SEBI at least one month before the opening of the issue for subscription. In case of more than one lead manager/merchant banker, the statement has to provide details about their respective responsibilities. He can not associate with a merchant banker who does not hold a certificate of registration with the SEBI.

A merchant banker should not lead manage an issue/be associated with any activity undertaken under any other SEBI regulation if he is a promoter/director/associate of the issuer/any person making an offer to sell/purchase securities in terms of any SEBI regulation. However, he may be appointed if he is involved only in the marketing of the issue/offer. A merchant banker would be deemed to be an **associate of the issuer/person** if **(a)** either of them directly/indirectly **(i)** through its subsidiary/holding controls at least 15 per cent of the voting rights in the other, **(ii)** by itself/in combination with other persons exercises control over the other or **(b)** there is a common director (excluding nominee director) amongst the issuer, its subsidiary/holding company to the merchant banker.

It is necessary for a lead manager to accept a minimum underwriting obligation of 5 per cent of the total underwriting commitment or ₹25 lakh, whichever is lesser. If he is unable to do so, he has to make arrangements for underwriting an equal amount by a merchant banker associated with that issue under intimation to the SEBI. In any issue by a small and medium enterprise (**detailed in Chapter 7**), he has to himself/jointly with others associated with the issue underwrite at least 15 per cent of the issue size.

Acquisition of Shares A merchant banker is prohibited from acquiring securities of any company on the basis of unpublished price sensitive information obtained during the course of any professional assignment either from the client or otherwise. He has to submit to the SEBI, the complete particulars of any acquisition of securities of a company whose issue is being managed by him, within 15 days from the date of transaction. Complete particulars of any acquisition of securities in pursuance of underwriting/market making obligations in respect of issues by small and medium enterprises should be submitted to the SEBI on quarterly basis.

Disclosures to the SEBI As and when required, a merchant banker has to disclose to the SEBI; **(i)** his responsibilities with regard to the management of the issue, **(ii)** any change in the information/ particulars previously furnished, which have a bearing on the certificate of registration granted to it, **(iii)** the names of the companies whose issues he has managed or has been associated with, **(iv)** the particulars related to the breach of capital adequacy requirements and **(v)** information related to his activities as manager, underwriter, consultant or adviser to an issue.

The merchant banker should submit a periodic report in a manner specified by the SEBI.

Compliance Officer Every merchant banker should appoint a compliance officer who would be responsible for monitoring compliance with SEBI acts/rules/regulations/ notification/guidelines/ instructions, issued by the SEBI/Government, and for redressal of investors grievances. He should immediately and independently report to the SEBI any non-compliance observed by him and ensure that the observations made/deficiencies pointed out by the SEBI on/in the draft prospectus/letter of offer do not recur.

Procedure for Inspection

The SEBI can undertake the inspection of the books of accounts, records and documents of a merchant banker to ensure that the books are maintained in the manner required, the provisions of the SEBI Act, rules and regulations are being complied with, and to investigate complaints from investors/other merchant bankers/any other person or any matter having a bearing on his activities as a merchant banker and, *suo moto*, in the interest of the securities business/investor's interest into the affairs of the merchant banker.

The merchant banker has an obligation to furnish all the information called for, allow reasonable access to the premises, extend reasonable facility for the examination of books/records/ documents/ computer data and provide copies of the same and give all assistance to the inspecting authority in connection with the inspection.

On the basis of the inspection report and after giving him an opportunity to make an explanation, the SEBI can call upon the merchant banker to take such measures as it deems fit in the interest of the securities market and for due compliance with the provisions of the SEBI Act, rules and regulations. In place of the inspection authority, the SEBI can appoint a qualified auditor, with the above powers of the inspection committee, to investigate into the books of accounts or the affairs and obligations of the merchant banker.

Liability for Action in Case of Default

A merchant banker who contravenes any provision of the SEBI Act/Regulations would be liable for action(s) specified therein including the action(s) under the **SEBI Intermediaries Regulation (2008)**.

UNDERWRITERS

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

Registration

To act as underwriter, a certificate of registration must be obtained from the SEBI. A SEBI-registered merchant banker/broker would not require a separate registration. The procedure for initial as well as permanent registration applicable to merchant bankers is also applicable to underwriters. The initial registration fee would be ₹13,33,300. The fee to keep permanent registration in force would be ₹5,00,000 every three years from the sixth year from the date of initial registration/completion of the period of renewal of registration. The non-refundable application fee for registration would be ₹25,000. In granting the certificate of registration, the SEBI considers all matters relevant/relating to the underwriting and in particular, **(a)** the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge the activities: **(b)** past experience in underwriting/employment of at least two persons with experience in underwriting: **(c)** any person directly/indirectly connected with the applicant is not registered with the SEBI as underwriter or a previous application of any such person has been rejected or any disciplinary action has been taken against such person under the SEBI Act/rules/regulations, **(d)** capital adequacy requirement of not less than the net worth (capital + free reserves) of ₹20 lakh; the capital adequacy requirement of a broker-underwriter would be specified by the stock exchange concerned; **(e)** the applicant/director/principal officer/partner has been convicted of offence involving moral turpitude or found guilty of any economic offence; and is a fit and proper person. **For determining whether an applicant/underwriter is a fit and proper person, the SEBI may take into account the criteria specified in the SEBI Intermediaries Regulation, 2008.** Failure to pay the fee would result in the suspension of the certificate of registration.

Conditions of Registration The conditions of registration applicable to merchant bankers are also applicable to underwriters.

General Obligations and Responsibilities

Code of Conduct for Underwriters An underwriter should:

1. Make all efforts to protect the interests of its clients.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Ensure that it and its personnel will act in an ethical manner in all its dealings with a body corporate making an issue of securities (i.e. the issuer).
4. Endeavour to ensure all professional dealings are effected in a prompt, efficient and effective manner.
5. At all times render high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
6. Not make any statement, either oral or written, which would misrepresent **(a)** the services that the underwriter is capable of performing for its client, or has rendered to any other issuer company; **(b)** his underwriting commitment.
7. Avoid conflict of interest and make adequate disclosure of his interest.
8. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in the an equitable manner.
9. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as underwriter which would impair its ability to render fair, objective and unbiased services.
10. Not divulge to other issuer, press or any party any confidential information about its issuer company, which has come to its knowledge and deal in securities of any issuer company without making disclosure to the SEBI as required under these regulations and also to the Board directors of the issuer company.
11. Not discriminate amongst its clients, save and except on ethical and commercial considerations.
12. Ensure that any change in registration status/any penal action taken by SEBI or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
13. Maintain an appropriate level of knowledge and competency and abide by the provisions of the SEBI Act, regulations, circulars and guidelines issued by the SEBI. The underwriter should also comply with the award of the Ombudsman under the SEBI (Ombudsman) Regulations, 2003.
14. Ensure that the SEBI is promptly informed about any action, legal proceedings, etc. initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.
15. Not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to the SEBI.
16. **(a)** Not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including its long or short position in the security has been made, while rendering such advice; **(b)** In case an employee of an underwriter is rendering such advice, the

underwriter should ensure that he should disclose his interest, the interest of his dependent family members and that of the employer including their long or short position in the security, while rendering such advice.

17. Not either through its account or their respective accounts or through their associates or family members, relatives or friends indulge in any insider trading.

18. Not indulge in any unfair competition, which is likely to be harmful to the interest of other underwriters carrying on the business of underwriting or likely to place such other underwriters in a disadvantageous position in relation to the underwriter while competing for, or carrying out any assignment.

19. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

20. Provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.

21. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interest, disclosure of shareholdings and interests, etc.

22. Ensure that good corporate policies and corporate governance is in place.

23. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

24. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.

25. Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.

26. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

27. Not be party to or instrumental for **(a)** creation of false market; **(b)** price rigging or manipulation, or; **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

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

General Responsibilities An underwriter cannot derive any direct or indirect benefit from underwriting the issue other than by the underwriting commission. The maximum obligation under all under-writing agreements of an underwriter cannot exceed twenty times his net worth. Underwriters have to subscribe for securities under the agreement within 45 days of the receipt of intimation from the issuers.

Compliance Officer Every underwriter should appoint a compliance officer who should be responsible for monitoring the compliance of the SEBI Act/rules/regulations/ notifications/ guidelines/ instructions issued by the SEBI/Government and for redressal of invertors grievances. He should immediately and independently report to the SEBI any non-compliance observed by him.

Power to Call for Information The SEBI may at any time call for any information from an underwriter with respect to any matter relating to underwriting business who would be duty bound to furnish the information.

Inspection and Disciplinary Proceedings

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

Liability for Action in Case of Default The liability for action in case of default arising out of contravention of any provision of the SEBI Act/rules/regulations, would be action(s) specified therein including the action(s) specified in the **SEBI Intermediaries Regulation 2008.**

BANKERS TO AN ISSUE

The **bankers to an issue** are engaged in activities such as acceptance of applications alongwith application money from the investors in respect of issues of capital and refund of application money. The term **issue** means an offer of sale/purchase of security by any body corporate/ person/group of persons on his/its/their behalf to or from the public/the holders of securities of the body corporate/person/group of persons.

Registration

To carry on activity as a banker to issue, a person must obtain a certificate of initial as well as permanent registration from the SEBI. The SEBI grants registration on the basis of all the activities relating to banker to an issue in particular with reference to the following requirements: **(a)** the applicant has the necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his activities, **(b)** the applicant/any of the directors of the applicant is not involved in any litigation connected with the securities market/has not been convicted of any economic offence; **(c)** the applicant is a scheduled bank; **(d)** grant of a certificate is in the interest of the investors; and **(e)** the applicant is a fit and proper person. For determining whether an applicant/banker to issue is a fit and proper person, the SEBI may take into account the criteria specified in the **SEBI Intermediaries Regulation, 2008**.

The procedure for initial as well as permanent registration and the fee for application/registration applicable to merchant bankers is also applicable to bankers to an issue.

Conditions of Registration The registration of a banker to an issue would be subject to the same conditions as are applicable to merchant bankers:

General Obligations and Responsibilities

Furnish Information When required, a banker to an issue has to furnish to the SEBI the following information: **(a)** the number of issues for which he was engaged as a banker to an issue; **(b)** the number of applications/details of the application money received; **(c)** the dates on which applications from investors were forwarded to the issuing company/registrar to an issue; **(d)** the dates/amount of refund to the investors.

Books of Account/Record/Documents A banker to an issue is required to maintain books of accounts/records/documents for a minimum period of three yeas in respect of, inter alia, the number of applications received, the names of the investors, the time within which the applications received were forwarded to the issuing company/registrar to the issue and dates and amounts of refund money to investors.

Agreement with Issuing Companies Every banker to an issue enters into an agreement with the issuing company. The agreement provides for the number of collection centres at which applications/application money received is forwarded to the registrar for issuance and submission of daily statement by the designated controlling branch of the banker stating the number of applications and the amount of money received from the investors.

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

Code of Conduct for Bankers to Issue A banker to an issue should:

1. Make all efforts to protect the interest of investors.
2. In the conduct of its business, observe high standards of integrity and fairness in the conduct of its business.
3. Fulfil its obligations in a prompt, ethical and professional manner.
4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment
5. Not any time act in collusion with other intermediaries or the issuer in a manner that is detrimental to the investor
6. Endeavour to ensure that **(a)** inquiries from investors are adequately dealt with; **(b)** grievances of investors are redressed in a timely and appropriate manner; **(c)** where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to the investor under the regulatory system.
7. Not **(a)** allow blank applications forms bearing brokers stamp to be kept the bank premises or peddled anywhere near the entrance of the premises; **(b)** accept applications after office hours or after the date of closure of the issue or on bank holidays; **(c)** after the closure of the public issue accept any instruments such as cheques/demand drafts/stock invests from any other source other than the designated registrar to the issue; **(d)** part with the issue proceeds until listing permission is granted by the stock exchange to the body corporate; **(e)** delay in issuing the final certificate pertaining to the collection figures to the registrar to the issue, the lead manager and the body corporate and such figures should be submitted within seven working days from the issue closure date.
8. Be prompt in disbursing dividends, interests or any such accrual income received or collected by him on behalf of his clients.

9. Not make any exaggerated statement whether oral or written to the client, either about its qualification or capability to render certain services or its achievements in regard to services rendered to other clients.
10. Always endavour to render the best possible advice to the clients having regard to the clients' needs and the environments and his own professional skill.
11. Not divulge to any body either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients except where such disclosures are required to be made in compliance with any law for the time being in force.
12. Avoid conflict of interest and make adequate disclosure of his interest.
13. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
14. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as banker to an issue which would impair its ability to render fair, objective and unbiased services.
15. Not indulge in any unfair competition, which is likely to harm the interests of other bankers to an issue or investors or is likely to place such other bankers to an issue in a disadvantageous position while competing for or executing any assignment.
16. Not discriminate amongst its clients, save and except on ethical and commercial considerations.
17. Ensure that any change in registration status/any penal action taken by the SEBI or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
18. Maintain an appropriate level of knowledge and competency and abide by the provisions of the SEBI Act, regulations, circulars and guidelines of the SEBI. The banker to an issue should also comply with the award of the Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.
19. Ensure that the SEBI is promptly informed about any action, legal proceedings, etc., initiated against it in respect of any material breach of non-compliance by it, of any law, rules, regulations, and directions of the SEBI or of any other regulatory body.
20. Not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to the SEBI.
21. Not neglect or fail or refuse to submit to the SEBI or other agencies with which it is registered, such books, documents, correspondence, and papers or any part thereof as may be demanded/requested from time to time.
22. Abide by the provisions of such acts and rules, regulations, guidelines, resolutions, notifications, directions, circulars and instructions as may be issued from time to time by the Central Government, the Reserve Bank of India, the Indian Banks Association or the SEBI and as may be applicable and relevant to the activities carried on the banker to an issue.
23. **(a)** Not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of its interest including long or short position in the security has been made, while rendering such advice; **(b)** In case an employee of the banker to an issue is rendering such advice, the

banker to an issue should ensure that he discloses his interest, the interest of his dependent family members and that of the employer including employer's long or short position in the security, while rendering such advice.

24. A banker to an issue or any of its directors, or employee having the management of the whole or substantially the whole of affairs of the business, should not, either through its account or their respective accounts or through their family members, relatives or friends indulge in any insider trading.

25. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

26. Provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.

27. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties as a banker to an issue and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholding and interests, etc.

28. Ensure that any person it employs or appoints to conduct a business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

29. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.

30. Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.

31. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

32. Endeavour to ensure that arms length relationship is maintained in terms of both manpower and infrastructure between the activities carried out as banker to an issue and other permitted activities.

33. Not be a party to or instrumental for **(a)** creation of false market; **(b)** price rigging or manipulation; or **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

Compliance Officer Every banker to an issue should appoint a compliance office who would be responsible for monitoring the compliance of the SEBI Act/rules/regulations/notifications/ guidelines/ instruction's issued by SEBI/Government and for redressal of investors' grievances.

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

After consideration of the inspection/investigation report, the SEBI can take such action as it may deem fit and appropriate including action under the SEBI Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty Regulations.

Liability for Action in Case of Default

A banker to an issue who controvenes any provision of the SEBI Act/Rules/Regulations would be liable for action(s) specified therein including the action(s) under the **SEBI Intermediaries Regulation, 2008**.

BROKERS TO THE ISSUE

Brokers are the persons mainly concerned with the procurement of subscription to the issue from the prospective investors. The appointment of brokers is not compulsory and the companies are free to appoint any number of brokers. The managers to the issue and the official brokers organise the preliminary distribution of securities and procure direct subscriptions from as large or as wide a circle of investors as possible. The stock exchange bye-laws prohibit the members from acting as managers or brokers to the issue and making preliminary arrangement in connection with any flotation or new issue, unless the stock exchange of which they are members gives its approval and the company conforms to the prescribed listing requirements and undertakes to have its securities listed on a recognised stock exchange. The permission granted by the stock exchange is also subject to other stipulations which are set out in the letter of consent. Their active assistance is indispensable for broad basing the issue and attracting investors. By and large, the leading merchant bankers in India who act as managers to the issue have particulars of the performance of brokers in the country. The company in consultation with the stock exchange writes to all active brokers of all exchanges and obtains their consent to act as brokers to the issue. Thereby, the entry of experienced and unknown agencies in to the field of new issue activity as issue managers, under-writers, brokers, and so on, is discouraged. A copy of the con-sent letter should be filed along with the prospectus to the ROC. The names and addresses of the brokers to the issue are required to be disclosed in the prospectus.

Brokerage may be paid within the limits and according to other conditions prescribed. The brokerage rate applicable to all types of public issue of industrial securities is fixed at 1.5 per cent, whether the issue is underwritten or not. The mailing cost and other out-of-pocket expenses for canvassing of public issues have to be borne by the stock brokers and no payment on that account is made by the companies. A clause to this effect must be included in the agreement to be entered into between the broker and the company. The listed companies are allowed to pay a brokerage on private placement of capital at a maximum rate of 0.5 per cent. Brokerage is not allowed in respect of promoters quota including the amounts taken up by the directors, their friends and employees, and in respect of the rights issues taken by or renounced by the existing shareholders. Brokerage is not payable when the applications are made by the institutions/bankers against their underwriting commitments or on the amounts devolving on them as underwriters consequent to the underscription of the issues.

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

The SEBI guidelines relating to stockbrokers and sub-brokers as important intermediaries in the stock markets are **detailed in Chapter 8**.

REGISTRARS TO AN ISSUE AND SHARE TRANSFER AGENTS

Registration

The **registrars to an issue**, as an intermediary in the primary market, carry on activities such as collecting application from the investors, keeping a proper record of applications and money received from investors or paid to the seller of securities and assisting companies in determining the basis of allotment of securities in consultation with stock exchanges, finalising the allotment of securities and processing/despatching allotment letters, refund orders, certificates and other related documents in respect of issue of capital. The share transfer agents maintain the records of holders of securities or on behalf of companies, and deal with all matters connected with the transfer/redemption of its securities. To carry on their activities, they must obtain initial/permanent registration certificate from the SEBI on payment of the requisite fee. The procedure for initial/permanent registration applicable to merchant bankers is applicable to them also. They are divided into two categories: **(a)** Category I, to carry on the activities as a registrar to an issue and share transfer agent; **(b)** Category II; to carry on the activity either as a registrar or as a share transfer agent. The registration is granted by the SEBI on the basis of consideration of all relevant matters and, in particular, the necessary infrastructure, past experience and capital adequacy. It also takes into account the fact that any connected person has not been granted registration and any director/partner/principal officer has not been convicted for any offence involving moral turpitude or has been found guilty of any economic offence. Moreover, it is a fit and proper person. For determining whether an applicant/registrar to an issue and share transfer agent is fit and proper person, the SEBI would take into account the criteria specified in the **SEBI Intermediaries Regulation**, 2008.

Capital Adequacy and Fee The capital adequacy requirement in terms of net worth (capital and free reserves) is ₹50 lakh and ₹25 lakh for Category I and Category II of registrars and share transfer agents respectively. However, the capital adequacy requirements are not applicable for a department/division of a body corporate maintaining the records of holders of securities issued by them and deal with all matters connected with transfer/redemption of securities. While Category I is required to pay a registration fee of ₹6,00,000. Category II has to pay ₹2,00,000. The non-refundable application fee for registration is ₹20,000. To keep the permanent registration in force, category I and II should pay respectively ₹2,00,000 and ₹90,000.

Conditions of Registration The conditions of registration applicable to merchant bankers/underwriters/bankers to an issue are also applicable to registrars to an issue and share transfer agent.

General Obligations and Responsibilities

Code of Conduct A registrar to an issue and share transfer agent should:

1. Maintain high standards of integrity in the conduct of its business.
2. Fulfil its obligations in a prompt, ethical and professional manner.
3. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
4. Exercise adequate care, caution and due diligence before dematerialisation of securities by confirming and verifying that the securities to be dematerialised have been granted listing permission by the stock exchange(s).

5. Always endeavour to ensure that **(a)** inquiries from investors are adequately dealt with; **(b)** grievances of investors are redressed without any delay; **(c)** transfer of securities held in physical form and confirmation of dematerialisation/rematerialisation requests and distribution of corporate benefits and allotment of securities is done within the time specified under any law.
6. Make reasonable efforts to avoid misinterpretation and ensure that the information provided to the investors is not misleading.
7. Not reject the dematerialisation/rematerialisation requests on flimsy grounds. Such requests could be rejected only on valid and proper grounds and supported by relevant documents.
8. Avoid conflict of interest and make adequate disclosure of its interest.
9. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
10. Make appropriate disclosure to the client of its source or potential areas of conflict of duties and interest which would impair its ability to render fair, objective and unbiased services.
11. Not indulge in any unfair competition, which is likely to harm the interests of other registrar to the issue and share transfer agent or investors or is likely to place him in disadvantageous position while competing for or executing any assignment.
12. Always endeavour to render the best possible advice to the clients having regard to their needs.
13. Not divulge to other clients, press or any other person any confidential information about its clients which as come to its knowledge except with the approval/authorisation of the client or when it is required to disclose the information under any law for the time being in force.
14. Not discriminate among its clients, save and except on ethical and commercial considerations.
15. Ensure that any change in registration status/any penal action taken by the SEBI or any material change in financials which may adversely affect the interest of clients/investors is promptly informed to the clients.
16. Maintain the required level of knowledge and competency and abide by the provisions of the SEBI Act, rules, regulations, circulars and directions issued by the SEBI and also comply with the award of the Ombudsman under the SEBI (Ombudsman) Regulations, 2003.
17. Cooperate with the SEBI as and when required.
18. Not neglect or fail or refuse to submit to the SEBI or other agencies with which he is registered, such books, documents, correspondence, and papers or any part thereof as may be demanded/requested from time to time.
19. Ensure that the SEBI is promptly informed about any action, legal proceeding, etc. initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.
20. Take adequate and necessary steps to ensure that continuity in data and record-keeping is maintained and that the data or records are not lost or destroyed. Further, it should ensure that for electronic records and data, up-to-date back up is always available with it.
21. Endeavour to resolve all the complaints against it or in respect of the activities carried out by it as quickly as possible.
22. **(a)** Not render, directly or indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real time, unless a disclosure of its long or

short position in the securities has been made, while rendering such advice; **(b)** In case an employee of a registrar to an issue and share transfer agent is rendering such advice, the registrar to an issue and share transfer agent should ensure that it also discloses its own interest, the interests of his dependent family members and that of the employer including their long or short position in the security, while rendering such advice.

23. Handover all the records/data and all related documents which are in its possession in its capacity as a registrar to an issue and/or share transfer agent to the respective clients, within one month from the date of termination of agreement with the respective clients within or within one month from the date of expiry/cancellation of certificate of registration as registrar to an issue and/or share transfer agent, whichever is earlier.

24. Not make any exaggerated statement, whether oral or written, to the clients either about its qualifications or capability to render certain services or about its achievements in regard to services rendered to other clients.

25. Ensure that it has satisfactory internal control procedures in place as well as adequate financial and operational capabilities which can be reasonably expected to take care of any losses arising due to theft, fraud and other dishonest acts, professional misconduct or omissions.

26. Provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.

27. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in carrying out its duties as a registrar to an issue and share transfer agent and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc.

28. Ensure that good corporate policies and corporate governance are in place.

29. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

30. Be responsible for the acts or omissions of its employees and agents in respect of the conduct of its business.

31. Not in respect of any dealings in securities be party to or instrumental for: **(a)** creation of false market; **(b)** price rigging or manipulation; **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary.

A registrar should not act for any issue in case he is an **associate** of the issuer, that is, **(a)** he/it controls directly/indirectly at least 10 per cent of the voting power of the issuer/registrar or **(b)** he/any of his relatives is a director/promoter of the issuer/registrar to an issue.

Maintenance of Records The registrars and share transfer agents have to maintain records relating to all applications received from investors in respect of an issue, all rejected applications together with reasons, basis of allotment of securities in consultation with the stock exchanges, terms and conditions of purchase of securities, allotment of securities, list of allotees and non-allotees, refund orders, and so on. In addition, they should also keep a record to the list of holders of securities of corporates, the names of transferors and transferees, and the dates of transfer of securities. The SEBI can require the regis-trars and transfer agents to file the books of accounts, and records, and so on. These have to be preserved by them for a period of three years.

Compliance Officer Every registrar to an issue and share transfer agent should appoint a compliance officer responsible for redressal of inverter's grievances and for monitoring the compliance of the SEBI Act/rules/regulations/notifications/guidelines/instructions issued by the SEBI/Government.

Inspection

The SEBI is authorised to undertake the inspection of the books of accounts, other records, and documents of the registrars and share transfer agents to ensure that they are being maintained in a proper manner and the provisions of the SEBI Act, rules, regulations and the provisions of the SCRA and the relevant rules are complied with, to investigate into complaints from investors/other registrars and share transfer agents/other intermediaries in the securities market or any matter relating to their activities, and to investigate on its own in the interest of securities market/investors into their affairs. On the basis of the inspection report, the SEBI can direct the concerned partly to take such measures as it deems fit in the circumstances. It can also appoint a qualified auditor to investigate into the books of accounts and affairs of the registrars and share transfer agents.

Action in Default

A registrar to an issue/share transfer agent who fails to comply with any condition subject to which registration is granted, or contravenes any of the provisions of the SEBI Act/SCRA, rules/regulations Depositories Act/rules and stock exchange bye-laws, rules and regulations would be dealt with in the manner provided under the **SEBI Intermediaries Regulation**, 2008.

DEBENTURE TRUSTEES

Registration

A **debenture trustee** is a trustee for a trust deed needed for securing any issue of debentures by a company/body corporate or any private placement of debentures by a listed/proposed to be listed company. A trust deed means a deed executed by the body corporate in favour of the trustees named therein for the benefit of the debentureholders. An issue means an offer of sale or purchase of securities by any body corporate/other person/group of persons on its/their behalf to the public/holders of securities of the body corporate/persons/group of persons. To act as a debenture trustee, a certificate of registration from the SEBI is necessary. Only banks, public financial institutions, insurance companies and body corporates fulfilling the capital adequacy requirement of ₹2 crore in terms of networth [i.e. aggregate of value of paid-up capital and free reserves (excluding reserves created out of revaluation) minus aggregate value of accumulated losses and deferred expenditure not written off (including miscellaneous expenses not writ-ten off)] as per the latest audited balance sheet can act as trustees. While considering the application for registration, the SEBI takes into account **(i)** the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge duties, **(ii)** any past experience as a debenture trustee or employment of minimum two persons with experience in matters relevant to a debenture trustee, **(iii)** any person directly/indirectly connected with the applicant has not been granted registration by the SEBI under the SEBI Act, **(iv)** employment of at least one person who possesses the professional qualification in law from a government recognised institution, **(v)** any of its directors/principal officer (i.e. a secretary/manager/director of the body corporate or any person connected with the management/administration of the body corporate upon whom the Board of Directors has served notice of its intention of treating him as its principal officer) is/has any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence and **(vi)** is a fit and proper person. For determining whether an applicant/debenture trustee is a fit and proper person, the SEBI may take into account the criteria specified in the **SEBI Intermediaries Regulation**, 2008. The procedure to obtain initial as well as permanent registration and the payment of the requisite fee is the same as applicable to merchant bankers.

Conditions of Registration The conditions of registration applicable to merchant bankers are also applicable to debenture trustees.

Responsibilities and Obligations

The responsibilities and duties of a debenture trustee as discussed below.

Obligation before Appointment A debenture trustee has to enter into a written agreement with the body corporate before the opening of the subscription list for issue of debentures. The agreement should, *inter alia*, contain **(i)** that the debenture trustee has agreed to act as the trustee under the trust deed for securing an issue of debentures for the body corporate and **(ii)** the time limit within which the security for the debentureholders would be created. However, a debenture trustee cannot act as trustee for any issue of debenture if **(a)** it is an associate [i.e. **(i)** who directly/indirectly by himself or in combination with relatives exercises control in terms of Regulations 2(C) of the SEBI Substantial Acquisition of Shares and Takeover Regulations over the debenture trustee/the body corporate or **(ii)** in respect of whom the debenture trustee/body corporate directly/indirectly exercises control or **(iii)** whose director is also a director of the debentures trustee/body corporate], **(b)** it has lent and the loan is yet not fully rapid/is proposing to lend money to the body corporate.

Obligations A debenture trustee should, among other matters, accept the trust deed containing matters specified below.

Contents of Trust Deed Every debenture trustee should ensure that the trust deed executed between a body corporate and debenture trustee should, amongst other things, provide for the following matters, namely:

Preamble This section should, *inter alia*, state the rights of the debentureholders and the manner in which these rights are vested in the trustee.

Description of Instruments This section should, *inter alia*, state the purpose of raising finance through debenture issue, description of debentures as regards amount, tenure, interest/coupon rate, periodicity of payment, period for redemption, options available, terms of conversion/redemption of the debentures in terms of the issue to the debentureholders, debt equity and debt service coverage ratio, if applicable.

Details of Charged Securities (Existing or Future) This section, should, *inter alia*, state the details regarding the following:

(i) Nature of charge, examination of title,
(ii) Rank of charge of assets, namely, first, second, *pari passu*, residual and so on,
(iii) Charging of future assets,
(iv) Time limit within which the future security for the issue of debentures would be created as specified in SEBI Disclosure and Investor Protection Guidelines, 2000,
(v) Enforceability of securities, events under which security becomes enforceable,
(vi) Obligation of company not to create future security for the issue of debentures would be created as specified in SEBI Disclosure and Investor Protection Guidelines, 2000,
(vii) Minimum security cover required,
(viii) Provision for subsequent valuation,
(ix) Circumstances when the security would become enforceable,
(x) Method and mode of preservation of assets charged as security for debentureholders,
(xi) Circumstances specifying when the security may be disposed of or leased out with the approval of trustee, and
(xii) Procedure for allowing inspection of charged assets, books of account, by debenture trustee or any person or persons authorised by it.

Events of Defaults This section should clearly define the event of default which, if occurs, would invite the action by debenture trustee. It should also contain the steps which would be taken by debenture trustee in the event of defaults.

Rights of Debenture Trustees This section should, *inter alia*, provide that the debenture trustee **(i)** is entitled to inspect the registers of the company and to take copies and extracts thereof; and **(ii)** has a right to appoint a nominee director.

Obligations of Body Corporates This section should, *inter alia*, state the following with respect to company's duties:

1. To maintain register of debentureholders with address with record of subsequent transfers and changes of ownership.
2. To keep proper books of account open for inspection by the debenture trustee.
3. To furnish whatever required information to debenture trustee including copies of reports, balance sheets, profit and loss accounts and so on.
4. To keep charged property/security adequately insured and in proper condition.
5. To permit debenture trustee to enter and inspect the state and condition of charged assets.
6. To pay all taxes, cases, insurance premia with respect to charged property/security, on time.
7. To inform debenture trustee before declaring or distributing dividend.
8. To comply with all guidelines/directions issued by any regula-tory authority, with respect to the instant debenture issue.
9. To create debenture redemption reserve as per the SEBI Disclosure and Investor Protection Guidelines, 2000 and the provisions of Companies Act and submit an auditor's certificate to the trustee.
10. To convert the debenture into equity in accordance with the terms of the issue, if applicable.
11. To inform debenture trustee about any change in nature and conduct of business by company before such change.

12. To keep the debenture trustee informed of all orders, directions, notices, of Court/Tribunal affecting or likely to affect the charged assets.

13. To inform debenture trustee of any major change in composition of its Board of Directors, which may amount to change in control as defined in SEBI Substantial Acquisition of Shares and Takeovers Regulations, 1997.

14. To submit any such information, as required by the debenture trustee.

15. Fee or commission of debenture trustees.

16. Obligation to inform debenture trustee about any change in nature and conduct of business by the body corporate before such change.

17. Obligation of the body corporate to forward a quarterly report to debenture trustees containing the following particulars:
- **(i)** updated list of the names and addresses of the debentureholders;
- **(ii)** details of interest due but unpaid and reasons thereof;
- **(iii)** the number and nature of grievances received from debentureholders and resolved by the body corporate;
- **(iv)** a statement that the assets of the body corporate which are available by way of security and sufficient to discharge the claims of the debentureholders as and when they become due.

Miscellaneous **(a)** Procedure for appointment and removal of trustee including appointment of new trustees; **(b)** Provision that the debenture trustee would not relinquish from its assignment unless another debenture trustee has been appointed; **(c)** Procedure to remove debenture trustee by debentureholders providing for removal on a resolution passed by at least 75 per cent of the total debentureholders of a body corporate; **(d)** Provisions for redressal of grievance of debentureholders.

Note: The debenture trustee may incorporate additional clause(s), provided they do not dilute or contravene the provisions of the above clauses.

Duties The duties of the debenture trustees include the following:

1. (a) Call for period reports from the body corporate,

(b) Take possession of trust property in accordance with the provisions of the trust deed,

(ba) Supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption fund.

(c) Enforce security in the interest of the debentureholders,

(d) Do such acts as are necessary in the event the security becomes enforceable,

(e) Carry out such acts as are necessary for the protection of the debentureholders and do all things necessary in order to resolve the grievances of the debentureholders,

(f) Ascertain and satisfy itself that
- **(i)** in case where allotment letter has been issued and debenture certificate is to be issued after registration of charge, the debenture certificate has been despatched by the body corporate to the debentureholders within 30 days of the registration of the charge with the Registrar of Companies,
- **(ii)** debenture certificates have been despatched to the debentureholders in accordance with the provisions of the Companies Act,
- **(iii)** interest warrants for interest due on debentures have been despatched to the debentureholders on/before the due dates,

(iv) debentureholders have been paid the money(ies) due to them on the date of the redemption of the debentures.

(g) Ensure on a continuous basis that the property charged to the debentures is available and adequate at all times to discharge the interest and principal amount payable to them and that the property is free from any other encumberances save and except those which are specifically agreed to by the debenture trustee,

(h) Exercise due diligence to ensure compliance by the body corporate with the provisions of the Companies Act, the listing agreement/trust deed,

(i) Take appropriate measures for protecting the interest of the debentureholders as soon as any breach of the trustee deed law comes to its notice,

(j) Ascertain that the debentures have been converted/redeemed according to the provisions/conditions under which they are offered to the debentureholders,

(k) Inform the SEBI immediately of any breach of trust deed/provisions of any law,

(l) Appoint a nominee director on the Board of Directors of the body corporate in the event of

(i) two consecutive defaults in payment of interest to the debentureholders,

(ii) default in creation of security for debentures,

(iii) default in redemption of debentures.

(m) Communicate to the debentureholders on half yearly basis the compliance of the terms of the issue by the body corporate, defaults, if any, in payment of interest or redemption of debentures and action taken theoron.

1-A The debenture trustee should **(i)** obtain reports from the lead bank regarding progress of the projects; **(ii)** monitor utilisation of funds raised in the issue; **(iii)** obtain a certificate from the issuer's auditors **(a)** in respect of utilisation of funds during the implementation period and **(b)** in case of debentures issued for financing working capital at the end of each accounting year.

2. A debenture trustee should call or cause to be called by the corporate body a meeting of all debentureholders on **(a)** a requisition in writing signed by at least 10 per cent of the debentureholders in value for the time being outstanding and **(b)** the happening of any event which constitutes a default or which in the opinion of the debenture trustee affects the interest of the debentureholders.

3. No debenture trustee should relinquish its assignments as debenture trustee in respect of the debenture issue of any body corporate, unless and until another debenture trustee is appointed in its place by the body corporate.

4. A debenture trustee should maintain the networth requirements as specified in these regulations on a continuous basis and should inform the SEBI immediately in respect of any shortfall in the networth and in such a case it would not be entitled to undertake new assignments until it restores the networth to the level of specified requirement within the time specified by the SEBI.

5. A debenture trustee may inspect books of account, records, registers of the body corporate and the trust property to the extent necessary for discharging its obligations.

Code of Conduct for Debenture Trustees A debenture trustee should:

1. Make all efforts to protect the interest of debentureholders.

2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.

3. Fulfil its obligations in a prompt, ethical and professional manner.
4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
5. Take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation and maintain record of the same.
6. Ensure that any change in registration status/any penal action taken by the SEBI or any material change in financial position which may adversely affect the interests of clients/debenture-holders is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
7. Avoid conflict of interest and make adequate disclosure of its interest.
8. Not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
9. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
10. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as debenture trustee which would impair its ability to render fair, objective and unbiased services.
11. Not indulge in any unfair competition, which is likely to harm the interests of other trustees or debentureholders or is likely to place such other debenture trustees in a disadvantageous position while competing for or executing any assignment nor should it wean away the clients of another trustee on assurance of lower fees.
12. Not discriminate among its clients, except and save on ethical and commercial considerations.
13. Share information available with it regarding client companies, with registered credit rating agencies.
14. Provide clients and debenture-holders with adequate and appropriate information about its business, including contact details, services available to clients, and the identity and status of employees and others acting on its behalf with whom the client may have to contact.
15. Ensure that adequate disclosures are made to the debenture-holders, in a comprehensible and timely manner so as to enable them to make a balanced and informed decision.
16. Endeavour to ensure that **(a)** inquiries from debenture-holders are adequately dealt with; **(b)** grievances of debenture-holders are redressed in a timely and appropriate manner; **(c)** where a complaint is not remedied promptly, the debenture-holder is advised of any further steps which may be available to the debenture-holder under the regulatory system.
17. Make reasonable efforts to avoid misrepresentation and ensure that the information provided to the debenture-holders is not misleading.
18. Maintain required level of knowledge and competency and abide by the provisions of the SEBI Acts/regulations, circulars and guidelines. He should also comply with the award of Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.
19. Not make untrue statement or suppress any material fact in any document, reports, papers or information furnished to the SEBI.
20. A debenture trustee or any of its directors, partners or manager having the management of the whole or substantially the whole of affairs of the business, should not either through

its account or their respective accounts or through their associates or family members, relatives or friends indulge in any insider trading.

21. Ensure that the SEBI is promptly informed about any action, legal proceeding, etc., initiated against it in respect of any material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.

22. **(a)** Not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non real-time unless a disclosure of his interest including long or short position in the security has been made, while rendering such advice; **(b)** In case an employee of the debenture trustee is rendering such advice, the debenture trustee should ensure that he discloses his interest, the interest of his dependent family members and that of the employer, including their long or short position in the security, while rendering such advice.

23. Ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

24. Ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.

25. Have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, debenture-holders and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

26. Be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.

27. Provide adequate freedom and powers to its compliance officer for the effective discharge of its duties.

28. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

29. That good corporate policies and corporate governance is in place.

30. Develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct of its employees and offers in the carrying out of their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc.

31. Not be a party to or instrument for **(a)** creation of false market; **(b)** price rigging or manipulation or; **(c)** passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary in the securities market.

Maintenance of Books of Records A trustee should keep and main-tain proper books of account, records and documents relating to the trusteeship function for at least 5 financial years preceding the current financial year. It should intimate to the SEBI the place where they are mentioned.

Compliance Officer Every trustee should appoint a compliance officer to monitor the compliance of the SEBI Act/rules/regulations, notification/guidelines/instructions issued by SEBI/Government and for redressal of investors grievances. He should immediately and independently report to the SEBI any non-compliance observed by him. He should also report any non-compliance of the requirements in the listing agreement with respect to the debenture issue and debentureholders by the body corporate to the SEBI.

Information to SEBI Every trustee would be duty bound, as and when required by the SEBI, to submit the following information and documents; **(i)** number and nature of grievances of the debentureholders received/resolved, **(ii)** copies of the trust deed, **(iii)** non/delayed payment of interest to debentureholders, **(iv)** details of despatch/transfer of debenture certificates and **(v)** any other details relevant to the trustee.

Inspection by SEBI

The SEBI is empowered to undertake an inspection of the books of accounts, other records and documents of the debenture trustees. The purpose of inspection can be to **(i)** ensure that they are maintained in the manner required by the SEBI and that the provisions of the Companies Act are being complied with, **(ii)** ascertain where circumstances warrant in eligibility of the trustee for the continuance of registration, **(iii)** investigate into complaints from investors/other trustees/any other person against the trustee's activities, and also *suo motu* in the interest of the securities business/investors into the affairs of the trustee. The SEBI can alternatively appoint a qualified auditor to investigate into the accounts or the affairs of the trustee.

On the basis of the inspection report, the SEBI can call upon the trustee to take measures in the interests of the securities market and for due compliance with the provisions of the SEBI Act, rules and regulations. It can also give direction to the effect that he should not act as a trustee for any issue of debenture, or that the trustee should act as per the covenants of the trust deed. Appropriate action against the trustee in accordance with the relevant regulations can also be taken by the SEBI.

Action for Default

A debenture trustee who **(a)** fails to comply with any condition subject to which certificate has been granted, **(b)** contravenes any provision of the SEBI Act/rules/regulations, **(c)** contravenes the provisions of the Companies Act/rules would be dealt with in the manner provided under the **SEBI Intermediaries Regulation**, 2008.

PORTFOLIO MANAGERS

Portfolio managers are defined as persons who, in pursuance of a contract/arrangement with clients, advise/direct/ undertake, on behalf of the client(s), whether discretionary portfolio manager or otherwise, the management/administration of portfolio of securities/funds of clients. The term portfolio means the total holdings of securities belonging to any person. Portfolio management can be **(i)** Discretionary or **(ii)** Non-discretionary. The first type of portfolio management permits the exercise of discretion with regard to investment/management of the portfolio of the securities/funds. A non-discretionary portfolio manager manages funds in accordance to the directions of the clients. In order to act as a portfolio manager, a certificate of registration from the SEBI is mandatory. The SEBI is authorised to grant and renew the certificate of registration, as a prior permission to portfolio managers, on the payment of the requisite application/registration/renewal fee. A certificate/renewal of registration is valid for three years. An application for renewal must be made three months before the expiry of the validity of the certificate. The non-refundable application fee is ₹1,00,000. The registration fee, and renewal fee after every three years, is ₹10 lakh and ₹5 lakh respectively. The portfolio manager has to also give an undertaking to take adequate steps for the redressal of grievances of clients within one month of the receipt of the complaint, keep the SEBI informed about the number, nature and other particulars of the complaints and abide by its rules and regulations.

Procedure for Registration

While considering the application for registration made in the prescribed form, the SEBI takes into account all matters relevant to the activities related to the portfolio manager, and in particular: **(a)** necessary infrastructure like adequate office staff, equipment and manpower to discharge his activities; **(b)** employment of a minimum of two persons who between them have at least five years experience in related activities in portfolio management/stock broking/investment management; **(c)** a person directly/indirectly connected with the applicant, that is, associate/subsidiary/inter-connected or group company that has not been refused registration; **(d)** capital adequacy of not less than a net worth of ₹2 crore, in terms of capital plus free reserves excluding revaluation reserves minus accumulated losses an deferred expenditure not written off; **(e)** that the applicant/partner/director/principal officer has not been convicted for any offence involving moral turpitude/guilty of any economic offence; **(f)** the applicant/partner/director/partner/principal officer is not involved in any litigation connected with the securities market; **(g)** the principal officer of the applicant has professional qualification in finance/law/accounting/business management or an experience of at least 10 years in related activities in the securities market including in portfolio manager/stock broker/fund manager, and **(h)** the grant of certificate is in the interest of the investors; **(i)** the applicant is a body corporate; **(j)** no disciplinary action has been taken by the SEBI against any person directly/indirectly connected with the applicant, that is, an associate/subsidiary/inter-connected company/company under the same management, under the SEBI Act/rules/regulations; and **(k)** the applicant is a fit and proper person. For determining whether an applicant/portfolio manager is a fit and proper person, the SEBI may take into account the criteria specified in the **SEBI Intermediaries Regulation, 2008**. The portfolio manager should fulfil the capital adequacy requirement separately and independently of capital adequacy requirement for each activity undertaken by him under the relevant regulations.

Conditions of Registration The registration/renewal of portfolio managers is subject to the following conditions: **(i)** Prior approval of the SEBI would be required for change of its status/constitution including amalgamation/demerger/consolidation/any other kind of corporate restructuring, change in its managing/whole-time director(s), and any change in control over the body corporate, that is, **(a)** in case of listed shares, change in control in terms of the SEBI Substantial Acquisition of Shares and Takeover Regulations, **(b)** in any other case, change in controlling interest in the body corporate to the extent of atleast 51 per cent of its voting rights; **(ii)** Payment of fee; **(iii)** Adequate steps for redressal of investors grievances within one month of the receipt of the complaint and keep the SEBI informed about the number/nature/other particulars of these complaints; **(iv)** Maintenance of the specified capital adequacy requirements; and **(v)** Abide by the regulations under the SEBI Act in respect of its activities.

General Obligations and Responsibilities

The general obligations and responsibilities of a portfolio manager are as given below.

Code of Conduct A portfolio manager has to, in the conduct of business, observe high standards of integrity and fairness in all his dealings with his clients and other portfolio managers. The money received by him from a client, for investment purposes should be deployed as soon as possible and money due and payable to a client should be paid forthwith.

A portfolio manager has to render, at all times, high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgement. He should either avoid any conflict of interest in his investment or disinvestment decision, or where any conflict of interest arises, ensure fair treatment to all his customers. He must disclose to the clients, possible sources of conflict of duties and interest, while providing unbiased services. A portfolio manager should not place his interest above those of his clients.

He should not make any statement or become privy to any act, practice or unfair competition that is likely to be harmful to the interests of other portfolio managers or is likely to place them in a disadvantageous position in relation to the portfolio manager himself, while competing for or executing any assignment.

Any exaggerated statement, whether oral or written, should not be made by him to the clients, about his qualification or capability to render certain services or his achievements in regard to services rendered to the other clients.

At the time of entering into a contract, he should obtain in writing from the client, the latters interest in various corporate bodies, which would enable him to obtain unpublished price sensitive information of the body corporate.

A portfolio manager should not disclose, to any client or the press, any confidential information about his clients, which has come to his knowledge.

Where necessary, and in the interest of the client, he should take adequate steps for the registration of transfer of the clients' securities and for claiming and receiving dividends, interest payments and other rights accruing to the client. He must also take necessary action for the conversion of securities and subscription/ renunciation of/or rights in accordance with the clients' instructions.

A portfolio manager has to endeavour to:

(a) Ensure that investors are provided with true and adequate information, without making any misguiding or exaggerated claims, and are made aware of the attendant risks before any investment decision is taken by them;

(b) Render the best possible advice to the client, taking into account to the client's needs and the environment, and his own professional skills;

(c) Ensure that all professional dealings are effected in a prompt, efficient and cost effective manner.

A portfolio manager should not be party to: **(a)** creation of false market in securities; **(b)** price rigging or manipulation of securities; **(c)** passing of price sensitive information to brokers, members of the stock exchanges and any other intermediaries in the capital market, or take any other action which is prejudicial to the interest of the investors. No portfolio manager or any of its directors, partners or managers should, either on their respective accounts or through their associates or family members/relatives, enter into any transaction in securities of companies on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment.

A portfolio manager or any of his employees should not render, directly or indirectly, any investment advice about any security in publicly accessible media, whether real-time or non-real-time, without disclosing his long/short position in the security while rendering such advice. The employee should also disclose the interest of his dependent family members and the employer, including their long/short position in the security.

Contract with Clients Every portfolio manager is required, before taking up an assignment of management of portfolio on behalf of a client, to enter into an agreement with such client clearly defining the *inter se* relationship, setting out their mutual rights, liabilities and obligations relating to the management of the funds/portfolio of the securities containing the details specified in the SEBI regulations. The agreement should, *inter-alia*, contain:

(i) The investment objectives and the services to be provided;
(ii) Areas of investment and restrictions, if any, imposed by the client with regard to investment in a particular company or industry;
(iii) Attendant risks involved in the management of the portfolio;
(iv) Period of the contract and provision of early termination, if any;
(v) Amount to be invested;
(vi) Procedure of settling the client's account, including the form of repayment on maturity or early termination of contract;
(vii) Fee payable to the portfolio manager;
(viii) Custody of securities.
(ix) Type of instruments and proportion of exposure;
(x) Tenure of portfolio investment;
(xi) Terms of early withdrawal of funds/securities by the clients;
(xii) Quantum and manner of fee payable by the client for each activity for which service is rendered by the portfolio manager directly/indirectly (where such service is outsourced);
(xiii) In case of a discretionary portfolio manager a condition that the liability of a client would not exceed his investment with the portfolio manager;
(xiv) Terms of accounts/audit and furnishing of reports to the clients; and
(xv) Other terms of the portfolio investments.

The portfolio manager should provide to the client(s) the Disclosure Document specified by the SEBI along with the specified certificate at least two days prior to entering into the agreement with the client. The disclosure document should *inter-alia*, contain **(i)** quantum/manner of payment of fee payable by the client for each activity for which service is rendered directly/indirectly, **(ii)** portfolio risks, **(iii)** complete disclosures in respect of transactions with related parties as per the accounting standards of the ICAI, **(iv)** performance of the portfolio manager; the performance of the discretionary portfolio manager should be calculated using weighted average method taking each individual category of investments for the immediately preceding three years and in such cases performance indicators should also be disclosed, and **(v)** audited financial statements of the portfolio manager for the immediately preceding three years. These contents should be certified by an independent chartered accountant. The portfolio manager should file with the SEBI a copy of it before it is circulated/issued to any person and every six months thereafter or whenever any material change is effected whichever is earlier.

The portfolio manager can charge an agreed fee from the client for rendering portfolio management services without guaranteeing or assuring, either directly or indirectly, any return, and such fee may be a fixed fee or a return-based fee or a combination of both. He may charge such fee for each activity for which service is provided directly/indirectly.

Profit sharing/performance-related fee are usually charged by the portfolio managers upon exceeding a hurdle rate/benchmark as specified in the agreement. Profit/performance should be computed on the basis of **high-water mark (HWM) principle** over the life of the investment for charging of performance/profit-sharing fee. The **HWM** would be the highest value that the portfolio account has reached on the date when performance fee is charged. The fee should be charged only on increase in portfolio value in excess of the previously achieved high-water mark and the frequency should not be less than quarterly. To illustrate, assuming annual frequency, and initial contribution of a client of ₹10,00,000 which rises to 12,00,000 in its first year, the performance fee/profit sharing would be payable on ₹2,00,000 (₹12,00,000 – ₹10,00,000) return. If the portfolio drops to ₹11,00,000 next year, no such fee would be payable. The fee would be payable only on ₹1,00,000 if the portfolio rises to ₹13,00,000 in the third year (₹13,00,000 – ₹12,00,000 i.e. high-water mark achieved previously) rather than one the full return.

All fee/charges would be levied on the actual amount of the asset under management of the client and the **HWM** will be applicable only to discretionary and non-discretionary but not to advisory services. The liability of a client in a discretionary portfolio cannot exceed his portfolio investment.

To ensure transparency and adequate disclosure, the client agreement should contain a separate annexure listing all fees/charges. It should contain details of levy of all applicable charges on a sample portfolio of ₹10 lakh over a one-year period for three scenarios, that is, change in the portfolio: **(i)** 20 per cent increase, **(ii)** 20 per cent decrease, and **(iii)** no change. This is illustrated below:

Portfolio performance: gain of 20 per cent

Nature of fee		*Amount (₹)*
Capital contribution	10,00,000	
Less: Up front fee	20,000	
Any other fee (mention)	—	
Asset under management	9,80,000	
Add: Profit on investment during the year (0.20)	1,96,000	
Gross portfolio value at the end of the year		11,76,000
Less: Brokerage/Depository participant (DP) charges (0.02 × ₹9,80,000)	19,600	
: Management fee (0.02 × ₹9,80,000)	19,600	
: Performance fee (0.20 × ₹9,80,000)	19,600	
: Any other fee (mention)	—	
Total charges during the year		58,800
Net value of the portfolio at the year-end		11,17,200
Percentage change over capital contributed		11.72

General Responsibilities The discretionary portfolio manager should individually and independently manage the funds of each client in accordance with the needs of the client in a manner that does not partake the character of a mutual fund, whereas the non-discretionary portfolio manager should manage the funds in accordance with the directions of the client. He should not accept from the clients funds/securities worth less than ₹25 lakh. He should act in a fiduciary capacity with regard to the client's funds, and transact in securities within the limitation placed by the client himself with regard to dealing in securities under the provisions of the Reserve Bank of India Act, 1934. The funds of all clients must be placed by the portfolio manager in a separate account to be maintained by him in a scheduled commercial bank. He should not derive any direct or indirect benefit out of the client's funds or securities. He cannot lend securities, held on behalf of clients, to a third person except as provided in the SEBI regulations. He should not borrow funds/securities on behalf of his client(s). He should ensure proper and timely handling of complaints from his clients and take appropriate action immediately.

Investment of Clients' Moneys The money/securities accepted by a portfolio manager should be invested/managed only in accordance with the agreement with the client. Any renewal of portfolio fund on the maturity of the initial period is deemed as a fresh placement. Portfolio funds can be withdrawn or taken back by the portfolio client, before the maturity date of the contract, under the following circumstances:

(a) Voluntary or compulsory termination of portfolio management services by the portfolio manager/client.
(b) Suspension or termination of registration of portfolio manager by the SEBI.
(c) Bankruptcy or liquidation of the portfolio manager.

The portfolio manager can invest funds of his clients in money market instruments (i.e. CPs/CDs/T-bills/trade and usance bills) or derivatives or as specified in the contract, but not in bill discounting, badla financing or for the purpose of lending or placement with corporate or non-corporate bodies. Leveraging of portfolio is not permitted in respect of investment in derivatives.

While dealing with clients' funds, he should not indulge in speculative transactions, that is, not enter into any transaction for the purchase or sale of any security in which transaction is periodically or ultimately settled otherwise than by actual delivery or transfer of security except transaction's in derivatives.

He should ordinarily purchase or sell securities separately for each client. However, in the event of aggregation of purchase or sales for economy of scale, *inter se* allocation should be done on a pro rata basis and at the weighted average price of the day's transactions. The portfolio manager should not keep any position open in respect of allocation of sales or purchases effected in a day.

Any transaction of purchase or sale, including that between the portfolio manager's own accounts and client's accounts or between two clients' accounts, should be at the prevailing market price. He should segregate each clients' funds and portfolio of securities and keep them separately from his own funds and securities and be responsible for the safekeeping of clients' funds and securities. He should not hold the listed/unlisted securities, belonging to the portfolio account, in its own name on behalf of the clients by virtue of a contract or otherwise. The portfolio manager on authorisation from his client may participate in securities lending scheme. The SEBI-registered Foreign portfolio managers may avail of the services of portfolio managers.

Every portfolio manager should appoint a custodian in respect of the securities managed/administered by it. However, portfolio managers who manage a portfolio of less than ₹500 crore or who performs purely advisory functions would be exempt from this stipulation.

Maintenance of Books of Accounts/Records Every portfolio manager must keep and maintain the following books of accounts, records and documents.

(a) A copy of balance sheet at the end of each accounting period;
(b) A copy of the profit and loss account for each accounting period;
(c) A copy of the auditor's report on the accounts for each accounting period;
(d) A statement of financial position; and
(e) Records in support of every investment transaction or recommendation, which indicate the data, facts and opinion leading to that investment decision.

After the end of each accounting period, copies of the balance sheet, profit and loss account and such other documents for any other preceding five accounting years, when required, must be submitted to the SEBI. Half-yearly unaudited financial results, when required, with a view to monitor the capital adequacy have also to be submitted to the SEBI. The books of account and other records and documents must be preserved for a minimum period of five years.

Audit of Accounts The portfolio manager is required to maintain separate client-wise accounts. The funds received from the clients, investments or disinvestment and all the credits to the account of the client, like interest, dividend, bonus or any other beneficial interest received on investments and debits, for expenses, if any, have to be properly accounted for and details properly reflected in the client's account. The tax deducted at source should be recorded in the portfolio account. The books of accounts have to be audited yearly by a qualified auditor to ensure that the proper accounting methods and procedures have been followed, and that the portfolio manager has performed his duties in accordance with the law. A certificate to this effect, if so specified, has to be submitted to the SEBI within six months closing the accounting period. The portfolio accounts of the portfolio manager should be audited by an independent chartered accountant and a copy of the certificate issued by him should be given to the client. The client may appoint a chartered accountant to audit the books of accounts of the portfolio manager relating to his transactions and the portfolio manager should extend full cooperation in such audit.

Reports to be Furnished to the Clients The portfolio manager should furnish a periodical report to the client, as agreed in the contract, but not exceeding a period of six months, (and as and when required by the client) containing the following details:

(a) The composition and the value of the portfolio, description of security, number of securities, value of each security held in the portfolio, cash balance and aggregate value of the portfolio as on the date of report;
(b) Transactions undertaken during the period of report, including the date of transaction and details of purchases and sales;
(c) Beneficial interest received during that period in respect of interest, dividend, bonus shares, rights shares and debentures;
(d) Expenses incurred in managing the portfolio of the client; and
(e) Details of risk foreseen by the portfolio manager and the risk related to the securities recommended by the portfo1io manager, for investment or disinvestment.

The report may be made available on the website of the portfolio manager with restricted access to each client.

He should also furnish in terms of the agreement the client with documents and information relating only to the management of a portfolio. On termination of the contract, the portfolio manager should give a detailed statement of accounts to the client and settle the account with the client, as agreed in the contract. The client has the right to obtain the details of his portfolio from the portfolio manager.

Every portfolio manager should, within two months from the date of the auditors' report, take steps to rectify the deficiencies made out in the auditor's report.

Disclosures to the SEBI A portfolio manager must disclose the following information to the SEBI, as and when required.

(i) Particulars regarding the management of a portfolio;
(ii) Any change in the information or particulars previously furnished, which have a bearing on the certificate granted to him;
(iii) Names of the clients whose portfolio he has managed and
(iv) Particulars relating to the capital adequacy requirement.

Appointment of Compliance Officer Every portfolio manager should appoint a compliance officer for **(i)** monitoring compliance with the SEBI Act/rules/regulations/notifications/guidelines/instructions and so on issued by SEBI/Government and **(ii)** redressal of investors' grievances. He should immediately and independently report any non-compliance observed by him to the SEBI.

Inspection and Disciplinary Proceedings

Right to Inspection The SEBI may appoint one or more persons as the inspecting authority to undertake the inspection of the books of account, records and documents of the portfolio manager:
(a) To ensure that the books of account are being maintained in the manner required;
(b) That the provisions of the SEBI Act, rules and regulations are being complied with;
(c) To investigate into the complaints received from investors, other portfolio managers or any other person or any matter having bearing on his activities as a portfolio manager; and
(d) To investigate, *suo motu*, in the interest of securities business/investors' interest into his affairs.

The inspection of portfolio managers can be undertaken by the SEBI, after giving reasonable notice, or in the interest of investors, without notice. During the course of investigation, every director/proprietor/partner/officer/employee has an obligation to produce to the inspecting authority, within the specified time, books, accounts and other documents in his custody/control and furnish statements of information relating to the activities of the portfolio manager. He should allow reasonable access to his premises and extend reasonable facilities for the examination of books/records/documents/computer data in his possession and also provide copies of documents/other material relevant to the purpose of inspection. The inspection authority is also entitled to examine/record statements of any principal officer, director, partner, proprietor and employee who should provide all assistance in connection with the inspection. The inspection can also be conducted by a qualified auditor approved by the SEBI. On the basis of the inspection, and for due compliance with the provisions of the SEBI Act, rules and regulations the SEBI is authorised to take appropriate measures in the interest of the securities market.

Action in Case of Default

A portfolio manager who contravenes any of the provisions of the SEBI Act, rules or regulations would be liable for action(s) specified therein including the actions under the **SEBI Intermediaries Regulation, 2008.**

PROHIBITION OF FRAUDULENT AND UNFAIR TRADE PRACTICES RELATING TO THE SECURITIES MARKET REGULATION, 2003

In order to prohibit fraudulent and unfair practices relating to the securities market, the SEBI had issued regulations in October 1995. These were repealed in 2003. A new set of regulations were issued in July 2003. The scheme of regulation contained in these is briefly discussed in this Section.

Prohibition of Fraudulent and Unfair Trade Practices

The prohibition of fraudulent and unfair trade practices relates to **(i)** prohibition of certain dealings in securities and **(ii)** prohibition of manipulative, fraudulent and unfair trades practices.

Prohibition of Certain Dealings in Securities Dealing in securities includes an act of buying, selling or subscribing pursuant to any issue of any security or agreeing to buy, sell or sub-scribe to any issue of any security or otherwise transacting in any way in any security by any person as principal, agent or intermediary referred to in Section 12 of the SEBI Act (discussed in Chapter 4). No person should directly or indirectly

(a) buy, sell or otherwise deal in securities in a fraudulent manner;
(b) use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the SEBI Act or the rules or the regulations made thereunder;
(c) employe any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognised stock;
(d) engage in any act, practice, course of business which operates/would operate as a fraud/deceit on any person in contravention of the provisions of the SEBI Act/regulations.

"Fraud" includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or his agent, while dealing in securities in order to include another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and would also include:

1. A knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment;
2. A suggestion as to a fact which is not true by one who does not believe it to be true;
3. An active concealment of a fact by a person having knowledge or belief of the fact;
4. A promise made without any intention of performing it;
5. A representation made in a reckless and careless manner whether it be true or false;
6. Any such act or omission as any other law specifically declares to be fraudulent;
7. Deceptive behaviour by a person depriving anothers of informed consent or full participation;
8. A false statement made without reasonable ground for believing it to be true;
9. The act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price.

And "fraudulent" would be construed accordingly. However, nothing contained in this clause would apply to any general comments made in good faith in regard to: **(a)** the economic policy of the Government; **(b)** the economic situation of the country; **(c)** trends in the securities market; or **(d)** any other matter of a like nature, whether such comments are made in public or in private.

Prohibition of Manipulative, Fraudulent and Unfair Trade Practices No person should indulge in a fraudulent or an unfair trade practice in securities. Dealing in securities would be deemed to be a fraudulent or an unfair trade practice if it involves fraud and may include all or any of the following, namely:

- **(a)** Indulging in an act which creates false or misleading appearance of trading in the securities market;
- **(b)** Dealing in a security not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress or cause fluctuations in the price of such security for wrongful gain or avoidance of loss;
- **(c)** Advancing or agreeing to advance any money to any person thereby inducing any other person to offer to buy any security in any issue only with the intention of securing the minimum subscription to such issue;
- **(d)** Paying, offering or agreeing to pay or offer, directly or indirectly, to any person any money or money's worth for inducing such person for dealing in any security with the object of inflating, depressing, maintaining or causing fluctuations in the price of such security;
- **(e)** Any act or omission amounting to manipulation of the price of a security;
- **(f)** Publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities;
- **(g)** Entering into a transaction in securities without intention of performing it or without intention of change of ownership of such security;
- **(h)** Selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialised form;
- **(i)** An intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security and retaining the difference in prices as profit for himself;
- **(j)** An intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security:
- **(k)** An advertisement that is misleading or that contains information in a distorted manner and which may influence the decision of the investors;
- **(l)** An intermediary reporting trading transactions to his clients entered into on their behalf in an inflated manner in order to increase his commission and brokerage;
- **(m)** An intermediary not disclosing to his client transactions entered into on his behalf including taking an option position;
- **(n)** Circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security;
- **(o)** Encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission.
- **(p)** An intermediary predating or otherwise falsifying records such as contract notes;
- **(q)** An intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract; and
- **(r)** Planting false or misleading news which may induce sale or purchase of securities.
- **(s)** Mis-selling of units of a mutual fund scheme, that is, direct/indirect sale by any person by: **(a)** making a false/misleading statement, **(b)** concealing/omitting material facts of the scheme, **(c)** concealing the associated risk factors of the scheme, and **(d)** not making reasonable care to ensure suitability of the scheme to the buyer.

(t) Illegal mobilisation of funds by sponsoring/causing to the sponsored or carrying on/causing to be carried on any collective investment scheme by any person.

The acts/omissions listed above are not exhaustive and any act/omission is prohibited if it falls within the purview of this regulation notwithstanding that it is not included here or is described as having been committed only by a certain category of persons.

Investigation

Where the SEBI, the Chairman, the member or the Executive Director (i.e. 'appointing authority') has reasonable ground to believe that **(a)** the transactions in securities are being dealt with in a manner deterimental to the investors or the securities market in violation of these regulations; **(b)** any intermediary or any person associated with the securities market has violated any of the provisions of the SEBI Act or the rules or the regulations, it may, at any time by order in writing, direct any officer not below the rank of Division Chief (i.e. the 'Investigating Authority') specified in the order to investigate the affairs of such intermediary or persons associated with the securities market or any other person and to report thereon to the SEBI in the manner provided in Section 11(C) of the SEBI Act.

The Investigating Authority would have the following powers for the conduct of investigation, namely:

1. To call for information or records from any person specified in Section 11(2)(i) of the SEBI Act;
2. To undertake inspection of any book, or register, or other document or record of any listed public company or a public company (not being intermediaries referred to in Section 12 of the SEBI Act) which intends to get its securities listed on any recognised stock exchange where the Investigating Authority has reasonable grounds to believe that such company has been conducting in violation of these regulations;
3. To require any intermediary or any person associated with securities market in any manner to furnish such information to, or produce such books, or registers, or other documents, or record before him or any person authorised by him in this behalf as he may consider necessary if the furnishing of such information or the production of such books, or registers, or other documents, or record is relevant or necessary for the purposes of the investigation;
4. To keep in his custody any books, registers, other documents and record produced under this regulation for a maximum period of one month which may be extended up to a period of six months by the SEBI. However, the Investigating Authority may call for any book, register, other document or record if the same is needed again. If the person on whose behalf the books, registers, other documents and record are produced requires certified copies of the books, registers, other documents and record produced before the Investigating Authority, he should give certified copies of such books, registers other documents and record to such person or on whose behalf the books, registers, other documents and record were produced;
5. To examine orally and to record the statement of the person concerned or any director, partner, member or employee of such person and to take notes of such oral examination to be used as an evidence against such person. These notes should be read over to, or by, and signed by, the person so examined.

6. To examine on oath any manager, managing director, officer or other employee of any intermediary or any person associated with securities market in any manner in relation to the affairs of his business and may administer an oath accordingly and for that purpose may require any of those persons to appear before him personally.

The Investigating Authority may, after obtaining specific approval from the Chairman or Member, also exercise all or any of the following powers, namely:

(a) To call for information and record from any bank or any other authority or board or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which are under investigation;

(b) To make an application to the Judicial Magistrate of the First Class having jurisdiction for an order for the seizure of any books, registers, other documents and record, if in the course of investigation, the Investigating Authority has reasonable ground to believe that such books, registers, other documents and record of, or relating to, any intermediary or any person associated with securities market in any manner may be destroyed, mutilated, altered, falsified or secreted;

(c) To keep in his custody the books, registers, other documents and record seized under these regulations for such period not later than the conclusion of the investigation as he considers necessary and thereafter to return the same to the person, the company or the other body corporate, to the managing director or the manager or any other person from whose custody or power they were seized. The Investigating Authority may, before returning such books, registers, other documents and record as aforesaid, place identification marks on them or any part thereof;

(d) Every search or seizure made under this regulation should be carried out in accordance with the provisions of the Code of Criminal Procedure, relating to searches or seizures.

It would be the duty of every person in respect of whom an investigation has been ordered

(a) to produce to the Investigating Authority or any person authorised by him such books, accounts and other documents and record in his custody or control, and to furnish such statements and information as the Investigating Authority or the person so authorised by him may reasonably require for the purpose of the investigation;

(b) to appear before the Investigating Authority personally when required to do so by him to answer any question which is put to him by him in pursuance of his powers.

It would be the duty of every manager, managing director, officer and other employee of the company and every intermediary or every person associated with the securities market to preserve and to produce to the Investigating Authority or any person authorised by him in this behalf, all the books, registers, other documents and record of, or relating to, the company, or, as the case may be, of or relating to, the intermediary or such person, which are in their custody or power. Such person should

(a) allow the Investigating Authority to have access to the premises occupied by him at all reasonable times for the purpose of investigation;

(b) extend to the Investigating Authority reasonable facilities for examining any books, accounts and other documents in his custody or control (whether kept manually or in computer or in any other form) reasonably required for the purposes of the investigation;

(c) provide to such Investigating Authority any such book, accounts and records which, in the opinion of the Investigating Authority, are relevant to the investigation or, as the case may be, allow him to take out computer out-prints thereof.

The Investigating Authority would, on completion of investigation, after taking into account all relevant facts, submit a report to the appointing authority. It may also submit an interim report pending completion of investigations if he considers necessary in the interest of investors and the securities market or as directed by the appointing authority.

After consideration of the report, if satisfied that there is a violation of these regulations and after giving a reasonable opportunity of hearing to the persons concerned, the SEBI may by an order, for reasons to be recorded in writing, in the interests of investors and securities market, issue or take any of the following actions or directions, either pending investigation or enquiry or on completion of such investigation or enquiry, namely:

(a) Suspend the trading of security found to be or *prima facie* found to be involved in fraudulent and unfair trade practice in a recognised stock exchange;
(b) Restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities;
(c) Suspend any office-bearer of any stock exchange or self-regulatory organisation from holding such position;
(d) Impound and retain the proceeds or securities in respect of any transaction which is in violation or *prima facie* in violation of these regulations;
(e) Direct an intermediary or any person associated with the securities market in any manner not to dispose of or alienate an asset forming part of a fraudulent and unfair transaction;
(f) Require the person concerned to call upon any of its officers, other employees or representatives to refrain from dealing in securities in any particular manner;
(g) Prohibit the person concerned from disposing of any of the securities acquired in contravention of these regulations;
(h) Direct the person concerned to dispose of any such securities acquired in contravention of these regulations, in such manner as the SEBI may deem fit, for restoring the *status quo ante;*

The SEBI would issue a press release in respect of any final order in at least two newspapers of which one should have nation-wide circulation and also put the order on its website.

The SEBI also by an order, for reasons to be recorded in writing, in the interests of investors and securities market, take the following action against an intermediary: **(a)** issue a warning or censure; **(b)** suspend the registration of the intermediary; or **(c)** cancel of the registration of the intermediary.

PROHIBITION OF INSIDER TRADING REGULATION 2015

The object of the regulation is to **(i)** put in place a framework for prohibition of insider trading in securities and **(ii)** strengthen the related legal framework. The main elements of the scheme of regulation, namely, restriction on communication and trading by insiders, disclosure of trading by insiders, code of fair disclosure/conduct and action for violation are discussed in this Section.

Restrictions on Communication and Trading by Insiders

The two aspects of the SEBI regulations are: **(i)** communication/procurement of unpublished price sensitive information and **(ii)** trading when in possession of such information.

Communication/Procurement of Unpublished Price Sensitive Information An **insider** means a person who is **(i)** a connected person or **(ii)** in possession of/having access to unpublished price sensitive information. A **connected person** means any person who is/has during the six months prior to the concerned act been directly/indirectly associated with a company, in any capacity including by reason of frequent communication with its officers or by being in any contractual, fiduciary or employment relationship or by being a director, officer or an employee of the company or holds any position including a professional or temporary or permanent business relationship between himself and the company, that directly/indirectly allows him access to unpublished price sensitive information or is reasonably expected to allow such access. The persons falling within the following categories would be deemed to be connected persons unless the contrary is established: **(a)** an immediate relative of connected persons, **(b)** a holding/associate/subsidiary company, **(c)** an intermediary/employee/director, **(d)** an investment/trustee/asset management company or an employee/director, **(e)** an official of a stock exchange/clearing house/corporation, **(f)** a member of board of trustees/ asset management company of a mutual fund/an employee, **(g)** a member of board of directors/an employee of a public financial institution, **(h)** an official or an employee of a SEBI-recognised/authorised self-regulatory organisation, **(i)** a banker of the company, and **(j)** a concern firm, trust, Hindu undivided family, company or association of persons wherein a director of a company or his immediate relative or banker of the company, has more than 10 per cent of the holding or interest.

Immediate relative means a spouse of a person and includes parent/sibling/child any of whom is either dependent financially or consults him in taking decisions relating to trading in securities. **Trading/trade** means and includes subscribing/buying/selling/ dealing or agreeing to subscribe/buy/sell/deal in any securities.

Unpublished price sensitive information means any information directly/indirectly relating to a company/its securities that is generally not available which upon becoming generally available (i.e. information that is accessible to the public on a non-discriminatory basis, for example, published on the website of a stock exchange) is likely to materially affect the price of securities, and should ordinarily including but not restricted to information relating to **(i)** financial results, **(ii)** dividends, **(iii)** change in capital structure, **(iv)** mergers/demergers/acquisitions/ delistings/ diposals and expansion of business and such other transactions, **(v)** change in key managerial personnel and **(vi)** material events in accordance with the listing agreement.

An insider should not communicate/provide/allow access to any price sensitive information relating to a company, its listed/proposed to be listed securities to any person including other insiders except for furtherance of legitimate purposes/performance of duties/discharge of legal obligations. Similar stipulations also apply to any person to procure from or cause the communication by an insider of such information. However, such information may be communicated provided access allowed to/procured in connection with a transaction that would:

- entail an obligation to make an open offer under the **SEBI Takeover Regulations**[@] where the Board of Directors of the company is of informed opinion that the proposed transaction is in the best interest of the company.
- not attract the obligation to make an offer but where the Board of Directors is of informed opinion that the proposed transaction is in the best interest of the company and the information that constitutes such information is disseminated to be made generally available at least two **trading days** (i.e., day on which the stock exchange is open for trading) prior to the transaction being effected in such form as it may determine.

[@]Ibid, Chapter 12

The Board of Directors would require the parties to execute agreements to contract confidentiality and non-disclosure obligations on their part and they should keep such information confidential except for the purpose mentioned above and not otherwise trade in securities of the company when in possession of unpublished price sensitive information.

Trading When in Possession of Unpublished Price Sensitive Information No insider should trade in listed or proposed to be listed securities on a stock exchange when in possession of unpublished price sensitive information. However, he may prove his innocence by demonstrating the circumstances including the following:

(i) The transaction is an off-market *inter se* transfer between promoters who were in possession of the same unpublished price sensitive information without being in breach of the stipulation relating to the non-communication of information and both parties had made a conscious and informed trade decision;

(ii) In the case of non-individual insiders: **(a)** the individuals who were in possession of such unpublished price sensitive information were different from those taking trading decisions and were not in possession of such unpublished price sensitive information when they took the decision to trade, and **(ii)** appropriate and adequate arrangements were in place to ensure that there are no violations and no unpublished price sensitive information was communicated by the individuals to the individuals taking trading decisions and there is no evidence of such arrangements having been breached;

(iii) The trades were pursuant to a trading plan (**discussed below**):

In the case of connected people the onus of establishing that they were not in possession of unpublished price sensitive information, would be on them and in other cases on the SEBI. The SEBI may specify standards and requirements deemed necessary for the purpose.

Trading Plans An insider would be entitled to formulate a trading plan and present it to the compliance officer for approval and public disclosure pursuant to which trades may be carried out on his behalf in accordance with such plan. A **compliance officer** means any designated senior officer, reporting to the Board of Directors/head of the organisation, who is financially literate and is capable of appreciating requirements for legal and regulatory compliance who would be responsible for compliance of policies, procedures, maintenance of records, monitoring adherence to the rules for the preservation of unpublished price sensitive information, monitoring of trades and the implementation of the SEBI-specified code under the overall supervision of the Board of Directors or the head of an organisation of the listed company.

The trading plan should: **(i)** not entail **(a)** commencement of trading on behalf of the insider earlier than six months from the public disclosure of the plan; **(b)** trading for the period between the twentieth trading day prior to the last day of any financial period for which results are required to be announced by the issuer of the securities and the second trading day after the disclosure of such financial results; **(ii)** entail trading for a period of not less than twelve months; **(iii)** not entail overlap of any period for which another trading plan is already in existence; **(iv)** set out either the value of trades to be effected or the number of securities to be traded along with the nature of the trade and the intervals at, or dates on which such trades would be effected; and **(v)** not entail trading in securities for market abuse.

The compliance officer should review the trading plan to assess whether it would have any potential for violation and would be entitled to seek such express undertakings as may be necessary to enable such assessment and to approve and monitor the implementation of the plan.

The trading plan once approved would be irrevocable and the insider would mandatorily have to implement the plan, without being entitled to either deviate from it or to execute any trade in the securities outside the scope of the trading plan. However, its implementation should not be commenced if any unpublished price sensitive information in possession of the insider at the time of formulation of the plan has not become generally available at that time and in such event he should confirm that the commencement ought to be deferred until such unpublished price sensitive information becomes generally available information. Upon approval, the compliance officer should notify the trading plan to the concerned stock exchanges.

Disclosures of Trading by Insiders

The disclosures relate to general provisions and disclosures by certain persons.

General Provisions Every public disclosure should be made in SEBI-specified form. They should include those relating to trading by such person's immediate relatives, and by any other person for whom such person takes trading decisions. The disclosures of trading should also include trading in derivatives of securities and their traded value should be taken into account. They should be maintained by the company for a minimum period of five years in the SEBI-specified form.

Disclosures by Certain Persons ***Initial Disclosures*** Every promoter, key managerial personnel and director of a listed company should disclose his holding of securities of the company. Every person on appointment as a key managerial personnel/director or upon becoming a promoter should disclose his holdings as on the date of appointment/becoming a promoter to the company within seven days.

Continual Disclosures Every promoter, employee, director should disclose to the company the number of such securities acquired or disposed of within two trading days of the transaction if the value of the securities traded, over any calendar quarter, aggregates to a traded value in excess of ₹10 lakh or a SEBI-specified value. Every company should notify the particulars of such trading to the concerned stock exchange within two trading days of receipt of the disclosure or from becoming aware of such information.

Disclosures by Other Connected Persons Any listed company may, at its discretion, require any other connected/class of connected persons to make disclosures of holdings and trading in its securities in form and frequency determined by it.

Codes of Fair Disclosure and Conduct

Code of Fair Disclosure The Board of Directors of every listed company should formulate and publish on its website, the following code of practices and procedures for fair disclosure of unpublished price sensitive information that it would follow in order to adhere to each of the principles set out below, without diluting the provisions of the SEBI regulations in any manner.

Principles of Fair Disclosure for Purposes of Code of Practices and Procedures for Fair Disclosure of Unpublished Price Sensitive Information

1. Prompt public disclosure of unpublished price sensitive information that would impact price discovery no sooner than credible and concrete information comes into being in order to make such information generally available.

2. Uniform and universal dissemination of unpublished price sensitive to avoid selective disclosure.
3. Designation of a senior officer as a chief investor relations officer to deal with dissemination of information and disclosure of unpublished price sensitive information.
4. Prompt dissemination of unpublished price sensitive information that gets disclosed selectively, inadvertently or otherwise to make such information generally available.
5. Appropriate and fair response to queries on news reports and requests for verification of market rumours by regulatory authorities.
6. Ensuring that information shared with analysts and research personnel is not unpublished price sensitive information.
7. Developing best practices to make transcripts or records of proceedings of meeting with analysts and other investor relations conferences on the official website to ensure official confirmation and documentation of disclosures made.
8. Handling of all unpublished price sensitive information on a need-to-know basis.

Every such code of practices and procedures for fair disclosure of unpublished price sensitive information and amendments should be promptly intimated to the concerned stock exchanges.

Code of Conduct The Board of Directors of every listed company, market intermediary and every other person who is required to handle unpublished price sensitive information in the course of business operations should formulate a code of conduct to regulate, monitor and report trading by its employees and other connected persons towards achieving compliance adopting the minimum standards set out below:

Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders

1. The compliance officer should report to the Board of Directors and in particular, to the Chairman and Audit Committee/Chairman at such frequency as may be stipulated by the Board of Directors.
2. All information should be handled within the organisation on a need-to-know basis and no unpublished price sensitive information communicated to any person except in furtherance of the insider's legitimate purposes, performance of duties or discharge of his legal obligations. The code of conduct should contain norms for appropriate Chinese Walls procedures, and processes for permitting any designated person to "cross the wall".
3. Employees and connected persons designated on the basis of their functional role ("**designated persons**") in the organisations should be governed by an internal code of conduct governing dealing in securities. The Board of Directors should in consultation with the compliance officer specify the designated persons on the basis of their role and function in the organisation. Due regard should be had to the access that such role and function would provide to unpublished price sensitive information in addition to seniority and professional designation.
4. Designated persons may execute trades subject to compliance with these regulations. Towards this end, a notional trading window should be used as an instrument of monitoring trading by them. It should be closed when the compliance officer determines that a designated persons can reasonably be expected to have possession of unpublished price sensitive information. Designated persons and their immediate relatives should not trade in securities when the trading window is closed.
5. The timing for re-opening of the trading window should be determined by the compliance officer taking into account various factors including the unpublished price sensitive

information in question becoming generally available and being capable of assimilation by the market, which in any event should not be earlier than 48 hours after the information becomes generally available. The trading window should also be applicable to any person having contractual or fiduciary relation with the company, such as auditors, accountancy firms, law firms, analysts, consultants and so on, assisting or advising the company.

6. When the trading window is open, trading by designated persons should be subject to pre-clearance by the compliance officer, if the value of the proposed trades is above such thresholds as the Board of Directors may stipulate. No designated person should apply for pre-clearance of any proposed trade if he is in possession of unpublished price sensitive information even if the trading window is not closed.
7. The compliance officer should confidentially maintain a list of securities as a "restricted list" which should be used as the basis for approving or rejecting applications for pre-clearance of trades.
8. Prior to approving any trades, the compliance officer should be entitled to seek declaration to the effect that the applicant for pre-clearance is not in possession of any unpublished price sensitive information. He should also have a regard to whether any such declaration is reasonably capable of being rendered inaccurate.
9. The code of conduct should specify any reasonable timeframe, which in any event should not be more than 7 trading days, within which trades that have been pre-cleared have to be executed by the designated person, failing which fresh pre-clearance would be needed for the trades to be executed.
10. It should specify the period, which in any event should not be less than six months, within which a designated person who is permitted to trade should not execute a contra trade. The compliance officer may be empowered to grant relaxation from strict application of such restriction for reasons to be recorded in writing provided that such relaxation does not violate these regulations. Should a contra trade be executed, inadvertently or otherwise, in violation of such a restriction, the profits from such trade should be liable to be disgorged for remittance to the SEBI for credit to the Investor Protection and Education Fund administered by it under the SEBI Act.
11. It should also stipulate such formats as the board of directors deems necessary for making applications for pre-clearance, reporting of trades executed, reporting of decisions not to trade after securing pre-clearance, recording of reasons for such decisions and for reporting level of holdings in securities at such intervals as may be determined as being necessary to monitor compliance with these regulations.
12. Without prejudice to the power of the SEBI under the SEBI Act, the code of conduct should stipulate the sanctions and disciplinary actions, including wage freeze, suspension etc., that may be imposed, by the persons required to formulate a code of conduct for the contravention of the code of conduct.
13. The code of conduct should specify that in case it is observed by the persons required to formulate a code of conduct, that there has been a violation of these regulations, they should inform the SEBI promptly.

Every listed company, market intermediary and other persons formulating a code of conduct should identify and designate a compliance officer to administer the code of conduct and other requirements.

Sanction for Violations

Any contravention of these regulations would be dealt with by the SEBI in accordance with the SEBI Act.

CONCLUDING OBSERVATIONS

- The framework of operation of the intermediaries in the primary market in India is prescribed by the SEBI. The SEBI's guidelines relate to: merchant bankers/lead managers; underwriters; bankers to an issue; brokers to an issue; registrar to an issue and share transfer agents; debenture trustees; portfolio managers; prohibition of fraudulent and unfair trade practices; and insider trading;
- The main elements of the SEBI's framework as applicable to merchant bankers are: registration, obligation and responsibilities, inspection/action in case of default and pre-issue and post-issue obligations.
- Merchant banking activities include managing of public issues of capital, including international offers of debt and equity (i.e. GDRs/ADRs/FCCBs and so on); private placement of securities; corporate advisory services, such as takeovers/mergers, project advisory services, loan syndication; portfolio advisory/management services and so on.
- Merchant bankers require compulsory registration with the SEBI. While granting registration, the relevant matters considered by SEBI are: the applicant is a body corporate, it has the necessary infrastructure, it has at least two experienced persons, it is not involved in any litigation, it is a fit and a proper person in terms of SEBI's fit and proper person regulations.
- The criteria for fit and proper person include financial integrity, absence of conviction/civil liability, competence, good reputation and character, efficiency and honesty, and absence of any disqualification to act as an intermediary by SEBI/other regulatory authorities such as conviction for offence involving moral turpitude, economic offence, securities laws or fraud, order for winding up, insolvency, debarred from dealings, cancellation of registration, financial unsoundness and so on.
- The obligations and responsibilities of merchant bankers include adherence to the requirements under the prescribed code of conduct, restriction on asset-based activities, maximum number of lead managers, responsibilities of lead managers, due diligence certificate, submission of documents, appointment of compliance officer and disclosures to the SEBI.
- The SEBI can undertake an inspection of the books of accounts, records, and documents of a merchant banker to ensure compliance with the provisions of the SEBI Act/rules/regulations and to investigate complaints into his affairs. Action in case of a default would be in a manner provided under the SEBI Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty Regulations.
- Underwriters make a commitment to get the issue subscribed either by others or by themselves. They are appointed by the issuers, in consultation with the lead managers/merchant bankers.
- To act as underwriters, registration with the SEBI is mandatory. The eligibility criteria are: infrastructure, past experience, capital adequacy, non-conviction for offence involving moral turpitude/non-guilty of any economic offence, fit and proper person in terms of SEBI Criteria for Fit and Prosper Person Regulation, payment of registration fee and so on.
- The general obligations and responsibilities of underwriters are: following the prescribed code of conduct, entering into an agreement with the clients, appointment of compliance officer, provide information regarding its business to the SEBI and general responsibilities.

- The framework of inspection, disciplinary proceedings and action in case of default by the SEBI is broadly on the same pattern as applicable to lead managers.
- Bankers to an issue are engaged in activities such as acceptance of applications along with application money from the investors in respect of issues of capital and refund of application money.
- To carry on as a banker to an issue, registration with the SEBI is necessary, which is given on the basis of eligibility criteria, such as infrastructure, non-involvement in litigation connected with the securities market/non-conviction of any economic offence, interest of the investors and payment of registration/renewal fee.
- Their obligations are furnishing of information, maintenance of accounts/records/ documents, entering into a agreement with issuing companies, subject to disciplinary action by the RBI, following the prescribed code of conduct, and appointment of compliance officer.
- The framework of inspection by the SEBI and action in case of default is broadly on the same pattern as applicable to lead managers/underwriters.
- The registrar to an issue (RI) carries on activities such as collecting applications from the investors, keeping a proper record of the applications and money received from investors/paid to sellers, assisting the issuers in determining the basis of allotment of securities in consultation with the stock exchange(s), finalising the allotment of securities and processing/despatching allotment letters, refund orders, certificates and other related documents in respect of issues of capital.
- The share transfer agent (STA) maintains the records of holders of securities on behalf of companies and deals with all matters connected with the transfer/redemption of its securities.
- The registration procedure of RI/STAs with the SEBI, their general obligations and responsibilities, inspection by the SEBI and action in case of default is broadly on the pattern applicable to lead managers/underwriters/bankers to an issue.
- A debenture trustee is a trustee for a trust deed. He is needed for securing any issue of debentures by a company/body corporate or any private placement of debentures by a listed company, proposed to be listed. A trust deed means a deed executed by the body corporate in favour of the trustees, for the benefit of the debentureholders.
- Only banks/FIs/insurance companies/body corporates fulfilling the minimum capital adequacy requirement can act as trustees. The compulsory registration procedure with the SEBI is on the same pattern as applicable to lead managers/underwriters/bankers to an issue/RI/STAs.
- The responsibilities and duties of a debenture trustee are: obligation before appointment and obligations.
- The obligation before appointment is to enter into a written agreement containing the specified details, with the body corporate, before the opening of the subscription list for issue of debentures.
- The obligation of the debenture trustee is to accept the trust deed containing the following: **(i)** description of instruments, **(ii)** details of charged securities (existing/future), **(iii)** events of defaults, **(iv)** rights of debentures trustees, **(v)** obligations of body corporate and miscellaneous. The obligations of the debenture trustees also include code of conduct, maintenance of books of accounts, appointment of compliance officer and providing information to the SEBI.
- The inspection procedure and action for default to the SEBI is broadly on the same pattern as applicable to the other intermediaries.
- ‘Portfolio’ means the total holdings of securities of a person. Portfolio managers advise/directly undertake the management/administration of portfolio of securities/funds of clients, on their

behalf. Portfolio management can be discretionary or non-discretionary. Discretionary portfolio management permits the exercise of discretion by the portfolio manager with regards to investment/management of the portfolio. Funds are invested in a non-discretionary portfolio management in accordance with the directions of the client(s).

- Portfolio management services in the country should be carried out within the framework of SEBI's regulations. According to these, merchant bankers can carry out such activities, but other categories of portfolio managers must obtain a certificate or registration from SEBI.
- While considering an application for registration, SEBI takes into account matters such as infrastructure, capital adequacy, non-involvement in any securities market-related litigation, professional qualification, non-conviction for any offence involving moral turpitude/guilty of an economic offence and so on.
- The general obligations and responsibilities of a portfolio manager include following the preseribed code of conduct, entering into contracts with clients, carrying out the general responsibilities of the discretionary portfolio manager, investing of clients, money, maintenance and audit of books of accounts, furnishing reports to clients, making the required disclosures to SEBI and appointment of they compliance officer.
- The SEBI can conduct an inspection of a portfolio manager to ensure that the books of accounts/records/documents are being maintained in the required manner, the provisions of SEBI Act/rules/regulation are being complied with and the SEBI can also investigate into complaints against him. On the basis of inspection, it can take appropriate measures in the interest of the securities market.
- Action in the case of default would be broadly on the pattern applicable to other intermediaries.
- The prohibition of fraudulent and unfair trade practices relates to **(1)** certain dealings in securities and **(2)** manipulative, fraudulent and unfair trade practices.
- Dealings in securities which are prohibited are: **(i)** buying, selling or otherwise dealing in a fraudulent manner, **(ii)** employing a manipulative/deceptive device or contrivance in contravention of the provisions of the SEBI Act/regulations and **(iii)** employing any device/artifice/scheme to defraud and (iv) engaging in any act, practice, course of business which operates/would operate as a fraud/deceit on any person, in contravention of the provisions of the SEBI Act/regulations.
- No person should indulge in a fraudulent or an unfair trade practice in securities. Dealings in securities would be deemed fraudulent/an unfair trade practice if it involves fraud.
- If there are reasonable grounds to believe that transactions in securities are being dealt with in a manner detrimental to the investors/securities market or there is violation of any provision of the SEBI Act/rules/regulation, the SEBI may conduct an investigation into the affairs of the intermediary/person associated with the securities market. On the findings, the SEBI can take action/issue a direction, such as suspension of trading of the security concerned, restraining persons from accessing the securities market, suspension of office-bearers of a stock exchange, impounding/retaining the proceeds/securities, direction not to dispose of/alienate an asset, prohibition on disposing of any security and so on. The SEBI can also suspend/cancel the registration of an intermediary.
- The main elements of the scheme of prohibition of insider trading regulation are: restriction on communication and trading by insiders, disclosure of trading by insiders, code of fair disclosure/conduct and action for violation.
- The two aspects of the restrictions on communications and trading by insiders are: **(i)** communication/procurement of unpublished price sensitive information and **(ii)** trading when in possession of such information.

- An **insider** means a person who is **(i)** a connected person or **(ii)** in possession of/having access to unpublished price sensitive information. A **connected person** means any person who is/has during the six months prior to the concerned act been directly/indirectly associated with a company, in any capacity including by reason of frequent communication with its officers or by being in any contractual, fiduciary or employment relationship or by being a director, officer or an employee of the company or holds any position including a professional or temporary or permanent business relationship between himself and the company, that directly/indirectly allows him access to unpublished price sensitive information or is reasonably expected to allow such access. The persons falling within the following categories would be deemed to be connected persons unless the contrary is established: **(a)** an immediate relative of connected persons, **(b)** a holding/associate/subsidiary company, **(c)** an intermediary/employee/director, **(d)** an investment/trustee/asset management company or an employee/director, **(e)** an official of a stock exchange/clearing house/corporation, **(f)** a member of board of trustees/ asset management company of a mutual fund/an employee, **(g)** a member of board of directors/an employee of a public financial institution, **(h)** an official or an employee of a SEBI-recognised/authorised self-regulatory by the SEBI, **(i)** a banker of the company, and **(j)** a concern firm, trust, Hindu undivided family, company or association of persons wherein a director of a company or his immediate relative or banker of the company, has more than 10 per cent of the holding or interest.

  Immediate relative means a spouse of a person and includes parent/sibling/child any of whom is either dependent financially or consults him in taking decisions relating to trading in securities. **Trading/trade** means and includes subscribing/buying/selling/ dealing or agreeing to subscribe/buy/sell/deal in any securities.

  Unpublished price sensitive information means any information directly/indirectly relating to a company/its securities that is generally not available which upon becoming **generally available** (i.e. information that is accessible to the public on a non-discriminatory basis, for example, published on the website of a stock exchange) is likely to materially affect the price of securities, and should ordinarily including but not restricted to information relating to **(i)** financial results, **(ii)** dividends, **(iii)** change in capital structure, **(iv)** mergers/demergers/acquisitions/delistings/diposals and expansion of business and such other transactions, **(v)** change in key managerial personnel and **(vi)** material events in accordance with the listing agreement.
- An insider should not communicate/provide/allow access to any price sensitive information relating to a company, its listed/proposed to be listed securities to any person including other insiders except for furtherance of legitimate purposes/performance of duties/discharge of legal obligations. Similar stipulations also apply to any person to procure from or cause the communication by an insider of such information.
- No insider should trade in listed or proposed to be listed securities on a stock exchange when in possession of unpublished price sensitive information. In the case of connected people the onus of establishing that they were not in possession of unpublished price sensitive information, would be on them and in other cases on the SEBI. The SEBI may specify standards and requirements deemed necessary for the purpose.
- An insider would be entitled to formulate a trading plan and present it to the compliance officer for approval and public disclosure pursuant to which trades may be carried out on his behalf in accordance with such plan. The trading plan should: **(i)** not entail **(a)** commencement of trading on behalf of the insider earlier than six months from the public disclosure of the plan; **(b)** trading for the period between the twentieth trading day prior to the last day of any financial period for which results are required to be announced by the issuer of the securities and the second trading day after the disclosure of such financial results; **(ii)** entail trading for a period of not less than twelve months; **(iii)** not entail overlap of any period for which another trading plan is already in existence; **(iv)** set out either the value of trades to be effected or the number

of securities to be traded along with the nature of the trade and the intervals at, or dates on which such trades would be effected; and **(v)** not entail trading in securities for market abuse.

- The disclosures of trading by insiders relate to general provisions and disclosures by certain persons.
- The general provisions should include those relating to trading by such person's immediate relatives, and by any other person for whom such person takes trading decisions. The disclosures of trading should also include trading in derivatives of securities and their traded value should be taken into account.
- Every promoter, key managerial personnel and director of a listed company should disclose his holding of securities of the company. Every person on appointment as a key managerial personnel/director or upon becoming a promoter should disclose his holdings as on the date of appointment/becoming a promoter to the company within seven days.
- Every promoter, employee, director should disclose to the company the number of such securities acquired or disposed of within two trading days of the transaction if the value of the securities traded, over any calendar quarter, aggregates to a traded value in excess of ₹10 lakh or a SEBI-specified value. Every company should notify the particulars of such trading to the concerned stock exchange within two trading days of receipt of the disclosure or from becoming aware of such information.
- Any listed company may, at its discretion, require any other connected/class of connected persons to make disclosures of holdings and trading in its securities in form and frequency determined by it.
- The Board of Directors of every listed company should formulate and publish on its website, a code of practices and procedures for fair disclosure of unpublished price sensitive information that it would follow in order to adhere to each of the principles set out below, without diluting the provisions of the SEBI regulations in any manner.
- The Board of Directors of every listed company, market intermediary and every other person who is required to handle unpublished price sensitive information in the course of business operations should formulate a code of conduct to regulate, monitor and report trading by its employees and other connected persons towards achieving compliance adopting the minimum standards set out below.
- Any contravention of the regulations would be dealt with by the SEBI in accordance with the SEBI Act.

CHAPTER 7

Primary Market Organisation: Activities/Procedures

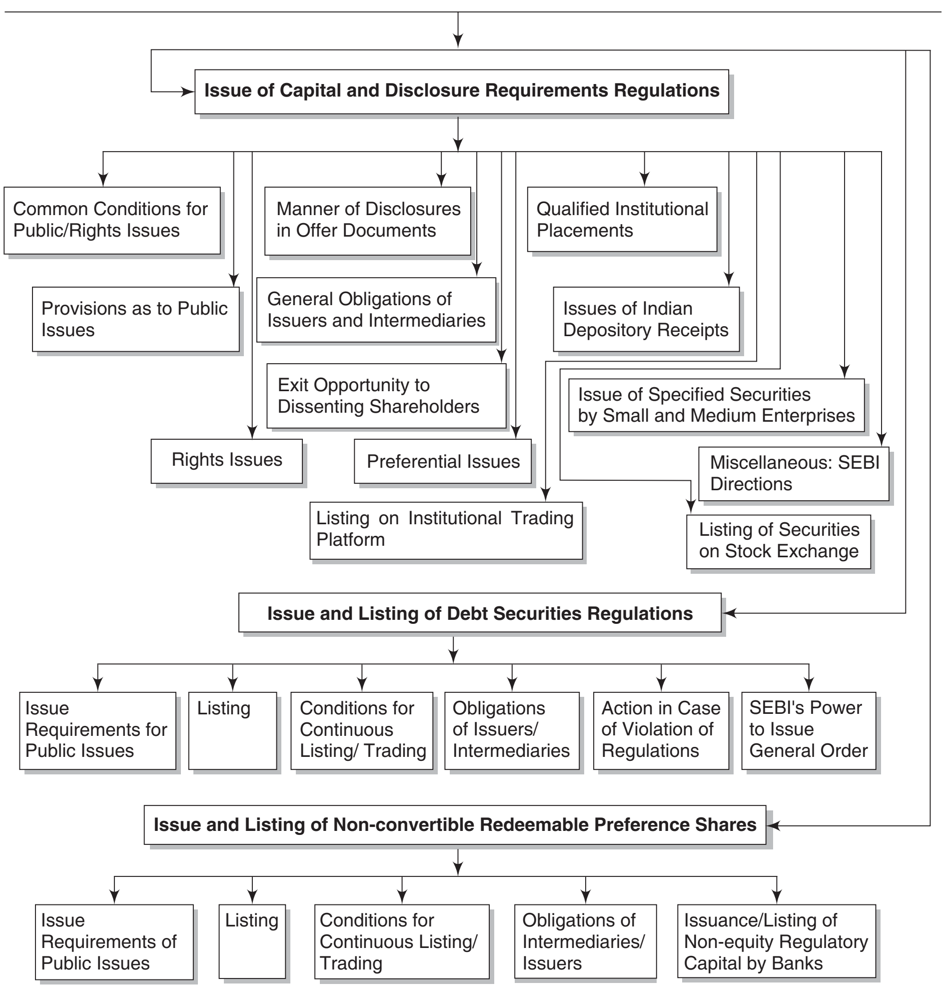
INTRODUCTION

In order to remove inadequacies and systematic deficiencies, protect the interests of investors and for the orderly growth and development of the securities market, the SEBI had put in place guidelines [Disclosure and Investor Protection (DIP) Guidelines] in 2000 as ground rules relating to new issue procedures/activities. These were rescinded in September 2009 and replaced by Issue of Capital and Disclosure Requirements (ICDR) Regulations, 2009. These are in addition to the company law requirements in relation to issues of capital/securities **(discussed in Chapter 4)**. The SEBI has also issued Issue and Listing of Debt Securities Regulations, 2008. The other two regulations relating to issues of capital by the SEBI are: **(i)** Listing and Issue of Capital by Small and Medium Enterprises on Institutional Trading Platform Without Initial Public Offering, 2013 and **(ii)** Issue and Listing of Non-convertible Redeemable Preference Shares, 2014. This Chapter comprehensively discusses the legal and procedural requirements of the SEBI regulations pertaining to capital issue activities. **They are portrayed in Exhibit 7.1**. They are applicable to all **(i)** Public issues, and **(ii)** Rights issues where the aggregate value of specified securities offered is ₹50 lakh and more, **(iii)** Preferential issues, **(iv)** Qualified institutional placement (QIP) by a listed issuer, and **(v)** Issues of Indian depository receipts (IDRs). The ICDR regulation is discussed in Section 1. The Chapter also discusses the SEBI Issue and listing of debt securities regulation in Section 2. Concluding observations are given in the last Section.

ISSUE OF CAPITAL AND DISCLOSURE REQUIREMENTS REGULATIONS

The issue procedure contained in the ICDR Regulation is illustrated with reference to **(a)** Common conditions for public and rights issues, **(b)** Provisions as to public issues in terms of **(i)** eligibility, **(ii)** pricing, **(iii)** promoters contribution, **(iv)** lock-in of promoters contribution, and **(v)** minimum offer to public and reservations, **(c)** Rights issue, **(d)** Disclosures in offer documents, **(e)** General obligations of issuers and intermediaries, **(f)** Preferential issues, **(g)** Qualified institutional placement, **(h)** Issue of Indian depository receipts, **(i)** Issue of specified securities by small and medium enterprises, and **(j)** SEBI directions.

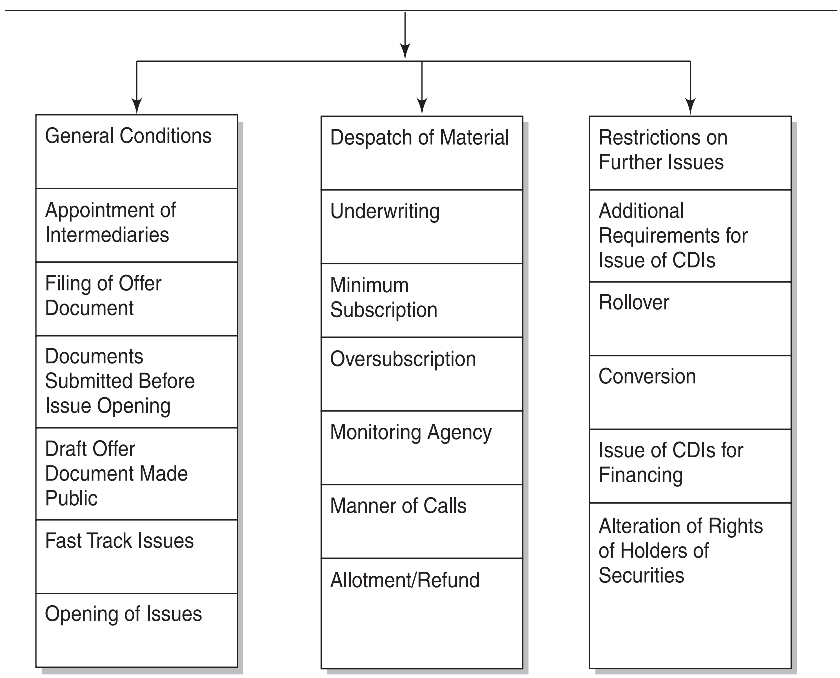
Exhibit 7.1 Issue Management: Procedures/Activities



Common Conditions for Public/Rights Issues

Public issue means an initial public offer (IPO) or further public offer (FPO). An **IPO** means an offer of **specified securities** (i.e. equity shares and convertible securities) by an **unlisted issuer** (i.e. any person making an offer of specified securities whose equity shares are not listed in a recognised stock exchange) to the public for subscription including an offer for sale to the public by existing holder of the securities in an unlisted issuer. A **FPO** means an offer of specified securities by a **listed issuer** (i.e. an issuer whose equity shares are listed in a recognised stock exchange) to the public for subscription including an offer for sale of the securities to the public by existing holders in a listed issuer. A **convertible security** means a security which is convertible into/exchangeable with equity shares of the issuer at a later date with/without the option of the holder and includes convertible debts instruments (CDIs) convertible preference shares. A **CDI** is an instrument which creates/acknowledges indebtedness and is convertible into equity shares of the issuer at a later date with/without the option of the holder, whether constituting a charge on the asset of the issuer or not. **Rights** issue means an offer of specified securities by a listed issuer to its shareholders as on the record date fixed for the purpose. **The main elements of the common conditions for public/rights issues are portrayed in Exhibit 7.2.**

Exhibit 7.2 Common Conditions for Public/Rights Issues



General Conditions The stipulated general condition are as discussed below.

(A) Any issuer of specified securities through a public/rights issue should satisfy the general conditions specified below at the time of **(i)** filing the draft offer document with the SEBI and **(ii)** registering/filing the final **offer document** (i.e. red-herring prospectus/prospectus/information memorandum in terms of Section 60-A of the Companies Act in case of a public issue and letter of offer in case of rights issue) with the Registrar of Companies (ROCs)/designated stock exchange (DSE). A **DSE** means a recognised stock exchange in which securities of the issuer are/proposed to be listed and which is chosen by him for the purpose of a **particular** issue out of those having nation-wide trading terminals.

(B) An issuer is prohibited from making a public issue in the following cases:

- The issuer/its promoter(s), promoter group/directors/ person(s) in control of the issuer are debarred from accessing the capital market by the SEBI. The term **promoter** includes person(s) **(i)** in control of the issuer in terms of **Regulation 2(1)(C)** of the **SEBI Substantial Acquisition of Shares and Takeover Regulation**[@] **(ii)** who are instrumental in the formulation of a plan/ programme pursuant to which specified securities are offered to public; and **(iii)** named in the offer document as a promoter. However, **(a)** a director/officer of the issuer or a person acting as such in his professional capacity, **(b)** a financial institution/ bank/foreign portfolio investor other than category III/mutual fund holding more than 10 per cent of capital of the issuer would not be deemed to be a promoter. These institutions would be treated as promoter for subsidiaries/companies/mutual funds promoted/ sponsored by them. The term **promoter group** includes the following: **(i)** promoter(s), **(ii)** his/of his spouse immediate relative (i.e. spouse/parent/brother/sister/child), **(iii) in case of body corporate-promote, (a)** subsidiary/holding company, **(b)** any body corporate in which the promoter holds 10 per cent share capital or which holds 10 per cent of the capital of the promoter and **(c)** any body corporate in which group of individuals/companies/combination thereof holds 20 per cent of its capital also holds 20 per cent of the share capital of the issuer; **(iv)** in case of **individual-promoter, (a)** any body corporate in which 10 per cent is held by the promoter/an immediate relative, a firm/HUF in which the promoter/an immediate relative, a firm/HUF in which the promoter/an immediate relative is a member, **(b)** any body corporate in which any body corporate as provided in **(a)** above holds a minimum 10 per cent of the share capital, **(c)** any Hindu Undivided Family (HUF)/firm in which the aggregate shareholding of the promoter and his immediate relatives is at least 10 per cent, and **(d)** all persons whose shareholding is aggregated for the purpose of disclosing in the prospectus under the heading **Shareholding of the Promoter Group**. However, FIs/banks/foreign portfolio investors other than category III/mutual fund holding 10 per cent share capital of the issuer would not be deemed to be promoter group. They would be treated as such for subsidiaries/ companies or mutual funds promoted/sponsored by them.
- Any promoter/director/person in control of the issuer was/is also in a similar capacity of any other company debarred from accessing the capital market by the SEBI.
- The issuer has not **(i)** made an application for listing of specified securities on a recognised stock exchange(s) and chosen one of them as the DSE. In case of an IPO, he should make an application for listing in at least one recognised stock exchange having nation-wide trading terminals; **(ii)** entered into an agreement with a depository for dematerialisation of securities already/proposed to be issued.
- All existing partly paid-up equity shares of the issuer have been made fully paid-up or forfeited.
- Firm arrangements of finance through verifiable means towards 75 per cent of the stated means of finance, excluding the amount to be raised through the proposed issue or through existing identifiable internal accruals have been made.

[@]Available in M Y Khan, *Financial Services*, McGraw Hill Education (India), 2017, Chapter 12.

- Warrants may be issued along with public/rights issues if their tenure does not exceed 18 months from the date of allotment and only one warrant is attached to one security. The price/conversion formula should be determined upfront and atleast 25 per cent of the consideration also received upfront. In case of non-exercise of option by a holder, the consideration paid should be forfeited by the issuer.
- The amount for **general corporate purposes** (i.e. such identified purposes by which no specific amount is allocated or any specified amount towards general corporate purposes in the draft offer document filed with the SEBI but would exclude issue-related expenses) should not exceed 25 per cent of the amount raised by the issuance of the securities.
- A public issue of equity securities cannot be made if the issuer/promoter(s)/director(s) is a **willful defaulter** (i.e. an issuer categorised in terms of the RBI guidelines by a bank/financial institution). Similarly, a public issue of convertible debt instruments is not permitted if: **(i)** the issuer/promoter/director is a willful defaulter or **(ii)** it is default of payment/repayment of interest/ principal for more than 6 months. The issuer of rights issues should make the specified disclosures in the offer document/abridged letter of offer if it/promoter/director is a willful defaulter. Moreover, the promoter/ promoter group of the issuer should not renounce their rights.

Appointment of Merchant Bankers/Other Intermediaries The issuer should appoint merchant banker(s) at least one of whom should be lead merchant banker and other SEBI-registered intermediaries in consultation with him to carry out the issue-related obligations. The lead merchant banker should advise the issuer on their appointment only after independent assessment of their capability to carry out their obligations. The rights/obligations/responsibilities relating, *inter-alia*, to disclosures/allotment/refund and underwriting obligations of each merchant banker should be predetermined and disclosed in the offer document as specified **in Appendix 7-A on the website. The website address is http://www.mhhe.com/khanifs10e.** However, where any of the merchant bankers is an associate of the issuer, it should declare itself as a marketing lead manager and its role should be limited to marketing of the issue. The issuer should also enter into an agreement with the lead merchant banker in the format specified **in Appendix 7-B on the website** and other intermediaries as required under the regulation(s) applicable to the intermediary concerned. However, such agreements may include such other clauses as the issuer and the intermediary(ies) may deem fit without diminishing/limiting their mutual obligations under the SEBI/Companies/Securities Contracts (Regulations)/ Depositories Act(s) and the rules/regulations or any statutory modifications/enactment. In case of **ASBA (Application Supported by Blocked Amount)** process, the issuer should take cognisance of the deemed agreement of the issuer with the **Self Certified Syndicate Banks (SCBs)**. The term **ASBA** means an application for subscription to an issue along with an authorisation to **SCSB** (that is, a SEBI-registered banker to an issue which offers the facility of ASBA) to block the application money in a bank account.

The issuer should appoint **syndicate members** (i.e. a SEBI-registered intermediary who is permitted to carry on underwriting activity) in case of issues through book building process and bankers to an issue at all mandatory collection centres specified in **Appendix 7-C on the website** and other collection centres it may deem fit. The lead merchant banker would act as the lead book runner and undertake the book building process. **Book-building** means a process undertaken to elicit demand/assess the price to determine the quantum/value of specified securities/Indian depository receipts (IDRs). The issuer should also appoint a registrar to an issue which has connectivity with all the depositories.

Filing of Offer Document Issuers of capital through public/rights issues should file an draft offer document along with the specified fee with the SEBI through the lead merchant banker at least 30 days prior to registering the prospectus/red herring prospectus/shelf prospectus with the ROCs or filing of letter of offer with the DSE. The payable fee is related to the issue size as listed below:

Size of issue including intended oversubscription	*Amount/Rate of fee*
(A) In Case of Public Issue:	
(i) Upto ₹10 crore	A flat charge of ₹25,000
(ii) ₹10 – ₹5,000 crore	0.025 per cent of the issue size
(iii) ₹5,000 – ₹25,000 crore	₹1,25,00,000 plus 0.00625 per cent of the portion of the issue size in excess of ₹5,000 crore
(iv) More than ₹25,000 crore	A flat charge of ₹3 crore
(B) Rights Issues:	
(i) Upto ₹10 crore	A flat charge of ₹25,000
(ii) ₹10 – ₹500 crore	0.005 per cent of the issue size
(iii) More than ₹500 crore	A flat charge of ₹5,00,000

The SEBI may specify changes/issue observations on the offer document within 30 days from the later of the date of **(i)** receipt of the offer document, **(ii)** satisfactory reply on any clarification/additional information from the merchant banker(s), **(iii)** clarification/information from any regulator/agency sought by the SEBI, or **(iv)** a copy of in-principle approval letter issued by the recognised stock exchange (RSE). The issuer/merchant banker should comply with the specific changes/observations before registering them with the ROCs or filing the letter of offer with the DSE. It should simultaneously or before the issue opening file a copy with the SEBI. The lead merchant banker should also file a copy with the concerned stock exchange. The offer document should also be filed with the SEBI in a soft copy in the manner specified in **Appendix 7-D on the website**.

Security Deposit The issuer should deposit before the opening of the subscription list with the stock exchange(s) of 1 per cent of the securities offered to the public. The amount would be refunded/forfeited in the manner specified by the SEBI/stock exchange(s).

Documents to be Submitted Before Issue Opening The lead merchant banker should submit to the SEBI along with the draft offer document a **(i)** certificate confirming an agreement between the issuer and the lead merchant banker in the specified format, **(ii)** due diligence certificate in **Form A of Appendix 7-E on the website, (iii)** due diligence certificate from the debenture trustees in **Form B of Appendix 7-E on the website** in case of issue of CDIs and **(iv)** certificate in **Form C of Appendix 7-G on the website** comprising compliance of the conditions.

The lead merchant banker should also submit the following documents to the SEBI: a **(i)** statement certifying that all changes/suggestions/observations made by the SEBI have been incorporated in the offer document, **(ii)** due diligence certificate in **Form C of Appendix 7-E on the website** at the time of registering the prospectus with the ROCs **(iii)** copy of the Broad of Directors resolution of the issuer for allotment of securities to promoters against promoters' contribution before issue opening, **(iv)** certificate from a chartered accountant certifying that promoters contribution has been duly received with promoter-wise details of names/addresses/amount, **(v)** due diligence certificate in **Form D of Appendix 7-E on the website** certifying that the necessary corrective measures has been taken and **(vi)** due diligence certificate in **Form E of Appendix 7-E on the website** after issue opening but before closure of subscription. The issuer should submit the PAN/bank account/passport number of its promoters to the concerned RSE at the time of filing the offer document.

Draft Offer Document Made Public The offer document should be hosted on the website of the SEBI/concerned RSEs/associated merchant banker(s) for public comments for at least 21 days from the date of its filing. The lead merchant banker should file with the SEBI a statement containing information of public comments and the consequential changes to be made in the offer document. The issuer should on the date of filing the offer document with the SEBI or the next day make a public announcement in one English/Hindi national daily with wide circulation and one regional language paper with wide circulation at the place of its registered office inviting the public to give their comments to the SEBI in respect of these disclosures.

Fast Track Issues The above requirements relating to **(i)** filing of offer documents, **(ii)** in-principle approval from the RSEs and **(iii)** documents to be submitted before issue opening would not apply (in a fast track issue) to a public/rights issue if the issuer satisfies the following conditions:

- Its shares have been listed on a RSE having nation-wide trading terminal for at least three years immediately preceding the **reference date** [(i.e. the date of registering a red herring prospectus (in case of a book-built issue) or prospectus (in case of fixed price issue) with the ROCs for a public issue and in case of a rights issue, the date of filing of the letter of offer with the DSE)];
- The **average market capitalisation** (i.e. the sum of the daily market capitalisation for one year upto the end of the quarter preceding the month in which the proposed issue was approved by its shareholders/Board of Directors, divided by the number of trading days) of its public shareholding (as per the listing agreement) is at least ₹3,000 crore;
- The annualised turnover of its shares during six calendar months immediately preceding the month of the reference date has been at least 2 per cent of the weighted average number of shares listed during the last six months available as free float in case of issuers whose public shareholding is less than 15 per cent of its issued capital;
- It has **(i)** redressed at least 95 per cent of the investors grievances till the end of the quarter and **(ii)** complied with the equity listing agreement for at least three years, immediately preceding in reference date. However, in case of non-compliance relating to the composition of the Board of Directors, a compliance at the time of filing of offer document with the ROCs/DSE and adequate disclosures in the offer document about such non-compliance would be deemed as compliance with this condition;
- The imposition of only monetary penalty fines by the more exchanges on the issues would not be a ground for ineligibility for undertaking issuances;
- The impact of the auditors' qualification on the its audited accounts for the years for which they are disclosed in the offer document does not exceed 5 per cent of its net profit/loss after tax for the respective years;

- No show-cause notice(s) have been issued/prosecution proceedings initiated by the SEBI or pending against the issuer/its promoters/whole time directors as on reference date;
- The issuer/promoter/promoter group/director of the issuer has not settled any alleged violation of securities law through consent/settlement mechanism with the SEBI during 3 years immediately preceding the reference date;
- The entire shareholding of the promoter groups of the issuer is held in demat form as on the reference date.
- In case of rights issues, promoters/promoter group should mandatorily subscribe to their rights entitlements except to the extent of renunciation within the group for complying with minimum public shareholding norms prescribed by the Rule 19-A of the Securities Contracts (Regulation) Rules;
- The equity shares of the issuer have not been suspended from trading as a disciplinary measure during last 3 years immediately preceding the reference date;
- The annualised delivery-based trading turnover of the equity shares during the 6 months immediately preceding the month of reference date has been at least 10 per cent of the weighted average number of equity shares listed during the 6-month period; and
- There should be no conflict of interest between the lead merchant banker(s) and the issuer/group/associate company in accordance with the applicable regulations.

The concerned issuer should before the opening of the issue file with the SEBI a copy of the red herring prospectus/prospectus filed with the ROCs or letter of offer filed with the DSE. The lead merchant banker should also file a copy of the offer document with the RSE where the securities are proposed to be listed. The payable fee in such issues would be the same as **discussed earlier** (in respect of a normal issue).

The lead merchant banker should also submit to the SEBI the following documents along with the offer document, namely, **(i)** a due diligence certificate in **Form F of Appendix 7-E on the website, (ii)** in case of fast track issue of CDIs, due diligence certificate from the debenture trustees in **Form B of Appendix 7-E on the website.**

Opening of Issue Subject to compliance with Section 60(4) of the Companies Act, a public/rights issue may be opened within **(a)** 12 months from the date of issuance of the SEBI's observation on the offer document, **(b)** 3 months of the expiry of 30 days in case the SEBI has not issued any observation. While in case of a fast track issue, the issue should open within the period specified in Section 60(4) of the Companies Act, the first issue in case of shelf prospectus may be opened within three months of the issuance of the SEBI's observations. Before registering the red herring prospectus/prospectus with the ROCs or filing the letter of offer with the DSE, the issuer should file with the SEBI through the lead merchant banker(s) an updated offer document highlighting all the changes made in relation to matters specified in **Form F of Appendix 7-E on the website.** The updated/new offer document should be filed with the SEBI along with a fee of ₹10,000 for updation/changes per section subject to total fee not exceeding the higher of one-fourth of the filing fee at the time of filing the draft document with the SEBI or ₹50,000. An issue should be opened after at least three working days from the date of registering the red herring prospectus with the ROCs.

Despatch of Issue Material The lead merchant banker(s) should despatch the offer document and other issue material including forms for **ASBA** to the DSE/**syndicate members** (i.e. a SEBI-registered intermediary who is permitted to carry on activity as an underwriter)/ /registrar to issue and share transfer agents/depository participants/stockbrokers/underwriters/ bankers to the issue/investors' associations and **SCSBs** in advance.

Underwriting While a non-book-built public issue or rights issue can be underwritten by SEBI-registered underwriters, a public issue through the book building process should be underwritten by book runners/syndicate members. However, 75 per cent of the **net offer to the public** (i.e. offer of securities to the public excluding reservations) proposed to be compulsorily allowed to qualified institutional buyers (**QIBs**) for the purpose of compliance of the eligibility conditions relating to IPO through book building and pricing on public issues (**discussed in the next Section),** cannot be underwritten. In case the public issue is made with at least 10 per cent public offer under **Rule 19(b)(2) of the Securities Contracts (Regulation) Rule (discussed later in another Section)**, the applicable bar would be 60 per cent. A **QIB** means a SEBI-registered **(i)** mutual fund/venture capital fund alternative investment fund/foreign venture capital investor, **(ii)** SEBI-registered FII and sub-account (other than a sub-account which is a foreign corporate/individual, **(iii)** Public financial institutions (PFI), **(iv)** bank, **(v)** Multilateral/bilateral financial institutions, **(vi)** State industrial development corporation, **(vii)** IRDA-registered insurance company, **(viii)** Provident/Pension fund with a minimum corpus of ₹25 crore, **(ix)** National investment fund, and Insurance funds set up/managed by army/navy/ air force and Department of Posts of India.

The issuer should enter into an agreement with the book runner who should in turn enter into an underwriting agreement with syndicate members containing the number of securities to be subscribed by them at the predetermined price in case of under-subscription in the issue. On failure of the syndicate members, the lead book runner would fulfil the underwriting obligation. The book runners/syndicate members cannot subscribe to the issue in any other manner. The lead merchant banker/book runner must undertake a minimum underwriting obligation of the lower of 5 per cent of the total underwriting commitment or ₹25 lakh. In case of 100 per cent underwriting of an issue, the underwriting obligation would be for the entire issue and not restricted upto the minimum subscription level.

Minimum Subscription The minimum subscription in an issue should be at least 90 per cent of the offer. In the case of an IPO, however, the minimum subscription to be received would be subject to the allotment of at least 25 per cent of each class of security. In case of its non-receipt, all the application moneys received should be refunded within **(i)** 15 days and **(ii)** 7 days respectively of the closure of a non-underwritten and an underwritten issue where the minimum subscription including devolvement obligations paid by the underwriters is not received within 60 days of the closure of the issue. The offer document should contain the disclosures regarding minimum subscription as specified in **Part A of Appendix 7-G on the website.**

The above requirement are, however, not applicable to **(i)** offer for sale of securities and **(ii)** public issue by **infrastructure** companies (i.e. an enterprise wholly engaged in the business of **(a)** developing, **(b)** operating and maintaining, **(c)** developing/operating/maintaining any infrastructure facility) if disclosures regarding alternative sources of funding of the objects of the issue have been made in the offer document.

Oversubscription Allotment in excess of the specified securities offered through the offer document is prohibited. However, in case of oversubscription, upto 10 per cent of the net offer to the public may be allotted for making allotment in minimum lots.

Monitoring Agency For a issue size exceeding ₹500 crore, arrangement should be made by the issuers, excepting public financial institutions (PFIs), banks, and insurance companies for monitoring the use of the issue proceeds by a PFI or a bank named in the offer document as banker to the issue. The monitoring agency would have to submit its report to the issuer in the format specified in **Appendix 7-H on the website** on a half-yearly basis till the full utilisation of the issue proceeds.

Calls on Shares Except in cases where a monitoring agency is appointed, the outstanding subscription should be called within 12 months from the date of allotment in the issue. The equity shares, on which there are calls in arrear along with the subscription/application money, should be forfeited.

Allotment/Refund/Payment of Interest The issuer/merchant banker should ensure that the securities are allotted and/or application moneys refunded within 15 days of the failure of the issue failing which the issuer would undertake to pay interest at the rate and within the time disclosed in the offer document.

Restrictions on Further Capital Issue Unless full disclosures regarding the total number of securities and the amount proposed to be raised from further issues are made in the offer/draft offer document, issuers are prohibited from making any further issues in any manner whether by way of rights/public/preferential issues or qualified institutional placement or otherwise during the period between the **(a)** date of red herring prospectus/prospectus with the ROCs or filing the letter of offer with the DSE and the listing of the securities/refund of application money in fast track issues; and **(b)** date of filing the draft offer document with the SEBI and the listing of the securities/refund of application moneys in other issues.

Additional Requirements for Issue of Convertible Debt Instruments (CDIs) In addition to the other requirements, an issuer making a public/rights issues of CDIs should comply with the following conditions: **(i)** Obtain credit rating(s); **(ii)** Appoint debenture trustee(s); **(iii)** Crate debenture redemption reserve (DRR); **(iv)** Ensure that assets on which charge/security is proposed to be created are **(a)** sufficient to discharge the principal amount at all times and **(b)** free from encumbrances. Moreover, the consent of financial institutions/banks and lessors for a second/*pari passu* charge should be obtained and submitted to the debenture trustees before the opening of the issue where security is already created on such assets/issue of CDIs is proposed to be secured by creation of security on a leasehold land respectively. The security/asset cover should be arrived at after deduction of the liabilities having a first charge in case the CDIs are secured by a second/subsequent charge. They should be redeemed in terms of the offer document.

Rollover of Non-Convertible Portion of Partly CDIs The non-convertible portion of partly CDIs by a listed issuer amounting to more than ₹50 lakh may be rolled over without change in the rate of interest subject to compliance, in addition to the provisions of Section 121 of the Companies Act, with the following conditions: **(i)** 75 per cent of the holders have approved it through postal ballot, **(ii)** an auditors' certificate on the cash flow of the issuer and with comments on its liquidity position has been sent, along with the notice for passing the resolution, to all holders, **(iii)** the issuer has undertaken to redeem the CDIs of all holders who have not agreed to the resolution and **(iv)** credit rating from at least one SEBI-registered rating agency has been obtained and communicated to them before the rollover. If the existing trust deed/security document(s) provide for the continuance of the security till redemption, the creation of fresh security/execution of fresh trust deed would not be mandatory.

Conversion of Optionally CDIs Positive consent of the holders would be necessary for conversion of such CDIs into equity shares and non-receipt of reply to any notice by the issuer for this purpose would not be construed as consent for conversion. The holders of CDIs, where the value of the convertible portion of CDIs by a listed company exceeds ₹50 lakh and the conversion price has not been determined, should have the option not to convert them into shares. Such an option may not be given in case the upper limit on their price together with the justification was determined/disclosed to the investors at the time of the issue. If some holders who have been given the option do not exercise it, the issuer should redeem the concerned instruments within one month from the last date for exercise of option at a price not below its face value. This condition would not be applicable if redemption is in terms of the disclosures in the offer document.

Issue of CDIs for Financing Issue of CDIs for **(i)** financing replenishment of funds, **(ii)** providing loan to or for acquiring shares of any person in the same group [in terms of Section 2(ef) or 2(g) of the Monopolies and Restrictive Trade Practice Act] or under the same management [in terms of Section 370 (1-B) of the Companies Act] are prohibited. However, fully CDIs may be issued for these purposes with a conversion period of less than 18 months from the date of their issue.

Alteration of Rights of Holders of Specified Securities The terms (including the terms of issue) of specified securities which may adversely affect the interests of the investors can be altered subject to the following conditions: with the **(i)** consent in writing of at least 75 per cent or **(ii)** sanction of a special resolution of the holders.

Provisions as to Public Issues

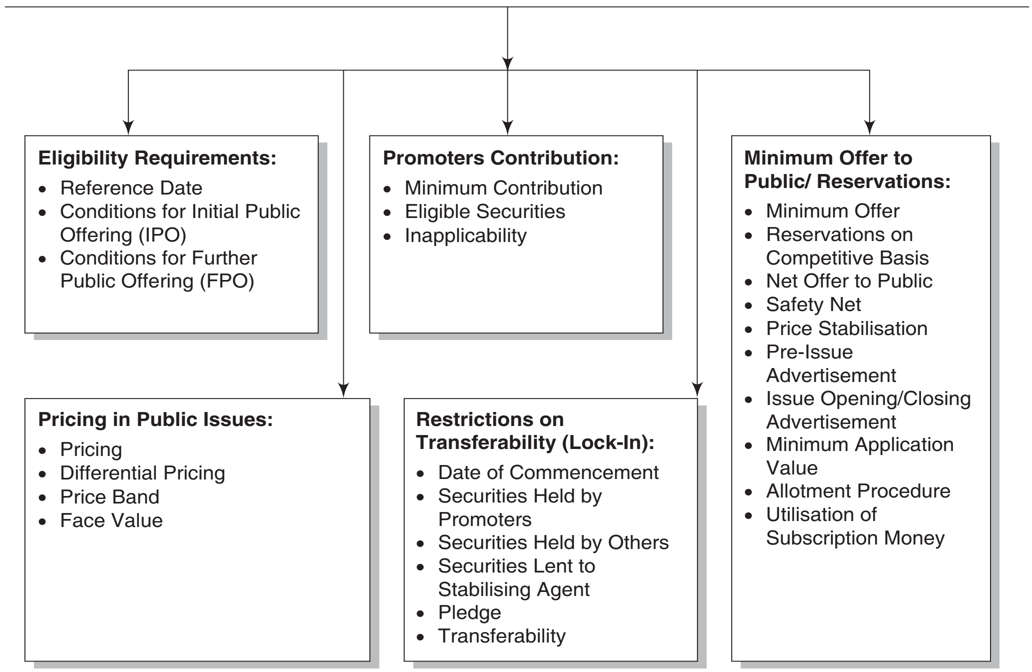
The provisions relating to public issues discussed below are **portrayed in Exhibit 7.3.**

Eligibility Requirements Eligibility conditions should be satisfied by an issuer on the date of **(i)** filing draft offer document with the SEBI and **(ii)** registering the offer document with the ROCs. The relate to IPOs and FPOs.

Conditions for IPO An IPO can be made by an issuer who satisfies the following conditions:

- **1(a)** **Net tangible assets** (i.e. all net assets excluding intangible assets as defined in **AS-26 issued by the ICAI**) of at least ₹3 crore in each of the preceding three full years, not more than 50 per cent of which should be monetary assets in its business/**project** [i.e. the object for which money(ies) are proposed to be raised to cover the objects of the issue]. If the monetary assets exceed 50 per cent, the issuer should make firm commitment to utilise the excess in its business/project. The limit of 50 per cent however, would not apply in case the public offer is made entirely through an offer for sale.
- **1(b)** Minimum average pre-tax profit of ₹15 crore calculated on a restated and consolidated basis during the three most profitable years out of the immediately preceding five years.
- **1(c)** A **net worth** [i.e. the aggregate of paid up share capital, share premium account, and reserves/surplus (excluding revaluation reserve) reduced by the total miscellaneous expenditure to the extent not adjusted/written off and the debit balance of profit and loss account] of at least rupees one crore in each of the preceding three years (of 12 months each);

Exhibit 7.3 Provision as to Public Issues



1(d) The aggregate of the proposed issue and all previous issues in the same financial year in terms of **issue size** (i.e. offer through offer document and promoters' contribution) does not exceed 5 times its pre-issue net worth as per the audited balance sheet of the last financial year;

1(e) In case of change of name within the last one year, at least 50 per cent of the revenue for the preceding one full year has been earned by the issuer from the activity indicated by the new name.

2. If an issuer does not satisfy any of the five conditions specified above, it can make IPO if the issue is made through book building process and the issuer undertakes to allot at least 75 per cent of the net offer to the public to QIBs and refund full subscription money(ies) if it is unable to make allotment to them.

3. An IPO of CDIs can be made without making a prior public issue/listing of the issuers' equity shares.

4. Allotments in public issues are not permitted in case the number of prospective allottees is less than 1,000.

5. An IPO cannot be made if there are outstanding convertible securities/other rights entitling any person the option to receive equity shares. However, this restriction would not be applicable to **(i)** a public issue made during the currency of CDIs issued through an earlier IPO if their conversion price was determined/disclosed in the relevant prospectus, **(ii)** outstanding options granted to employees pursuant to an employee stock option scheme framed in accordance with the Guidance Notes/Accounting Standards issued by the ICAI (Institute of Chartered Accountants of India), and **(iii)** fully paid-up outstanding securities convertible on/before the data of filing the red herring prospectus/prospectus.

6. Subject to the provisions of the Companies Act/SEBI's ICDR Regulations, equity shares may be offered for sale if held by the sellers for at least one year prior to the filing of the draft offer document with the SEBI. For computing the one-year period, the holding period of the convertible securities as well as that of the resultant equity shares together would be considered in case the shares being offered have been received on conversion/exchange of fully paid-up CDIs including depository receipts. The one-year requirement would not be applicable **(i)** in case of securities of a Government company/ statutory authority (corporation)/any SPV set up by them engaged in infrastructure sector, **(ii)** if acquired pursuant to a scheme approved by a High Court under Sections 391-394 of the Companies Act in lieu of business/invested capital which has been in existence for more than one year prior to such approval, and **(iii)** if issued under a bonus issue on securities held for at least one year prior to the filing of the offer document with the SEBI subject to the condition that they are being issued out of free resources and share premium and not by utilisation of revaluation reserve/unrealised profits of the issuer. The term **infrastructure** includes the facilities/services specified in **Appendix 7-H on the website.**
7. Every issuer may obtain grading for the IPO from at least one SEBI-registered credit rating agency as on the date of registering prospectus/red herring prospectus with the ROCs.

Conditions for Further Public Offer (FPO) A FPO can be made if the issuer satisfies the following two conditions: **(i)** the aggregate of the proposed issue and all other issues in the same financial year in terms of issue size does not exceed 5 times its pre-issue networth and **(ii)** in case of change of its name within the last one year, not less than 50 per cent of its revenue for the preceding full year has been earned from the activity indicated by the new name. If the issuer does not satisfy these conditions, it may make a FPO in terms of the stipulations listed below:

(a) **(i)** The issue is made through book building process and at least 50 per cent of the net offer to the public would be allotted to QIBs or **(ii)** At least 15 per cent of the cost of the project is contributed by banks/PFIs of which a minimum 10 per cent would come from the appraisers and at least 10 per cent of the net offer to the public would be allotted to QIBs. The full subscription money would have to be refunded on failing to make the specified allotments to the QIBs.

(b) **(i)** The minimum post-issue face value capital of the issuer is ₹10 crore or **(ii)** The issuer undertakes to provide market making for at least two-years from the date of listing of the specified securities subject to the conditions that **(1)** the buy and sell quotes are for a minimum depth of 300 securities and the bid-ask spread never exceeds 10 per cent, **(2)** the inventory of the market make as on the date of allotment of securities would be at least 5 per cent of the proposed issue.

Pricing in Public Issues The elements are pricing, differential pricing, price and price band, and the face value of equity shares.

Pricing An issuer may determine the **(i)** price of specified securities and **(ii)** coupon rate/ conversion price of CDIs in consultation with the merchant banker or through the book building process. The manner of book building process is specified in **Appendix 7-J on the website.** There are two alternative methods for pricing for book-built issues. The compliance requirements in the two methods for book-built issues are listed below:

(A) Method I:

- The issuer should appoint merchant banker(s) as book runner(s) and the lead merchant banker should act as the lead book runner and be primarily responsible for the book building. There should be one lead book runner and other merchant bankers would be co-book runners/syndicate members. Their rights/obligations/responsibilities should be delineated in the *inter se* allocation of responsibility specified in **Appendix 7-A on the website**.
- The issue should be compulsorily underwritten/sub-underwritten respectively by the book/co-book runners and syndicate members. They should furnish details forthwith to the SEBI about their underwriting/sub-underwriting agreement and the details indicating actual number of shares should be disclosed/printed in the prospectus before registering with the ROCs. The fact that the book-runner(s) would have to make good the shortfall in case of undersubscription should be incorporated in the *interse* allocation of responsibility.
- The issuer should enter into an agreement with a stock exchange(s) having on-line system of offer of securities specifying, *inter-alia*, their *interse* rights/duties/responsibilities/obligations as well as a dispute resolution mechanism.
- The book runner(s)/syndicate members should appoint SEBI-registered stock brokers financially capable of honouring their commitments on defaults of clients/investors to accept bid/applications and place orders with the issuer. In case of **ASBA**, the **SCSBs** would also accept/upload the application details in electronic bidding system of the stock exchange(s). These brokers/SCSBs would be deemed as **bidding/collection centres**. The book runners/syndicate members/brokers/SCSBs would be paid by the issuer a commission/fee for their services and brokers cannot levy a service charge on the clients/investors.
- If the issue size is specified, the red-herring prospectus may not contain the price/number of securities. The draft red-herring prospectus containing all the disclosures (including total issue size) specified in **Appendix 7-G on the website** should be filed with the SEBI by the lead merchant banker except in case of a fast track issue.
- The issuer may mention the floor price/price band in the red-herring prospectus. However, in case of its non-disclosure the red-herring prospectus should contain **(i)** a statement that it would be disclosed at least one and two working days before the bid opening in an IPO and FPO respectively and the invertors may be guided in the mean-time by the secondary market prices (in FPO), and **(ii)** names of website/journals/other media/edition of the newspaper in which the announcement would be made.

  In case the issuer opts for price band and not floor price, the compliance requirement would be: **(i)** the cap of the price band would not be more than 120 per cent of the floor of the price band, **(ii)** in case of revision of the price band during the bidding period, the floor of the price band can move up/down upto 20 per cent of floor of the price band disclosed in the prospectus and the cap of the revised band will be fixed according to **(i)** above. The revision should be widely disseminated and the bidding period would be extended by three working days. The manner in which the shortfall in project financing on account of lowering of the price band by 20 per cent would be met, should be disclosed in the prospectus and allotment should not made unless the financing is tied up.
- The minimum application value of anchor investor should be ₹10 crore in a public issue. Allocation to them would be on a discretionary basis, subject to a minimum number of two and five for allocation upto ₹250 crore and more than ₹250 crore respectively. Upto 30 per cent of the portion available to QIBs can be allocated/allotted to them (i.e. anchor

investor portion), one-third of which should be reserved for mutual funds. The bidding for them should open one day before the issue opening date and they should pay at least 25 per cent margin on application and the balance within two days of the closure of the issue. The allocation to the anchor investors should be completed on the day of bidding by them. They would pay the additional amount if the price for book building is higher than the one at which the allocation was made to them. Any excess payment resulting from the difference between the fixed price and the allotment price would not be refundable. The number/price of shares allocated to them should be made available in public domain by the merchant banker before issue opening. The shares allotted to them would have a 30-day lock-in. The merchant banker or any person related to the promoter/promoter group/merchant banker is not eligible to apply under the anchor investor category. The applications by the QIBs under the anchor and non-anchor categories would not be considered multiple applications.

- The margin money from non-QIB category should be uniform for each category of investors. The QIBs and anchor investors would have to pay at least 10 and 25 per cent margin money on their respective bids. The entire application money may be collected as margin money before placing of order on their behalf. Bids beyond the investment limit under any law should not be accepted by the syndicated members/brokers from any category of clients/investors. The brokers would have to pay in case clients/investors fail to pay for securities on which they had collected the margin money. The **SCSBs** should follow the procedure specified by the SEBI in regard to **ASBA**.
- The bidding process should be through an electronically-linked transparent bidding facility provided by the recognised stock exchange (RSE). While the lead book-runner should ensure the availability of adequate infrastructure with the syndicate members for data entry of the bids in a timely manner, the syndicated members should be present at the bidding centres to ensure the availability of atleast one electronically-linked computer terminal at all the centres. The public-applicants may approach the concerned brokers/SCSBs for placing an order for bidding. Whereas the brokers would accept orders for all clients/investors, the **SCSB** would accept applications only from **ASBA** investors. The QIBs can place bids only through the brokers who have the right to vet the bids. The bidding terminals would contain an online graphical display of demand and bid prices updated at periodic intervals upto 30 minutes. At the end of each day, the demand including allocations to the anchor investors should be shown graphically on the terminals of syndicate members/websites of the RSEs for information of public. All non-ASBA investors can revise their bids. The QIBs cannot withdraw their bids after the closure of bidding and their identity should not be disclosed. The RSEs should continue to display on their website the data pertaining to the issue in the specified format giving, *inter alia*, category-wise details of received bids for at least three days after the closure of bids.
- The issuer in consultation with the lead book runner should determine the issue price on the basis of the bids received and the number of securities to be offered (i.e issue size × price). All the successful bidders whose bids are above the final/cut-off price would be entitled for allotment. The retail individual investors may bid at the cut-off price. A bid by a QIB may be rejected by the lead book-runner for reasons recorded in writing at the time of its acceptance and disclosed to him. Necessary disclosures in this regard should also be made in the red-herring prospectus.

- The final prospectus containing all the specified provision including the price and the number of securities proposed to be issued should be registered with the ROCs.
- Allotment to retail individual investors, non-institutional investors and QIBs other than anchor investors should be made proportionately as illustrated below. The unsubscribed portion in any category should be allocated to the bidders as per the disclosures in the red-herring prospectus. However, undersubscription in the QIB category would not be available to any other category in case the book building process is undertaken for compliance of eligibility conditions for public issues.

Proportionate Allotment to QIBs other than Anchor Investors The proportionate allotment is shown below:

1. Issue details: (i) Issue size, 200 crore shares, **(ii)** Portion available to QIBs (50 per cent), 100 crore shares, **(iii)** Anchors investor portion, 30 crore shares, **(iv)** Portion available to non-anchor investor QIBs (100 – 30), 70 crore shares of which reserved to mutual funds (5 per cent), 3.5 crore shares; balance available for all QIBs, including mutual funds, 66.5 crore shares, **(v)** Number of QIBs, 10, **(vi)** Number of shares applied for, 500 crore shares.

2. Details of QIB Bids: (A) Non-mutual fund QIBs (A), **300** crore shares [A1, 50; A2, 20; A3, 130; A4, 50; and A5, 50], (B) Mutual fund–QIBs (MF), **200** crore shares [MF_1, 40; MF_2, 40; MF_3, 80; MF_4, 20; and MF_5, 20] = 500 crore shares.

3. Details of Proportionate Allotment of Shares to QIB Bidders/Applicants (in crores)

Type of QIB Bidder	*Shares Bid For*	*Allocation of Shares to Mutual Funds (3.5)*[@]	*Allocation of Shares to QIBs (66.5)*[@@]	*Aggregate Allocation to Mutual Funds*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
A1	50	0	6.65	0
A2	20	0	2.66	0
A3	130	0	17.29	0
A4	50	0	6.65	0
A5	50	0	6.65	0
	(A) 300	0	39.90	0
MF1	40	0.70	5.32	6.02
MF2	40	0.70	5.32	6.02
MF3	80	1.40	10.64	12.04
MF4	20	0.35	2.66	3.01
MF5	20	0.35	2.66	3.01
	(MF) 200	3.50	26.60	30.10
(A + MF)	500	3.50	66.50	30.10

[@]5 per cent of 70 crore shares would be allocated on proportionate basic among five mutual funds applying for 200 crore shares in the QIB category. The balance [66.5 (70 – 3.5) crore shares will be allocated on proportionate basis among 10 QIBs who have applied for 500 crore shares] including 5 mutual funds who have applied for 200 crore shares.

[@@]For non-mutual fund QIBs = Number of shares bid for (column 2) multiplied by (66.5 $\times$ 496.5, that is, 500 – 3.5).

For mutual funds = [Numbers of shares bid for (column 2) less shares allotted (column 3)] multiplied by (66.5 $\times$ 496.5).

(B) Alternative Method II:
In case of further public offer (FPO), an issuer may opt for an alternative method of book building in terms of the procedure outlined above excepting the requirements relating to **(i)** determination of prices and **(ii)** allocation/allotment to non-anchor investors on proportionate basis.

A floor price should be disclosed in the red-herring prospectus and the non-retail individual investors (RIIs) should bid above the floor price. The allotment would be in descending order of bids beginning with the highest price till the securities on offer are exhausted. Allotment to the non-RIIs should be on price priority basis and on proportionate basis to the RIIs. However, it should be on proportionate basis where the bid at a price exceeds the available quantity of securities. The allotment to the RIIs should be at the floor price. The issuer may place a cap **(i)** in terms of number of securities, **(ii)** percentage of its issued capital that may be allotted to a single bidder.

Differential Pricing The specified securities may be offered at different prices to different investors. In the first place, offer of securities to **retail individual investors** (i.e. an investor who applies/bids for securities upto rupees two lakh) and retail individual shareholders or employees entitled to reservation for securities for value not exceeding ₹2,00,000, may be made at a price 10 per cent lower compared to other categories of investors. A **retail individual shareholder** means a shareholder of a listed issuer who applies/bids for securities upto rupees two lakh. Secondly, the price of securities offered in the public issue component of a **composite** issue (i.e. an issue by a listed issuer on public-cum-rights basis in which allotments would be made simultaneously) may be different from the price in the rights issue but justification for the price differential should be given in the offer document. In case of the alternative method of book building, specified securities may be offered to the employees of the issuer at a price upto 10 per cent lower than the floor price.

Price/Price Band An issuer may mention a price/price band in the draft prospectus and floor price/price band in the red herring prospectus and determine the price at a later stage before registering the prospectus (containing only one price/specific coupon rate on CDIs) with the ROCs. The floor price/price band may be announced by the issuer in all newspapers in which the pre-issue advertisement was released at least five (in case of IPO) and one (in case of FPO) working days before the opening of the bid. The announcement should contain relevant financial ratios computed for both upper and lower end of the price band together with a statement drawing attention of the investors to the **Section titled "Basis of Issue Price** in the prospectus. The announcement should be disclosed on the website of the concerned stock exchange(s) and pre-filled in the application form available on their website. The cap on the price band/coupon rate can be upto a maximum of 120 per cent of the floor price and the floor/final price should not be less than the face value of the securities.

Face Value of Equity Shares Subject to the provisions of the Companies/SEBI Act/regulations, an issuer (other than a Government company/statutory authority/corporation/any SPV set by them engaged in infrastructure sector) making an IPO may determine the face value of the shares in the following manner: **(i)** Issue price per share is ₹500 and more, below ₹10 but not below ₹1; **(ii)** Issue price per share is below ₹500, ₹10 per share. The disclosures about the face value of shares (including a statement about the issue price being **X times** of the face value) should be made in the advertisements/offer documents/application forms in font size identical to the issue price/price band.

Promoters Contribution The main elements are **(i)** minimum promoters contribution, **(ii)** securities ineligible for minimum promoters contribution and **(iii)** inapplicability of the requirement.

Minimum Contribution The promoters of the issuer should contribute in a public issue **(i)** at least 20 per cent of the post-issue capital in case of an IPO, **(ii)** 20 per cent of the proposed issue size/post-issue capital in case of FPO and **(iii)** 20 per cent of the proposed issue size/post-issue capital excluding the rights issue component in a composite issue. In case the post-issue shareholding of the promoters in IPO is below 20 per cent, alternative investment funds may contribute upto 10 per cent of the post-issue capital for meeting the shortfall.

The specified contribution in a public/composite issue of convertible securities should be by way of equity shares/subscription to convertible securities. If, however, the price of shares allotted on conversion is not determined/disclosed in the offer document, the contribution should be by way of subscription to the convertible securities with an undertaking in writing to subscribe to the shares on their conversion. The contribution by way of equity shares should be at the weighted average price of the shares arising out of their conversion in case of securities convertible/exchangeable on different dates of conversion price is predetermined. For computing the weighted average price, **weights** would be the number of shares arising out of conversion at various stages and **price** would be the price on conversion after taking into predetermined conversion price at various stages.

In case of an IPO of CDIs without a prior public issue of equity shares, the promoters contribution would be 20 per cent of the project cost in the form of shares and at least 20 per cent of the issue size should come from their own funds. If the project is to be implemented in stages, the contribution would be for the total equity participation till the respective stages *vis-à-vis* the debt raised/proposed to be raised through public issue.

The allotment with respect to contribution of promoters in excess of the minimum requirement should be made at the higher of the price determined in terms of the provisions relating to pricing of shares in preferential issues (**discussed later**) and the issue price.

The contribution should be brought in at least one day before the issue opening date and kept in an escrow account with a bank and released to the issuer along with the issue proceeds. If the contribution is more than ₹100 crore, at least ₹100 crore must be brought in before the issue opening date and the balance on *pro-rata* basis before calls are made to public. Where the contribution has already been brought in and utilised, the cash flow statement disclosing their use should be given in the offer document.

The contribution should be computed on the basis of the post-issue expanded capital assuming **(a)** full proposed conversion of convertible securities into shares and **(b)** exercise of all vested options where any employee stock options are outstanding at the time of the IPO in terms of conditions for initial offer (**discussed later**).

Securities Ineligible for Minimum Promoters Contribution The securities specified below acquired by/allotted to promoters would not be eligible for computing their contribution:

- Acquired during the preceding three years **(i)** for consideration other than cash and revaluation of assets/capitalisation of intangible assets is involved in the transactions, **(ii)** resulting from a bonus issue by utilisation of revaluation reserves/unrealised profits or from bonus issue against equity shares ineligible for minimum contribution. However, these would be eligible if acquired pursuant to a scheme approved under Sections 391-94 of the Companies Act.

- Acquired by the promoters/alternative investment funds during the preceding one year at a price lower than the price at which being offered to the public in the IPO. However, shares acquired would be eligible if **(i)** the difference between the two prices is paid by the promoters/alternative investment fund, **(ii)** acquired in terms of a scheme under Sections 391-94 of the Companies Act as approved by a High Court in lieu of business/invested capital in existence for more than one year prior to the approval and **(iii)** an IPO by a Government company/statutory authority/corporation/any SPV set up by them engaged in infrastructure sector.
- Allotted to promoters during the preceding one year at prices less than the issue price against funds brought in during that period in case of an issuer formed by conversion of a partnership firm(s) where the partners are the promoters of the issuer and there is no change in management. However, specified securities allotted to promoters against capital existing in such firms for more than one year on a continuous basis would be eligible. Such securities would also be eligible if acquired pursuant to a scheme approved under Sections 391-94 of the Companies Act.
- Specified securities pledged with any creditor.

Inapplicability of Requirement The requirement of minimum promoters contribution would not apply in the following cases: **(a)** an issuer does not have any identifiable promoter; **(b)** a FPO where the shares are not infrequently traded for at least three years and the issuer has a track record of dividend payment for at least immediately preceding three years. Where, however, promoters propose to subscribe to the securities offered to the extent greater than the two options, namely, 20 per cent of **(i)** issue size and **(ii)** post-issue capital, the excess should be made at a price determined in terms of the provisions relating to preferential issues (**discussed later**) or the issue price whether is higher; **(c)** rights issue.

Restrictions on Transferability (Lock-in) of Promoters Contribution These relate to **(i)** date of commencement of lock-in, **(ii)** lock-in of securities held by promoters/others, **(iii)** lock-in of securities lent to stabilising agent under green shoe option, **(iv)** pledge of lock-in securities and **(v)** transferability of lock-in securities.

Date of Commencement of Lock-in and Inscription of Non-transferability Specified securities held by promoters/others are not transferable (*i.e.* lock-in) from the date of their allotment in a public issue for the period(s) specified below. The securities certificate should contain the inscription: **Non-transferable** and the lock-in for **demat securities** should be recorded by the depository. If the securities subject to lock-in are partly paid-up and the amount called up on them is less than the amount called up from the public, the lock-in would be three years after they have become *pari passu* with those issued to the public.

Securities Held by Promoters The lock-in of securities held by promoters in a public issue would be: **(i)** minimum contribution including by alternative investment fund, 3 years from the date of **(a) commencement of commercial production** (*i.e.* the last date of the month in which commercial production is expected to commence as stated in the offer document), **(b)** allotment in public issue whichever is earlier, **(ii)** excess contribution, one year. However, excess contribution in a FPO where the shares of the same class which are proposed to be allotted pursuant to conversion/exchange of convertible securities offered/proposed to be allotted in the offer have been listed and are not infrequently traded for at least three years and the issuer has a track record of dividend payment for at least immediately preceding three years would not be subject to lock-in.

Securities Held by Others In case of an IPO, the entire pre-issue capital held by them would be locked-in for one year. The lock-in would, however, not be applicable to equity shares **(a)** allotted to **employees** (*i.e.* permanent/full-time employees, working in India or abroad, of the **(i)** issuer or **(ii)** holding/subsidiary or **(iii)** material associate(s) of the issuer whose financial statements are consolidated as per the Accounting Standard-21 or **(iv)** whole-time or part-time director of the issuer but does not include promoters/an immediate relative of the promoter, that is, any spouse/parent/brother/sister/ child) under an employee stock option/ purchase scheme prior to the IPO if full disclosures with respect to such options/schemes are made as specified in **Part A of Appendix 7-G on the website**, **(b)** held by a VCF category I alternative investment fund/FVCI for at least one year from the date of purchase by them. In case the shares held by the VCF/FVCI have resulted from conversion of fully paid-up compulsorily convertible securities, their holding period together would be considered for computing the one-year period and the convertible securities would be deemed to be fully paid-up if the entire consideration has been paid.

Securities Lent to Stabilising Agent Under Green Shoe Option The securities lent to **stabilising agent** (*i.e.* a merchant banker resopnsibile for stabilising the price of shares under a green shoe option) under **green shoe option** (*i.e.* an option of allotting shares in excess of those offered in the public issue as a post-listing price stabilising mechanism) would not be subject to lock-in during the period starting from the date of lending and ending on the date they are returned to the lender. They would, however, be subject to lock-in for the remaining period from the date of their return to the lender.

Pledge of Lock-in Securities The lock-in securities may be pledged by the promoters with a bank/public financial institution for loan for financing the object(s) of the issue and pledge of securities is one of the terms of the sanction of the loan.

Transferability of Lock-in Securities Subject to the provisions of the SEBI Substantial Acquisition of Shares and Takeovers Regulations, the promoters can transfer the lock-in securities to another promoter/any person of the promoter group/new promoter/person in control of the issuer. Non-promoter holders of lock-in securities can transfer them to any other person holding the specified securities which are locked-in along with the securities proposed to be transferred. The lock-in on them will continue for the remaining period with the transferee who will not be eligible to transfer them till the stipulated lock-in expires.

Minimum Offer to Public and Reservations etc. The main features relate to **(i)** minimum public offer, **(ii)** reservation on competitive basis, **(iii)** allocation in net offer to public, **(iv)** safety net arrangements, **(v)** price stabilisation through green shoe option, **(vi)** subscription period, **(vii)** pre-issue advertisement for public issue, **(viii)** issue opening/closing advertisement for public issue, **(ix)** minimum application value, **(x)** allotment procedure/basis and **(xi)** utilisation of subscription money.

Minimum Offer to Public The minimum net offer to the public would be subject to the provisions of **Rule 19(2)(b) of the Securities Contracts (Regulation) Rules**, that is, at least **(i)** 25 per cent and 10 per cent of each class of issued shares/convertible debentures if the post-issue capital of the company calculated at offer price is upto ₹1,600 crore and above ₹4,000 crore respectively, **(ii)** such percentage of issued shares/convertible debentures equivalent to ₹400 crore if the port-issued capital calculated at offer price is ₹1,600 crore.

Reservation on Competitive Basis Issuers may make reservations on **competitive basis** (*i.e.* allotment of securities in proportion of the number of securities applied for in a particular reserved category to the number of securities reserved for that category) out of the issue size excluding promoters contribution and net offer to public as specified below:

(a) In case of issue through the book building process: **(i)** employees in case of a **new issuer** (*i.e.* an issuer who has not completed 12 months of commercial operation and its audited operative results are not available) persons who are in permanent/full-time employment of the promoting companies excluding the promoters/his immediate relatives; and **(ii)** shareholders (other than promoters) of **(1)** listed promoting companies in case of a new issuer and **(2)** listed group companies in case of an existing issuer, upto 5 per cent of the issue size. However, shareholders of promoting companies which are designated financial institutions/state and central financial institutions would not be eligible; and **(iii)** persons who, on the date of filing the draft offer document with the SEBI, are associated with the issuer as depositors/bondholders/subscribers to the services of the issuer, upto 5 per cent of the issue size. But reservations cannot be made to the issue management team/syndicate members/their promoters, directors and employees and their group/associate companies.

(b) In case of an issue other than through book building process: To categories **(i)** and **(ii)** above.

(c) In case of FPO (other than a composite issue): To its retail individual shareholders.

The reservation would be subject to the following conditions: **(i)** upto a maximum of 5 per cent of the post-issue capital for employees, and **(ii)** up to 5 per cent and 10 per cent of the issue size to **(a)** shareholders and **(b)** persons who have business association as depositors bondholders/subscribers to services with the issuer respectively.

Further applications for subscription in net offer to public category may be entertained from only employees and retail individual shareholders in favour of whom reservation is made. Any unsubscribed portion in any reserved category may be added to any other reserved category and the unsubscribed portion after such *inter se* adjustment should be added to the net offer to the public category. The value of allotment to any employee should not exceed ₹2,00,000. In case of under-subscription in the net offer to the public, spill-over to the extent of under-subscription would be permitted from the reserved category to the net offer to the public category. A single applicant in the reserved category may apply for a number of specified securities exceeding the reservation.

Allocation in Net Offer to Public The allocation in net offer to public should be made as specified below:

- **In an issue through book building process satisfying the conditions for IPO: (a)** retail individual investors, not less than 35 per cent, **(b)** non-institutional investors, not less than 15 per cent, **(c)** QIBs, not more than 50 per cent of which 5 per cent to mutual funds. In addition, they would be eligible for allocation under the balance available for QIBs; upto 60 per cent of the portion available to QIB to an **anchor investor** (*i.e.* a QIB who makes an application for a value of ₹10 crore or more) in accordance with the conditions specified in **Appendix 7-J on the website**. In an IPO through book building by an issuer who does not satisfy the specified eligibility conditions for IPO, at least 75 per cent should be allocated to QIBs including 5 per cent for mutual funds; upto 10 and 15 per cent to retail individual and non-institutional investors respectively.

- **In case of non-book building process: (a)** at least 50 per cent to retail individual investors. They should be allocated the higher percentage, if entitled to more than 50 per cent on proportionate basis; **(b)** remaining to other individual applicants and other investors including corporate bodies/institutions. The unsubscribed portion in either category may be allocated to the applicants in the other category(ies).

Safety-net Arrangement The **safety net arrangement** is an arrangement provided by the issuer under which a person offers to purchase the specified securities from the original resident retail individual allottee at the issue price. Subject to disclosures in **Part A of Appendix 7-G on the website**, an issuer may provide a safety-net arrangement to purchase upto a maximum of 1,000 specified securities per allotee within 6 months from the last date of despatch of security certificate/credit of demat account.

Price Stabilisation Through Green Shoe Option (GSO) An issuer may provide GSO for stabilising the post-listing price of its specified securities, subject to the following:

- The shareholders resolution approving the public issue should authorise the issuer;
- The issuer should appoint a merchant banker/book runner as a stabilising agent **(SA)** responsible for the price stabilisation process;
- Prior to filing the draft offer document with the SEBI, **(i)** the issuer and the SA should enter into an agreement stating all the terms/conditions relating to the GSO including fee charged/expenses to be incurred by the SA for discharging his responsibilities; **(ii)** the **SA** should enter into an agreement with the promoters/pre-issue shareholders or both holding more than 5 per cent of specified securities for borrowing from them. It should specify the maximum number of securities that may be borrowed for allotment/allocation in excess of the issue size (*i.e* **over-allotment**) not exceeding 15 per cent of the issue size. The lead merchant banker/book runner in consultation with the **SA** should determine the amount to be overallotted;
- The draft/final offer document should contain all material disclosures about the **GSO** specified in **Part A of Appendix 7-G on the website**;
- The securities borrowed should be in demat form and their allocation would be *pro-rata* to all successful applicants.

The **SA** should determine the relevant aspects including the timing of buying/selling of securities, quantity and the price at which to be bought from the market. The stabilisation would be available upto 30 days from the date on which trading permission is given by the recognised stock exchange in respect of these securities. The **SA** should open a **(i)** special account distinct from the issue account, with a bank to credit the money received from the applicants against the overallotment and **(ii)** depository participant account to credit the securities to be bought from the market during the stabilisation period out of the money credited in the special bank account. These securities should be returned to the promoters/pre-issue shareholders within a maximum of two working days after the end of the stabilisation period.

If, on the expiry of the stabilisation period, the **SA** has not been able to buy the securities from the market to the extent of over-allotment, the issuer should allot specified securities at the issue price in demat form to the extent of the shortfall to the special account with the depository participant within 5 days of the closure of the stabilisation period. These would be returned to the promoters/pre-issue shareholdes by the **SA** in lieu of those borrowed from them and the depository account would be closed. The issuer should make a listing application in respect of the further allotted securities to all the recognised stock exchanges where those allotted in the public issue are listed. Such allotments would not be subject to the stipulations relating to preferential issues. The **SA** should remit the monies with respect to these securities to the issuer from the special bank account. Any monies left in the special bank account after the remittance to the issuer and deduction of expenses incurred by the **SA** should be transferred to the SEBI's **Investor Protection and Education Fund** and the special bank account closed.

The **SA** should submit a report to the stock exchange on a daily basis during the stabilisation period and a final report to the SEBI in the format specified in **Appendix 7-K on the website**. He should also maintain a register for at least 3 years from the end of the stabilisation period containing **(i)** names of promoters/pre-issue shareholders from whom the securities were borrowed together with the number borrowed from each, **(ii)** price/date/time of each transaction in the course of the stabilisation process and **(iii)** allotment details by the issuer on the expiry of the process.

Period of Subscription A public issue should be kept open for a minimum of 3 and a maximum of 10 working days including the days for which it is kept open in case of revision in price band. The bidding (issue) period disclosed in the red herring prospectus should be extended for at least 3 days in case of revision of price band in a book-built public issue.

Pre-issue Advertisement Subject to the provisions of Section 66 of the Companies Act, the issuer should, after registering the red herring prospectus/prospectus with the ROCs, make a pre-issue advertisement in one **(i)** English and Hindi national daily newspaper with wide circulation and **(ii)** regional language newspaper with wide circulation at the place of the registered office of the issuer. It should be in the format and contain the disclosures specified in **Part A of Appendix 7-L on the website**. **Advertisement** includes notices, brochures, pamphalets, show cards, catalogues, hoardings, placards, posters, insertion in newspapers, cover pages of offer documents, pictures and films in any print/electronic media, radio, television programme.

Issue Opening/Closing Advertisement The advertisement should be in the format specified in **Part B of the Appendix 7-L on the website**.

Minimum Application Value The minimum application value with reference to the issue of securities is in the range of ₹10,000 to ₹15,000. The issuer should stipulate in the offer document the minimum application size in terms of number of specified securities within this range. Applications should be invited in multiples of the minimum application value. This is illustrated in **Appendix 7-M on the website**. Assuming an issue price of ₹390 per share, the minimum application size/lot can be determined within the range of 13-17 shares (in value terms between ₹5,000–₹7,500) as illustrated below.

Options	*A*	*B*	*C*	*D*	*E*
Lot size @ ₹390 per share (shares)	13	14	15	16	17
Application/bid amount for (rupees):					
1 lot	5,070	5,469	5,850	6,240	6,630
2 lots	10,140	10,920	11,700	12,480	13,260
4 lots	20,280	21,840	23,400	24,960	26,520
8 lots	40,560	43,680	46,800	49,920	—
9 lots	45,630	49,140	—	—	—

If the selected bid size is 14 (option B), necessary disclosures should be made in the offer document that an applicant should apply for 14 shares and multiples thereof.

The minimum application money should be at least 25 per cent of the issue price. In an offer for sale, however, the entire issue price should be brought in as application money.

Allotment Procedure/Basis The allotment of securities to non-anchor/retail individual investors-applicants should be on proportionate basis within the specified investor categories an the number of securities allotted rounded off to the nearest integer; the minimum allotment should be equal to the minimum application size determined/disclosed by the issuer. However, the value of securities allotted to any person under reservation category should not exceed ₹2,00,000. The allotment to each retail individual investor should not be less than the minimum bid lot subject to availability of share in this category and the remaining shares allotted on proportionate basis. The **(i)** ED/MD of the DSE, **(ii)** post-issue lead merchant banker(s) and **(iii)** registrars to the issue should ensure that the basis of allotment is finalised in a fair/proper manner in accordance with the allotment procedure specified in **Appendix 7-N on the website**. Assume **(i)** number of securities offered at ₹600 per share, 10 crore, **(ii)** offered to retail individual investors, 2.5 crore shares. **(iii)** oversubscription of issue, 4 times and in the retail individual investors category, 8.25 times, **(iv)** minimum application/bid size, 9 shares within the range of ₹5,000 – ₹7,500 **(v)** three retail individual investors A, B and C applying for 81,72 and 45 shares respectively. The allotment to them would be on proportionate basis, that is, at 1/8.25th of the total number of shares applied for. The actual allotment would be as shown below.

Investor	*Number of Specified Securities Applied for*	*Number of Specified Securities Eligible for Allotment (Number of Securities Applied for × 8.25)*
(1)	*(2)*	*(3)*
A	81	81 ÷ 8.25 = 9.82 = 10
B	72	72 ÷ 8.25 = 8.73 = 9
C	45	45 ÷ 8.25 = 5.45 (liable to rejected as the entitlement is less than the minimum application lot of 9)

The successful applicants would be determined by draw of lots.

Utilisation of Subscription Money The post-issue lead banker should ensure that the monies received in respect of the issue are released to the issuer in compliance with the provisions of Section 73 of the Companies Act.

Annual Updation of Offer Document The disclosures made in the red herring prospectus should be updated on an annual basis by the issuer and made publicly accessible in the SEBI-specified manner.

Rights Issues

The main elements of the SEBI framework for rights issues are **(i)** record date, **(ii)** restrictions on rights issues, **(iii)** letter/abridged letter of offer, pricing and subscription period, **(iv)** pre-issue advertisement and **(v)** utilisation of funds.

Record Date To determine the eligibility of shareholders to apply for the specified securities in the rights issue, the listed issuer should announce a record date after which a rights issue cannot be withdrawn. In case of a withdrawal, the issuer is prohibited from applying for listing any of its specified securities for 12 months. It may, however, seek listing of its equity shares allotted pursuant to conversion/exchange of convertible securities issued prior to such announcement.

Restrictions An issuer can make a rights issue only after reserving shares of the same class in favour of holders of outstanding compulsorily convertible debt instruments in proportion to the convertible part. The reserved shares would be issued at the time of conversion of the CDIs on the same terms at which the rights issues were made.

Letter/Abridged Letter of Offer, Pricing and Subscription Period The abridged letter of offer, along with the application form, should be sent through registered/speed post to all existing shareholders at least 3 days before the issue opening date. Any existing shareholder can get the letter of offer from the issuer/lead merchant banker on request. Application in writing on a plain paper along with the requisite application money are permitted. Such shareholders would not be allowed to renounce their rights. Applications by shareholders on application form as well as on plain paper are liable to be rejected.

The issue price should be decided before determining the record date in consultation with the DSE. The issue should be open for a minimum of 15 days and a maximum of 30 days. The investors should have the option of either part payment on application with balance money to be paid in calls or full payment on application. The part payment should be atleast 25 per cent of the issue price.

Pre-issue Advertisement The advertisement should disclose the following:

(a) The date of completion of dispatch of abridged letter of offer and the application form;

(b) The centres other than the registered office of the issuer where the shareholders/persons entitled to receive the rights entitlements may obtain duplicate copies of the application form in case of its non-receipt within a reasonable time after the opening of the issue;

(c) A statement that if the shareholders entitled to receive the rights entitlements have neither received the original application forms nor they are in a position to obtain the duplicate forms, they may make application in writing on a plain paper to subscribe to the rights issue;

(d) A format to enable the shareholders to make the application on a plain paper specifying therein necessary particulars such as name, address, ratio of rights issue, issue price, number of equity shares held, ledger folio numbers, depository participant ID, client ID, number of equity shares entitled and applied for, additional shares if any, amount to be paid along with application, and particulars of cheque, and so on to be drawn in favour of the issuer's account;

(e) A statement that the applications can be directly sent by the shareholders through registered post together with the application moneys to the issuer's designated official address given in the advertisement;

(f) A statement to the effect that if the shareholder makes an application on plain paper and also on application form both his applications would be liable to be rejected at the option of the issuer.

The advertisement should be made in at least one **(i)** English, **(ii)** Hindi national daily newspaper and one **(iii)** regional language daily newspaper with wide circulation at the place where registered office of the issuer is situated, at least three days before the date of opening of the issue.

Utilisation of Funds Raised The issuer should utilise funds collected in rights issues after the finalisation of the basis of allotment.

Reservation for Employees Reservation for employees along with the rights issues upto ₹2,00,000 may be made by an issuer.

Manner of Disclosure in Offer Documents

The element of the SEBI framework are: **(i)** disclosures in offer document and **(ii)** abridged prospectus/letter of offer and ASBA.

Disclosure in Offer Document In general, the offer documents should contain all material disclosures which are true/adequate so as to enable the applicant to take informed investment decisions. In particular, while the red-herring prospectus/shelf prospectus/prospectus should contain the disclosures specified in **(i)** Scheudle II of the Companies Act and **(ii) Parts A, B and C of Appendix 7-G on the website**, the letter of offer should contain those specified in **Part E of Appendix 7-G on the website.** In addition, suitable reference should be made to the updated disclosures in the offer document.

Abridged Prospectus/Letter of Offer and ASBA While the abridged prospectus should contain the disclosures of the memorandum under Section 56(3) of the Companies Act and additional disclosures specified in **Part D of Appendix 7-G on the website**, the abridged letter of offer should contain the disclosures specified in **Part F of Appendix 7-G on the website.**

The abridged prospectus/letter of offer should not contain any mater extraneous to the contents of the offer document.

Every application form including **ASBA** form should be accompanied by a copy of the abridged prospectus/letter of offer. In all **(i)** public issues and rights issues with one payment option, the issuer should accept bids using only ASBA facility in the manner specified by the SEBI. In case of QIBs and non-institutional investors, bids should accepted using ASBA facility only.

General Obligations of Issuers/Intermediaries

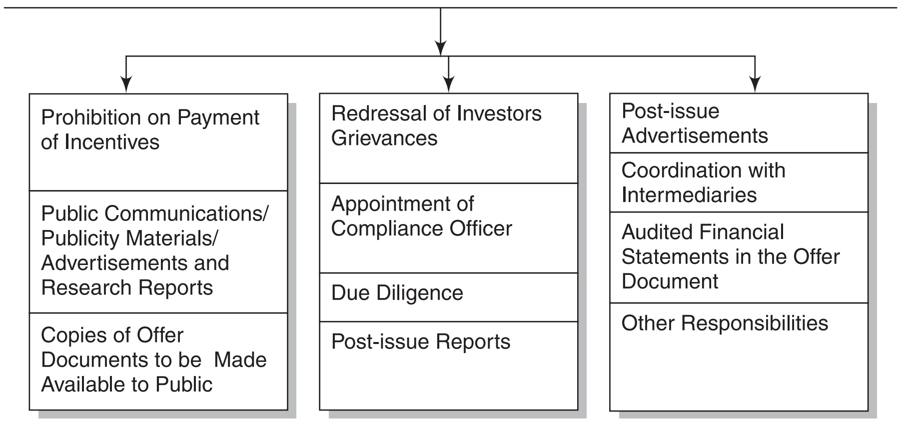
The general obligations of issuers and intermediaries with respect to public/rights issues discussed in this Section are **depicted in Exhibit 7.4.**

Prohibition on Payment of Incentives Offer by any person connected with an issue including those connected with its distribution to applicants for allotment of securities of incentives in any manner, direct/indirect, in cash/kind, service/otherwise is prohibited. However, payment of fee/commission for services rendered in relation to issues is permitted.

Public Communications/Publicity Materials/Advertisements and Research Reports All public communications including advertisement and publicity materials/research reports by the issuers/intermediaries connected with the issue or their associates should contain only factual information and not projections/ estimates/conjectures or matters extraneous to the contents of the offer document. **Public communication/publicity material** includes **(i)** corporate, product and issue advertisements of the issuer, **(ii)** interviews by its promoters/directors/duly authorised employees/representatives, **(iii)** documentaries about the issuer/its promoters, and **(iv)** periodical reports and press releases.

- All public communications/publicity materials issued/published in any media during the period between the date of meeting of the Board of Directors of the issuer approving the issue and the filing of draft offer document with the SEBI should:

Exhibit 7.4 General Obligations of Issuers/Intermediaries



(i) Be consistent with its past practices; otherwise, it should be prominently displayed/ announced that it is proposed to make an issue of specified securities in the near future and the issuer is in the process of filing a draft offer document with the SEBI,

(ii) Prominently disclose that the **(a)** the issuer is proposing to make a public/rights issue and has filed a draft offer document with the SEBI/red herring prospectus/prospectus with the ROCs/letter of offer with the DSE, **(b)** draft offer document/red herring prospectus/final offer document is available on the website of the SEBI/lead merchant bankers (book runners). These requirements are not applicable in case of product advertisement.

- The issuer should make prompt/true/fair disclosures of all material development relating to **(i)** its business/securities and **(ii)** those of its subsidiaries/group companies, having a material effect on the issuer by issuing public notices in all newspapers in which its pre-issue advertisement was issued, during the period between the date of **(a)** registering final/red herring prospectus with the ROCs and the date of allotment of securities in public issue and **(b)** filing the letter of offer with the DSE and allotment of securities.
- The issuer should **(i)** not directly/ndirectly release during a conference/any other time any material/information which is not contained in the offer document, **(ii)** obtain approval from the lead merchant banker(s) responsible for marketing the issue in respect of all public communications/issue advertisement/publicity materials and also make copies of all issue-related materials available with the lead merchant banker at least until the completion of the allotment.
- All advertisements/research reports by the issuer/intermediaries/associates should comply with the following:

(a) It should **(i)** be truthful/fair and not manipulative/deceptive /distorted and not contain any untrue/misleading statement/promise/forecast, **(ii)** reproduce any information contained in the offer document in full and disclose all relevant facts and not be restricted to select extracts, **(iii)** be set forth in a clear/concise/understandable language, **(iv)** not include any issue slogans/brand names except the normal commercial name of the issuer/brand of its products already in use, **(v)** include financial data for the past three years along with the particulars relating to sales/gross profit/net profit/share capital/reserves, earnings per share/dividends/book values. An issue advertisement would be considered **misleading** if it contains **(a)** statements about the performance/activities of the issuer without necessary explanatory/qualifying statements which may give an exaggerated picture of performance/activities, **(b)** an inaccurate portrayal of past performance/portrayal in a manner implying past gains/income will be repeated in future.

(b) No issue advertisement should: **(i)** use extensive technical/legal terminology, complex language and excessive details which may distract the investors, **(ii)** contain statements promising/guaranteeing rapid increase in profits, **(iii)** display models/celebrities/fictional characters/landmarks/caricatures/the likes, **(iv)** appear in the form of **crawlers** (i.e. which run simultaneously with the programme in a narrow strip at the bottom of the television screen) on television, **(v)** contain slogans/expletives/non-factual and unsubstantiated titles, **(vi)** also contain risk factors with equal importance in all respects including at least points seven print size, if it contains highlights, **(vii)** not contain information other than those specified in **Part A, B and C of Appendix 7-L on the website** in an issue advertisement displayed on a bill board, **(viii)** contain risk factors if the issue advertisement contains highlights/information other than the details contained in **Parts A and B of Appendix 7-L on the website**.

(c) In any advertisement on television screen, the risk factors should not be scrolled on the television screen and it should advise the viewers to refer to the red-herring prospectus/other offer documents for details.

- No advertisement should give the impression that the issue has been fully subscribed/oversubscribed during the period the issue is open for subscription.
- An announcement regarding closure of the issue should be made only after the lead merchant banker(s) is satisfied that at least 90 per cent of the offer has been subscribed and a certificate obtained to this effect from the Registrar to the Issue. The announcement should not be made before the date on which the issue is to be closed.
- No advertisement/distribution material should contain any offer of direct/indirect incentives in any manner in cash/kind/services/otherwise.
- No product advertisement should contain any direct/indirect reference to the performance of the issue during the period between the date of the resolution of the Board of Directors approving the issue and the allotment of securities.
- A research report may be prepared only on the basis of information disclosed to the public by updating the offer document/otherwise.
- Selective/additional information/information extraneous to the one disclosed to the public through the offer document/otherwise should not be given to the issuer/any member of the issue management team/syndicate or to any particular section of the investors/any research analyst in any manner including at road shows/presentations, in research/sales reports/at bidding centres.
- The merchant banker should submit a compliance certificate in the specified format for the period between the date of **(i)** filing the draft offer document with the SEBI and **(ii)** closure of the issue in respect of news appearing in any: **(a)** newspapers in which public announcement was made, or **(ii)** major business magazines, or **(iii)** print/electronic media controlled by a media group having a private treaty/shareholders agreement with the issuer/promoters of the issuer.

Copies of Offer Document Available to Public The issuer/lead merchant banker(s) should ensure that the contents of the offer documents hosted on the website are the same as that of their printed versions filed with the ROCs/SEBI/stock exchanges. The lead merchant banker(s)/recognised stock exchanges should provide copies of the draft/final offer document(s) to the public on request for a reasonable charge.

Redressal of Investor Grievances The post-issue lead merchant banker(s) should be actively associated with post-issue activities such as allotment/refund/despatch, instructions to syndicate members/**SCSBs**/other intermediaries. They should also regularly monitor redressal of the associated investor grievances.

Appointment of Compliance Officer The issuer-appointed compliance officer would be responsible for redressal of investor grievances and compliance of the securities laws [i.e. Companies/ Securities Contracts (Regulation)/Depositories Act/rules/regulations and regulations/general or special orders/guidelines/circulars made/issued by the SEBI].

Due Diligence The lead merchant banker(s) should **(i)** exercise due diligence and satisfy about all the aspects of the issue including the veracity/adequacy of disclosures in the offer documents, **(ii)** call upon the issuer/its promoters/directors/the selling shareholders in offer for sale to fulfil their obligations disclosed in the offer document/required in terms of the SEBI ICDR regulations. Their responsibility would continue even after the completion of the issue process.

The post-issue merchant banker would continue to be responsible for post-issue activities till the subscribers have received the security certificates/credit to their demat account or refund of application money and the listing agreement is entered into by the issuer with the stock exchange and listing/trading permission is obtained.

Post-Issue Reports In public issues the lead merchant banker should submit final post-issue repost specifies in **Part C of Appendix 7-O on the website** within 7 days of the date of finalisation of basis of allotment/refund of money in case of failure of issue. In rights issues, the initial post-issue report specified in **Part B of Appendix 7-O on website** should be submitted within 3 days of closure of the issue and the final post-issue report specified in **Part D of Appendix 7-O** within 15 days of the date of finalisation of basis of allotment/refund of money in case of failure of issue. The lead merchant banker should submit a due diligence certificate in the specified format along with the final post-issue report.

Post-Issue Advertisements The post-issue merchant banker should ensure that:

- Advertisement is released within 10 days from the completion of the various activities in at least one English/Hindi national daily newspaper with wide circulation and one regional language daily newspaper with wide circulation at the place of the registered office of the issuer giving details relating to **(i)** oversubscription, **(ii)** basis of allotment, **(iii)** number/value/percentage of all applications including **ASBA**/successful allottees for all applications including **ASBA**, **(iv)** date of completion of despatch of refund orders/instructions to **SCSBs** by the Registrar, and **(v)** date of despatch of certificates/filing of listing application and so on.
- Issuer/advisors/brokers any other entity connected with the issue do not publish any advertisement stating that it has been oversubscribed/indicating investors response to it during the period when the public issue is open for subscription.

Coordination With Intermediaries The post-issue merchant banker should:

(1) Maintain close coordination with the Registrar to the issue and depute its officers to the offices of the various intermediaries at regular intervals after the closure of the issue to monitor the **(i)** flow of applications from the collecting bank branches and/or **SCSBs,**

(ii) processing of applications including those for **ASBA**/and **(iii)** other matters till the basis of allotment is finalised, despatch of security certificates/refund orders are completed and securities are listed. Any act of omission/commission on the part of any intermediary noticed during such visits should be duly reported to the SEBI.

(2) Ensure that the notice for devolvement on underwriters containing their obligations is issued within 10 days from the date of closure of the issue.

(3) Furnish information in respect of underwriters who have failed to meet their underwriting devolvements in an undersubscribed issue to the SEBI in the format specified in **Appendix 7-P on the website**.

(4) Confirm to the bankers to the issue by way of copies of listing/trading approvals that all formalities in connection with the issue have been completed and the banker is free to release the money to the issuer/for refund in case of failure of the issue.

Audited Financial Statements in the Offer Document The merchant banker should ensure that **(i)** the information contained and **(ii)** the particulars as per the audited financial statements in the offer document are not more than 6 months old from the issue opening date.

Other Responsibilities The post-issue merchant banker should ensure that:

- The despatch of refund orders/allotment letters/share certificates is by registered post/certificate of posting,
- Payment of interest to the applicants for delayed despatch of allotment letters/refund orders and so on is made as per the disclosures in the offer document,
- Transactions in securities by the promoter/promoter group between the date of registering of the offer document with the ROCs/filing the letter of offer with the DSE and the closure of the issue should be reported to the DSE within 24 hours of the transactions,
- Issue is kept open, in case of absence of definite information about subscription figures, for the required number of days to avoid any dispute at a later date by the underwriters in respect of their liability.

Conditions/Manner of Providing Exit Opportunity to Dissenting Shareholders **Dissenting shareholders** mean shareholders who have voted against the resolution for change in objects/variations in terms of a contract referred to in the prospectus of the issuer. The main elements of the SEBI regulations are: **(i)** conditions for exit offer, **(ii)** eligibility of shareholders for availing of the exit offer, **(iii)** exit offer price, **(iv)** manner of providing exit to dissenting shareholders and **(v)** offer not to exceed maximum permissible non-public shareholding.

Conditions The promoters/shareholders in control should make the exit offer if **(i)** 10 per cent dissenting shareholders voted in the general meeting and **(ii)** the amount to be utilised for the object for which the prospectus was issued is less than 75 per cent of the amount raised.

Eligibility Only dissenting shareholders who hold shares on the **relevant date** (i.e. date of the meeting of the Board of Directors in which the proposal for change in objects/variation in terms of a contract is approved) can avail of the offer.

Exit Offer Price The exit price payable to the dissenting shareholders would be the highest of the following:

- the volume weighted average price paid/payable for acquisition during 52 weeks immediately preceding the relevant date;

- the highest price paid/payable for any acquisition during the 26 weeks immediately preceding the relevant date;
- the volume weighted average market price for frequently traded shares for 60 trading days immediately preceding the relevant date as traded on the stock exchange where the maximum volume of trading is recorded; and
- in case of infrequently traded shares, the price determined by the promoter/shareholders having control and the merchant banker taking into valuation parameters including book value, comparable trading multiples and other customary parameters.

Exit The notice proposing the passing of special resolution changing the objects of the issue/varying the terms of the contract should also contain information about the exit offer to the dissenting shareholders. The explanatory statement to the notice should contain, in addition to other disclosures, a statement that exit opportunity would be provided. The voting results on the special resolution should be submitted to the stock exchange(s) together with a list of dissenting shareholders. A SEBI-registered merchant banker would finalise the exit offer price. The issuer should intimate the stock exchange(s) about the exit offer price which should immediately disseminate the same to public within one working day. To ensure security for performance of obligations, an interest-bearing escrow account should be created to deposit the aggregate considerations at least two working days prior to the tendering period which should start within 7 working days from the passing of the special resolution and remain open for 10 working days. The dissenting shareholders who have tendered their shares would have the option to withdraw till the closure of the tendering period. The promoter/shareholders should facilitate tendering of shares and its settlement through the SEBI-specified stock exchange mechanism for takeover/buyback/delisting. They should make payment of the consideration within 10 working days from the date of the tendering period. Within 2 days from the payment of consideration, the issuer should furnish to the stock exchange(s) disclosures detailing aggregate number of shares tendered/accepted, payment of consideration and its post-offer shareholding pattern and a report by the merchant banker that the payment has been duly made to the concerned dissenting shareholders.

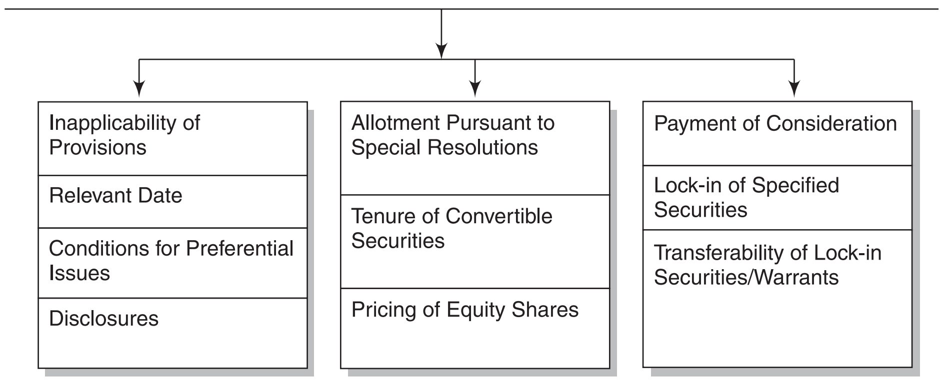
Maximum Offer The promoter/shareholders in control would have to bring down the non-public shareholding to the specified level within the permitted time under the **Securities Contract (Regulation)** Rules if the completion of the exit offer results in these shareholdings exceeding the maximum permissible non-public shareholding.

Preferential Issues

A **preferential issue** means an issue of specified securities by a listed issuer to any select person/group of persons on a private placement basis. It does not include an offer of securities through public/rights/bonus issue, employee stock option/purchase scheme, qualified institutional placement, issue of sweat equity shares, depository receipts in a country outside India and foreign securities. The main elements of such issues are portrayed in Exhibit 7.5.

Inapplicability of Provisions The provisions relating to preferential issues would not be applicable to issue of equity shares made **(a)** pursuant to **(i)** conversion of loan/option attached to a CDI in terms of Sections 81(3)/(4) of the Companies Act, **(ii)** a scheme approved by a High Court under Sections 391-394 of the Companies Act and **(b)** in terms of a rehabilitation scheme approved by the BFIR under the Sick Industrial Companies (Special Provisions) Ac. But such issues would be subject to lock-in stipulations pertaining to preferential issues. However, the lock-in provisions would apply in this case.

Exhibit 7.5 Preferential Issues



The pricing and lock-in requirements would not be applicable to equity shares allotted to any financial institution in terms of Section 2(h)(ia) and **(ii)** of the Recovery of Debts Due to Banks and Financial Institutions Act. Moreover, preferential issues of equity shares and fully/partly compulsorily CDIs would be exempt from the disclosures and pricing requirements (**discussed later in this Section**) where the SEBI has granted relaxation to the issuer in terms of Regulation 29-A of the SEBI Substantial Acquisition of Shares and Takeover Regulations if adequate disclosures about the plan/process proposed to be followed for identifying the allottees are given in the explanatory statement to the notice for the general meeting of the shareholders. The provisions relating to holding shares in demat form and lock-in would not apply to a preferential issue allotted to mutual funds registered with the Board of Directors of IRDA-registered insurance company.

The provisions would also not apply where the issue is made pursuant to conversion of debt into equity under strategic debt restructuring scheme of the RBI. The conversion price should not be less than the face value of the shares. It should be certified by two independent qualified valuers. The lock-in period would be one year from the date of trading approval. The applicable provisions of the Companies Act should be complied with.

Frequently Traded Shares Such shares mean shares of an issuer in which the turnover on a stock exchange during the 12 months preceding the relevant date is at least 10 per cent of the total number of shares. The weighted average number of total shares would represent the total number where the share capital of the issuer is not identical throughout the 12-month period.

Conditions for Preferential Issues The conditions for preferential issues by a listed issue are: **(i)** a special resolution by the shareholders, **(ii)** all equity shares held by the proposed allottees are in demat form, **(iii)** the issuer is in compliance with the conditions for continuous listing specified in the listing agreement, and **(iv)** it has obtained the PAN of the proposed allottees.

Preferential issue cannot be made to person(s) who have sold equity shares of the issuer during the six months preceding the **relevant date** except where the SEBI has granted relaxation in terms of Regulation 29-A of its Substantial Acquisition of Shares and Takeover Regulation. Where any person belonging to promoter(s)/promoter group has **(i)** sold his shares during the 6 months preceding the relevant date **(ii)** previously subscribed to warrants of the issuer but failed to exercise, the promoters/group would be ineligible for one year from the date of **(1)** expiry of the tenure, **(2)** cancellation of the warrants. The **relevant** date means in case of preferential issue of **(a)** equity shares: the date 30 days prior to the date on which the shareholders meeting to consider the issue is held; however, the date of approval of the corporate debt restructuring package would be the relevant date for such issues pursuant to the RBI's CDR framework, **(b)** CDIs: a date 30 days prior to the date on which the **(i)** shareholders meeting to considers the issue is held or **(ii)** holders become entitled to apply for the shares.

Disclosures In addition to the disclosures under Section 173 of the Companies Act or other applicable laws, the issuers should disclose in the explanatory statement to the notice for the general meeting proposed for passing the special resolution the following: **(a)** objects of the issue, **(b)** proposal of the promoters/directors/**key management personnel** (i.e. officers vested executive powers/at the level immediately below the Board of Directors including any other person who is declared as a key management personnel by the issuer) of the issuer to subscribe to the offer, **(c)** shareholding pattern before/after the issue, **(d)** the time within which the issue would be completed, **(e)** identity of the natural person(s) who are the ultimate beneficial owners of the shares proposed to be allotted and/or who ultimately control the proposed allottees/percentage of post issue capital to be held by them/change in control in the issuer consequent to the issue; however, no further disclosures will be necessary if any listed company/bank/mutual fund/insurance company is in the chain of ownership of the proposed allottee, **(f)** undertaking that the **(i)** price of the securities would be recomputed where required in terms of these regulations, **(ii)** securities would continue to be locked-in till such time the amount payable on account of the recomputation of price is paid by the allottees; (g) specified disclosures if the issuer/promoter/director is a willful defaulter. The special resolution should specify the relevant date on the basis of which the price of the equity shares to be allotted on conversion/exchange of convertible securities would be calculated.

A copy of the certificate of its statutory auditors should be placed by the issuer before the general meeting of its shareholders certifying that the issue is being made in accordance with the requirements of these regulations.

The valuation of the assets in consideration for which the equity shares are being issued on a preferential basis to promoters/their relations/associates/related entities for consideration other than cash should be done by an independent qualified valuer and submitted to the concerned stock exchange. On not being satisfied with the appropriateness of the valuation, the stock exchange may get it done by another valuer by obtaining all the deemed necessary information from the issuer.

Allotment Pursuant to Special Resolution The allotment should be completed within 15 days from the date of **(i)** passing of the special resolution, **(ii)** order/approval or permission on a pending application for exemption from the applicability of the SEBI Substantial Acquisition of Shares and Takeover Regulations/approval or permission by any regulatory authority/Central Government. The 15-day limit would not apply to allotment pursuant to a scheme of corporate debt restructuring. On failure to complete the allotment within 15 days, a fresh special resolution would be necessary. The preferential issue of shares/compulsorily partly/fully CDIs should be made within the time specified by the SEBI in its order granting the relaxation to the issuer in terms of **Regulation 29-A of the SEBI Takeover Regulation**. Allotment should be made only in dematerialised form including allotment pursuant to exercise option attached to warrant or conversion of convertible securities.

Tenure of Convertible Securities The tenure should not exceed 18 months from the date of their allotment.

Pricing of Equity Shares: Frequently Traded Shares The stipulations relating to pricing of equity shares in a preferential issue are summarised below:

- **If shares have been listed for at least 26 weeks on the relevant date:** They shares should be allotted at a price higher of the average of the weekly high and low of the volume weighted average price of the related shares quoted on the stock exchange (in which the highest trading volume have been recorded) during the **(i)** 26 weeks and **(ii)** 2 weeks preceding the relevant date.
- **If listed for less than 26 weeks:** At a price higher than the following: **(a)** the average of the weekly high and low of the volume weighted average prices during the **(i)** period shares have been listed and **(ii)** 2 weeks preceding the relevant date and **(b)** **(i)** the price at which they were issued in the IPO or **(ii)** the value per share in a scheme of arrangement under the Companies Act pursuant to which the shares were allotted. The price should be recomputed on completion of 26 weeks with reference to the average of the weekly high and low of the volume weighted average prices during these weeks and the allottees would have to pay any difference between the (higher) recomputed price and the allotment price.
- Preferential issues to a maximum of 5 QIBs should be made not below the average of the weekly high and low of the volume weighted average prices of the related shares during the two weeks preceding the relevant date.

Pricing of Equity Shares: Infrequently Traded Shares The price should take into account valuation parameters including book value, comparable trading multiples and other customary parameters for valuation of shares of such companies. The issuer should submit a certificate of compliance from an independent merchant banker/chartered accountant having a maximum of 10 years of experience to the concerned stock exchange.

The pricing for preferential issues in respect of frequently/infrequently traded shares would be subject to appropriate adjustments if the issuer **(a)** makes **(i)** an issue of shares by way of capitalisation of profits/reserves other than by way of a dividend on shares, **(ii)** a rights issue, **(b)** consolidates its outstanding shares into a smaller number of shares, **(c)** divides them including by way of stock split, **(iii)** reclassifies them into other securities and **(iv)** is involved in similar other events/circumstances which in the opinion of the stock exchange requires adjustments.

Payment of Consideration Full consideration (price) of the specified securities other than warrants should be paid by the allottees at the time of allotment. The consideration in a preferential issue pursuant to a scheme of corporate debt restructuring (CDR) would be according to the terms of the scheme.

At least 25 per cent of the consideration should be paid against each warrant on the date of their allotment; the balance 75 per cent should be paid on allotment of shares pursuant to exercise of option. Failure on the part of the warrantholder to exercise the option would result in the forfeiture of the 25 per cent payment. The issuer should ensure that the consideration received in cash would be received from the allottees' bank accounts. A certificate of compliance from the auditors should be submitted to the stock exchange.

Lock-in of Specified Securities The specified securities allotted/shares allotted pursuant to exercise of option attached to warrants on preferential basis to promoter/promoter group, should be locked-in for 3 years from the date of **trading approval** (i.e. the latest date when trading approval has been granted by the concerned stock exchanges). However, not more than 20 per cent of the **total capital of the issuer** (i.e. equity share capital by way of public/rights issues and conversion of convertible securities and securities on preferential basis to promoter/promoter group) should be locked-in; the excess over 20 per cent would be subject to lock-in of one year.

The lock-in of securities allotted to others and those pursuant to a scheme of CDR would be one year. It would be reduced to the extent of the already lock-in of convertible securities in case of shares allotted pursuant to their conversion. Partly paid-up shares would be locked-in from the date of trading approval and would end after one year from the date they become fully paid-up. The shares would continue to be locked-in till the amount representing the difference between the **(i)** recomputed price after completion of 6 months in case of listing of shares for less than 6 months and **(ii)** allotment price is paid by the allottee. The entire pre-preferential allotment shareholding of the allottees should be lock-in from the relevant date upto 6 months from the date of trading approval.

Transferability of Lock-in Securities/Warrants Subject to the provisions of the SEBI Substantial Acquisition of Shares and Takeover Regulation, the specified securities held by promoters and lock-in may be transferred among promoters/promoter group or new promoter/persons in control of the issuer. However, the lock-in would continue for the remaining period with the transferee. The allotted securities should not be transferred by the allottees till the grant of trading approval.

Qualified Institutional Placement (QIP)

The **QIP** means allotment of **eligible securities** (i.e. shares/non-convertible debt instruments along with warrants and other convertible securities) by a listed issuer to QIBs on private placement basis. The main elements of the framework relating to the QIPs are: conditions, placement document, pricing, allotment restrictions, minimum number of allottees, validity of the special resolution, tenure, and transferability of eligible securities.

Conditions for QIP A listed issuer may make a QIP of securities if it satisfies the following conditions:

- A special resolution by its shareholders for the purpose,
- Listing of shares of the same class which are proposed to be allotted/pursuant to conversion or exchange of eligible securities offered to QIP on a stock exchange having nationwide trading terminal for at least one year prior to the issue of notice to the shareholders for convening their meeting to pass the special resolution. For computing the one-year period, the period for which the shares of the same class of the issuer being a transferor company were listed in case of a transferee company in a scheme of merger/demergers/ amalgamation/ arrangement sanctioned by a High Court under Sections 391-394 of the Companies Act would also be considered.
- Is in compliance with the requirement of minimum public shareholding specified in the Securities Contracts (Regulation) Rules.
- The special resolution should, *inter-alia*, specify that the allotment would be through QIP. The relevant date should also be specified. **Relevant date** means **(i)** the date of meeting

in which the Board of Directors/ its duly authorised committee decides to open the issue in case of allotment of shares, **(ii)** in case of allotment of eligible convertible securities the date **(a)** of the meeting specified in **(i)** or **(b)** on which their holders became entitled to apply for shares.

A SEBI-registered merchant banker(s) should manage QIP and exercise due diligence. While seeking in-principle approval for listing, he should furnish to the stock exchange(s) on which the same class of shares of the issuer are listed a due diligence certificate to the effect that the eligible securities are being issued under QIP and all the requirements have been complied with.

Placement Document The QIP should be made on the basis of a placement document containing all material information including those specified in **Appendix 7-Q on the website** and disclosures pertaining to willful defaulters. It should be serially numbered and its copies should be circulated only to select investors. While seeking in-principle approval for listing, the issuer should furnish a copy of it/a certificate confirming compliance with all the requirements along with other documents required by the stock exchange. The placement document should also be placed on the website of the stock exchange/issuer with a disclaimer that it is in connection with QIP and no offer is being made to public/any other category of investors.

Pricing The price at which a QIP is made should not be less than the average of the quoted weekly high and low of the closing prices of the shares of the same class during the two weeks preceding the relevant date. Subject to approval of shareholders, discount upto 5 per cent on this price may be offered. The price of equity shares allotted pursuant to conversion/exchange of eligible securities should be determined taking the relevant date as decided/disclosed by the issuer while passing the specified resolution.

Partly paid-up eligible securities should not be allotted. However, allottees may pay the full/ part consideration in case of allotment of non-convertible debt instruments along with warrants at the time of their allotment. Equity shares allotted on exercise of option attached to warrants should be fully paid-up.

The prices determined for a QIP would be subject to appropriate adjustments if the issuer **(a)** makes **(i)** an issue of shares by way of capitalisation of profits/reserves, **(ii)** a rights issue; **(b)** consolidates its outstanding shares into smaller number of shares; **(c)** divides them including by way of stock split; **(d)** reclassifies them into its other securities; and **(e)** is involved in similar events/circumstances which, in the opinion of the concerned stock exchange, require adjustment.

Restrictions on Allotment A minimum of 10 per cent of the eligible securities should be allotted to mutual funds. Their unsubscribed portion may be allotted to other QIBs. Driect/indirect allotment cannot be made to any QIB who is a promoter/any person related to the promoter of the issuer. A QIB would be deemed to be a person related to the promoter if has **(i)** right(s) under a shareholders/voting agreement/to appoint any nominee director and **(ii)** veto rights.

An investor can subscribe either to the combined offerings of non-CDIs with warrants or to individual securities, that is, non-convertible debt instruments or warrants. Bids by applicants in QIP cannot be withdrawn after the closure of the issue.

Minimum Number of Allottees The minimum number of allottees for each placement should be at least two and five for issue size upto and more than ₹250 crore respectively. No single allotee can be allotted more than 50 per cent of the issue size. The QIB belonging to/under the same group/control would be deemed to be a single allottee.

Validity of the Special Resolution The allotment of eligible securities should be completed with 12 months from the date of passing the resolution. A subsequent QIP can be made after 6 month of a prior QIP pursuant to a special resolution(s).

Restrictions on Amount Raised The aggregate of the proposed QIP together with all previous QIPs in the same financial year should not exceed 5 times the networth of the issuer as per its audited balance sheet of the previous year.

Tenure The maximum tenure of the convertible/exchangeable eligible securities would be 5 years from the date of allotment.

Transferability The allottees can sell the eligible securities for one year **only** on a recognised stock exchange.

Institutional Placement Programme (IPP) The provisions discussed below relate to issuance of fresh and/or offer for sale of shares in a listed issuer for achieving the minimum public shareholding in terms of Section 19(2)(b) and 19-A of the Securities Contracts (Regulation) rules.* In addition, the undermentioned provisions of the SEBI ICDR Regulations would also apply to such issues: **(i)** definitions of terms/concepts, **(ii)** debarring of promoters/directors/persons in control from accessing the capital market, **(iii)** in-principle stock exchange approval for listing, **(iv)** dispatch of issue material, **(v)** allotment/refund and payment of interest, **(vi)** restriction on further capital issue, **(vii)** pre-issue advertisement, **(viii)** issue opening/closing advertisement, **(ix)** utilisation of subscription money, **(x)** prohibition on payment of incentives, **(xi)** public communication/publicity material/advertisements and research reports, **(xii)** copies of offer document to public, **(xiii)** due diligence, **(xiv)** post-issue report, **(xv)** post-issue advertisement, and **(xvi)** audited financial statements in the offer document. The main elements of the SEBI regulations are discussed below.

- An **IPP** (i.e. a further public offer of eligible securities, that is, equity shares of same class listed/traded in the stock exchange, by an eligible seller, that is, listed issuer, promoter/promoter group of listed issuer, in which the offer/allocation/allotment of the securities is made only to the QIBs) requires a special resolution by the shareholders in terms of Section 81(1A) of the Companies Act. Partly-paid shares cannot be offered. In-principle approval from a stock exchange should also be obtained. A SEBI-registered merchant banker should manage the IPP and exercise due diligence.
- The offer document should contain all material information specified by the SEBI for disclosure in offer document/abridged prospectus/letter of offer. Simultaneously, with registering the offer document with the ROCs, a copy should also be filed with the SEBI/stock exchange together with the specified fee. It should also be placed on the website of the issuer/stock exchange stating that the offer is only to QIBs. A due diligence in the specified form should be submitted by the merchant banker to the SEBI that all conditions have been complied with.
- The eligible seller should announce a floor price/price band at least one day before the opening of the IPP. Allocation/allotment may be made on **(a)** proportionate/price priority basis, or **(b)** criteria mentioned in the offer document. The allotment method should be disclosed in the offer document and overseen by the stock exchange.
- The promoter/promoter group should not purchase/sell the eligible securities during the 12 weeks **(a)** prior to **(b)** after the date of the IPP. However, subject to a minimum gap

***For details, refer to Khan M.Y., *Indian Financial System*, McGraw Hill Education (India), 2017, Chapter 4.**

of two weeks between two successive offers/programmes, they can offer the securities held by them through IPP/offer for sale through stock exchange mechanism specified by the SEBI. The allocation/allotment of the securities would be subject to the condition that **(i)** at least 25 per cent to mutual funds/insurance companies, the unsubscribed portion being offered to other QIBs, **(ii)** a QIB-promoter/any person related to the promoter (i.e. who has rights **(1)** to appoint any nominee director, **(2)** under a shareholders/visiting agreement), and **(3)** veto rights. The **ASBA** facility would be available for bidding. Bids cannot be revised downward/withdrawn.

- The minimum number of allottees would be ten and a maximum of 25 per cent of the offer size can be allotted to a single allottee. The QIBs belonging to the same group/under same control would be deemed to be a single allottee.
- The aggregate of all the tranches of the IPP of any eligible seller should not result in increase in pubic shareholding by more than 10 per cent and in case of oversubscription, allotment should be restricted to 10 per cent of the offer size.
- The issue can be kept open for a minimum of one day and a maximum of two days. The aggregate demand schedule should be displayed by the stock exchange without disclosing the price. The offer can be withdrawn in case it is not fully subscribed. The allotted securities can be sold by the allottee within one year only on a recognised stock exchange.

Bonus Issues

Subject to the provisions of the Companies Act, a listed issuer may issue bonus shares if it: **(i)** is an authorised by its articles of association, **(ii)** has not defaulted in payment of interest/principal in respect of fixed deposits/debt securities, **(iii)** has sufficient reason to believe that it has not defaulted in the payment of statutory dues of the employees such as contribution to provident fund/gratuity/bonus and **(iv)** has made partly paid-up share fully paid-up.

A bonus issue of equity shares can be made only if reservation is made of shares of the same class in favour of outstanding fully/partly CDIs at the time of the bonus issue in proportion to the convertible part. The reserved shares should be issued at the time of conversion of the CDIs on the same term/portion in which the bonus share was issued.

The bonus issue can be made only out of free reserves built out of genuine profits/securities premium collected in cash only. Bonus shares should not be issued in lieu of dividend.

The bonus issue should be implemented within 15 days from the date of its approval by the Board of Directors of the issuer. It should be implemented within 2 months from the date of the Board of Directors announcing the decision subject to shareholders approval for capitalisation of profits/reserves for bonus issue. Once announced, the decision to make a bonus issue cannot be withdrawn.

Issue of Indian Depository Receipts (IDRs)

The issues of IDRs should conform to **(a)** Companies IDR Rules and
(b) SEBI ICDR regulations.

Companies Issue of Indian Depository Receipts (IDRs) Rules, 2004 The main elements of the IDRs rules are: eligibility, procedure, other conditions, registration documents, condition for issue of prospectus, listing, transfer/redemption, continuous disclosures, distribution of corporate benefits, and penalty.

Eligibility An **IDR** means an instrument in the form of a depository receipt created by a Domestic Depository (DD) in India against the underlying equity shares of the issuing company incorporated outside India. The issuing company of IDRs should satisfy the following conditions: **(i)** Its pre-issued paid-up capital and free reserves are at least US $ 100 million and its has had an average turnover of US $ 500 million during the three preceding years; **(ii)** It has been making profits and declaring a minimum 10 per cent dividend for at least 5 years preceding the issue; **(iii)** Its pre-issue debt equity ratio does not exceed 2:1; and **(iv)** It would fulfill the eligibility criteria prescribed by the SEBI from time to time **(discussed subsequently)**.

Procedure Prior permission from SEBI should be obtained to raise funds in India by issuing IDRs. The application for permission from SEBI should be made at least 90 days before the opening of the issue together with a non-refundable fee of US $ 10,000. The issue fee would be 0.50 per cent of the issue value subject to a minimum of ₹10 lakh for an issue size of upto ₹100 crore and for issue size/value exceeding ₹100 crore, additional 0.25 per cent of the issue value. The issuer should obtain the necessary approvals/exemptions from the appropriate authorities from the country of its incorporation. It should appoint an **Overseas Custodian Bank (OCB)** [i.e. a bank established outside India, acting as a custodian for the equity shares of the issuer against which IDR are being issued by having a custodial arrangement/agreement with the domestic depository or by having a place of business in India], a Domestic Depository (DD) and a merchant banker for the issue of IDRs. It would deliver the underlying equity shares to the OCB who would authorise the DD to issue IDRs. It would file through a merchant banker/DD a due diligence report with the Registrar of Companies (ROCs) and SEBI in the specified form. It would also file with the ROCs and SEBI a prospectus certified by two authorised signatories one of whom should be a whole-time director and other the Chief Accounts Officer (CAO) stating the particulars of the resolution of the Board of Directors approving the issue. The draft prospectus should be filed with the SEBI at least 21 days prior to filing of the prospectus. Any changes suggested by SEBI must be incorporated in the prospectus. The issuer may appoint SEBI-registered underwriters and should obtain in-principle listing permission from stock exchange(s) having nation-wide trading terminals in India.

Other Conditions The ceiling on IDRs by a company in any financial year is 15 per cent of paid-up capital and reserves and they would be denominated in Indian rupees only. The repatriation of the issue proceeds of IDRs would be subject to laws relating to export of foreign exchange.

Registration Documents The merchant banker to the IDR issue should deliver for registration to the SEBI and ROCs the following documents/information: **(i)** instrument constituting/defining the constitution of the issuer, **(ii)** enactments/provisions under/by which the issuer was incorporated together with an attested copy by an officer, **(iii)** address of principal office in India/an address in India where the instrument/enactments/provisions are available for inspection, **(iv)** a certified copy of the certificate of incorporation in the country in which incorporated, and **(v)** copies of agreements between issuer, OCB, DD specifying, *inter-alia*, the rights of the IDR holders. The prospectus to filed with the SEBI/ROCs should contain the prescribed particulars signed by all the whole-time directors and the CAO.

Conditions for the Issue of Prospectus/Application The application form for the securities of the issue should be accompanied by a memorandum containing the salient features of the prospectus except when it is issued in connection with invitation to enter into an underwriting agreement with respect to the IDRs. Any statement by an expert can be circulated/issued/distributed in India/abroad only if his consent to the issue appears on the prospectus.

Listing of IDRs The IDRs should be listed on a recognised stock exchange(s) and they can be purchased/possessed/freely transferred by a person resident in India.

Procedure for Transfer and Redemption A holder may transfer or may ask the DD to redeem the IRDs. In case of redemption, the DD would request the OCB to get the corresponding underlying shares released in favour of the holder of IDRs for being sold on his behalf/transferred in the book of the issuer in the name of holder of IDRs. Nomination facility for IRDs is available. The issued IDRs may be purchased/possessed and transferred by a non-resident person if the issuing company obtains specific approval from the RBI in this regard or complies with any policy/ guidelines issued by the RBI on the subject-matter.

Continuous Disclosure Requirement Every issuing company should comply with such continuous disclosure requirements as may be specified by the SEBI in this behalf.

Distribution of Corporate Benefits The DD should distribute the dividends/other corporate action on the IDRs in proportion to the holdings of IDRs.

Penalty Contravention of these rules by the company/any person for which no punishment is provided in the Companies Act would be punishable with fine upto the amount of the IDR issue and a further fine upto ₹5,000 per day during which the contravention continues.

SEBI ICDR Regulations, 2009 All the provisions of the SEBI ICDR regulations are applicable in case of IDRs excepting the **(i)** disclosure requirements with respect to public/rights issues of specified securities and **(ii)** other specified provisions. The aspects of IDRs discussed here relate to: **(i)** eligibility, **(ii)** conditions for issue of IDRs, **(iii)** minimum subscription, **(iv)** fungibility, **(vi)** filing of draft prospectus/due diligence-certificates/payment of fee/issue advertisement, **(vi)** display of bid data, **(vii)** post-issue reports, **(viii)** unsubscribed issue, **(ix)** and basis of allotment.

Eligibility An issuer of IDRs should **also** satisfy the following: It **(i)** is listed in its **home country** (i.e. the country where it is incorporated/listed), **(ii)** not prohibited to issue securities by a regulatory body and **(iii)** has track record of compliance with securities market regulations in its home country.

Conditions for Issue The conditions for IDR issue are: **(i)** minimum issue size, ₹50 crore, **(ii)** procedure to be followed by each class of applicant should be mentioned in the prospectus, **(iii)** minimum application amount, ₹20,000, **(iv)** at least 50 per cent of the issue should be allotted to QIBs on proportionate basis as per illustration in **Part C of Appendix 7-J on the website**, **(v)** balance 50 per cent may be allotted among categories of non-institutional/retail individual investors including employees at the discretion of the issuer and the manner of allocation should be disclosed in the prospectus; allotment to investors within a category should be on proportionate basis; at least 30 per cent of the IDRs being offered to the public should be allocated to retail individual investors and spill over to the extent of under-subscription in this category would be permitted to others, and **(vi)** there should be only one denomination of the

IDR at a time, **(vii)** the issuing company should ensure that the underlying **(1)** equity shares have been/will be listed in the home country before listing of IDRs, **(2)** shares of IDRs would rank *pari passue* with the existing shares of the same class, **(viii)** the issuing company should ensure that the underlying shares of IDRs would rank *pari passue* with the existing shares of the same class.

Minimum Subscription If the issuer does not receive in a **non-underwritten issue** the minimum subscription of 90 per cent of its offer through the offer document on the date of closure or the subscription level falls below 90 per cent after its closure on account of cheques returned unpaid/ withdrawal of applications, the entire subscription money should be refunded forthwith. Failure to refund within 15 days would be liable to pay 15 per cent interest for the period of delay.

For an **underwritten issue**, the issuer should forthwith refund the entire subscription in case of under-subscription below 90 per cent including devolvement on underwriters with 60 days and with 15 per cent interest for delay beyond 60 days.

Fungibility The DIRs would not b automatically fungible into the underlying shares of the issuing company.

Filing of Offer Document/Due Diligence Certificate, Payment of Fee and Issue Advertisement The issuing company should appoint merchant banker(s) at least one of whom would be lead merchant banker and also appoint other intermediaries in consultation with the lead merchant banker and enter into an agreement with a merchant banker(s) on the lines of the format specified **in Appendix 7-B on the website**. The rights/obligations/responsibilities relating, *inter-alia*, to disclosures/allotment/refund/ underwriting obligations of each merchant banker should be determined/disclosed in the prospectus on the lines of the format specified **in Appendix 7-A on the website**.

It should also file a draft prospectus in a soft copy on the lines specified **in Appendix 7-D on the website** with the SEBI through a merchant banker with the requisite fee as prescribed in Companies Issue of IDRs Rules (**discussed earlier**). The merchant banker should **(i)** submit due diligence certificate in the format given in **Part C of Appendix 7-R on the website** to the SEBI along with the draft prospectus, **(ii)** certify that all amendments/suggestions/observations made by the SEBI have been incorporated in the prospectus, **(iii)** submit a fresh due diligence certificate specified in **Part C of Appendix 7-R on the website** while filing the prospectus with the ROCs, **(iv)** furnish a certificate specified in **Part C of Appendix 7-R on the website** immediately before the opening of the issue, certifying that no corrective action is required on its part and **(v)** furnish a certificate specified in **Part C of Appendix 7-R on the website** after the issue has been opened but before it closes for subscription.

The issuing company should **(a)** make arrangements for mandatory collection centres as specified in **Appendix 7-C on the website**, **(b)** issue an advertisement in one English/Hindi national daily newspaper with wide circulation soon after receiving final observations on the publicly-filed draft prospectus with the SEBI containing the minimum disclosures given in **Part A of Appendix 7-L on the website.**

Agreement with Other Intermediaries The issuing company should **(i)** appoint a registrar and share transfer agent which has connectivity with all depositories, **(ii)** enter into an agreement with overseas custodian bank and domestic depository.

Display of Bid Data The stock exchanges offering online bidding system for book building process should display on their website the data pertaining to the book-built IDR issue in the format specified in **Part B (II) of Appendix 7-J on the website** from the date of opening till at least 3 days after closure of the bids. The issuing company should ensure that the letter of allotment for IDRs are issued simultaneously to all allottees. On failure to issue letters of regret simultaneously, a notice should be issued in the media on the morning following the despatch of the allotment of letters.

Disclosures in Prospectus/Abridged Prospectus The prospectus should contain, in general, all material disclosures which are true/correct/adequate so as to enable the applicants to take an informed investment decision. In particular, the prospectus should contain the disclosures **(a)** specified in Companies Issue of IDR Rules and **(b)** in the manner specified in **Part A of Appendix 7-R on the website**. The abridged prospectus should contain the disclosures specified in **Part B of Appendix 7-R on the website.**

Post-issue Reports The merchant banker should submit to the SEBI **(i)** initial post-issue report on the lines of **Part A of Appendix 7-O on the website** within 3 days of closure of the issue and **(ii)** final post-issue report on the lines of **Part C and D of Appendix 7-O on the website** within 15 days of the finalisation of the basis of allotment/refund of money in case of failure of issue.

Undersubscribed Issue The merchant banker should furnish information in case of under-subscribed issues regarding underwriters who have failed to meet their underwriting devolvement to the SEBI in the format specified **in Appendix 7-P on the website.**

Finalisation of Basis of Allotment The ED/MD of the stock exchange where the IDRs are proposed to be listed along with the post-issue lead merchant banker(s) and registrar to the issue should ensure that the basis of allotment is finalised in a fair and proper manner in accordance with the allotment procedure specified **in Appendix 7-N on the website.**

Rights Issues of IDRs In addition to compliance with the requirements relating to the issue of IDRs discussed above, the listed issuer offering IDR through a rights issue should, at the time of filing the offer document, satisfy the conditions specified below. However, the conditions applicable to the issue of IDRs relating to **(i)** issue size/procedure for application/minimum application amount/reservation for QIBs, **(ii)** display of bid data and **(iii)** disclosure in prospectus/abridged prospectus would not apply in case of their rights issues. The issuer should prepare the offer document in accordance with the home country requirements along with an addendum containing disclosure specified by the SEBI and filed with the SEBI/concerned stock exchange. The applicable conditions are; **(i)** eligibility, **(ii)** renunciation, **(iii)** depository, **(iv)** record date, **(v)** disclosures, **(vi)** filing of offer document, **(vii)** fast track issue, **(viii)** dispatch of abridged letter of offer, **(ix)** period of subscription, **(x)** pre-issue advertisement and **(xi)** utilisation of funds.

- The issues should **(i)** not be in breach of ongoing material obligation under the IDR listing/deposit agreement, **(ii)** apply to the concerned stock exchange(s) for listing of issue and chose one of them as the designated stock exchange;
- Subject to the laws of the home jurisdiction of the issuer, the rights offering would be deemed to include the right of renunciation in favour of any other person and disclosed in the offer document;
- The domestic depository should take the necessary steps to enable the IRD holders to have entitlements under the rights offering and issue additional IDRs, to distribute the rights to

them, arrange for their renunciation/subscription for any additional rights available due to lack of take-up of other holders.

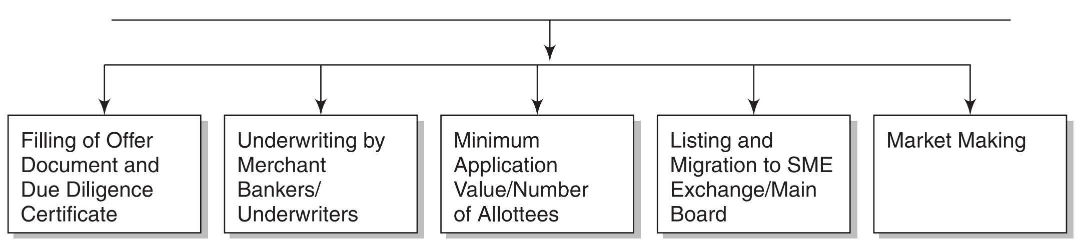
- The issuer should announce a record date for determining the eligible shareholders. Withdrawal of the rights issue after announcing the record date should be notified to **(i)** the SEBI, **(ii)** in one **(a)** English/Hind national and **(b)** regional language daily newspaper with wide circulation at the place of the principal office of the issuer. The issuer would be eligible to apply for IDR offering on a rights basis only after 12 months from the record date.
- The offer document should contain **(i)** disclosures required under the home country regulations, **(ii)** addendum to the offer document containing SEBI-specified disclosures. It should contain all material information which are true/correct/ adequate for informed investment decision.
- A lead merchant banker(s) and other intermediaries should carry out the obligations relating to the issue. The draft offer document and the addendum should be filed with SEBI by the lead merchant banker together with the specified fee. The SEBI may specify changes or issue observations within the later of 30 days or from the following dates, namely, date of receipt of **(i)** the draft offer document/addendum, **(ii)** satisfactory reply on any clarification/additional information by the lead merchant banker, **(iii)** clarification/information sought by the SEBI from any regulator/agency, and **(iv)** a copy of in-principle approval letter from the concerned stock exchange. The revised draft offer should be filed in the light of changes/observations of the SEBI. The issuer should also submit from the overseas custodian/domestic depository an undertaking to comply with their obligations. He should ensure that the concerned compliance officer functions from within the territorial limits of India.
- An issuer, on satisfying the following conditions, can fast track an issue and file the offer document/addendum with the SEBI only for record purposes: **(a)** he is in compliance in all material respects with the provisions of the deposit/listing agreement for at least 3 years immediately preceding the date of its filing, **(b)** the offer document has been filed/ reviewed by the securities regulator in his home country, **(c)** there are no pending show-cause notices/prosecution proceedings against him/promoters/directors on the reference by the SEBI/regulatory authorities in the home country restricting them from accessing the capital market and, **(d)** the issuer has redressed at least 95 per cent of the IRD holders complaints before the end of 3 months immediately preceding the month of date of filing the letter of offer with the designated stock exchange.
- The abridged letter along with the application form should be dispatched through registered/speed post to all the eligible IDR holders at least 3 days before the issue opening date and made available on the website of the issuer with appropriate access restrictions. A hard copy should be made available at the principal office of the issuer/lead merchant banker to the existing IRD holders. Those who have not received the application form can apply in writing on a plain paper to the domestic depository with the requisite application money but they cannot renounce their rights. An application on an application form as well as on plain paper would be liable to be rejected. The issue price and ratio would be decided simultaneously with record date in accordance with the home country regulations.
- The subscription period would in case be less than 10 days.

- The pre-issue advertisement should be made in at least **(i)** one English/Hindi national daily newspaper with wide circulation and **(ii)** on regional language daily with wide circulation at the place of the principal office of the issuer in India at least 3 days before the issue opening. It should disclose the following: **(i)** date of completion of dispatch of the abridged letter of offer/application form, **(ii)** centres other than the principal office of the issuer in India where the eligible IDR holders may obtain duplicate copies of application form, **(iii)** statement that they can make application in writing on a plain paper to subscribe to the issue together with the format to make such application, **(iv)** statement that the application can be directly sent together with the application money to the designated official at the given address, and **(v)** statement to the effect that application made simultaneously on plain paper and application form would be rejected at the option of the issuer.
- The issuer can utilise the funds only upon completion of the allotment process.

Issue of Specified Securities by Small and Medium Enterprises (SMEs)

This Section describes the capital issue procedure of issuer whose post-issue face value capital does not exceed ₹10 crore. Issuers whose post-issue face value capital is between ₹10–25 crore may also use this procedure. The provisions of the SEBI's Issue of Capital and Disclosure Requirements (ICDR) Regulations **discussed in earlier sections of this chapter** would *mutatis mutandis* apply to such issues in respect of matters not specified by the procedure described in this Section. However, the provisions of the ICDR Regulations specified below would not apply to them: **(i)** Minimum subscription value (**Regulation 49**), **(ii)** Conditions for further public offer (**27**); **(iii)** Conditions for IPO (**26**); **(iv)** Reference date (**25**); **(v)** Fast track issues (**10**); **(vi)** Draft offer document made public (**9**); **(vii)** Documents to be submitted before opening of the issue (**8**); **(viii)** In-principle approval from recognised stock exchange (**7**); and **(ix)** Filing of offer document (**Regulation 6**). The main elements of the issue procedure by the SMEs: **(i)** filing of offer document and due diligence certificate, **(ii)** underwriting by merchant bankers and underwrites, **(iii)** minimum application value/minimum number of allottees, **(iv)** listing of specified securities, migration to SME exchange/main board and **(v)** market making are portrayed in **Exhibit 7.6**.

Exhibit 7.6 Issue of Specified Securities by Small and Medium Enterprises (SMEs)



Filing of Offer Document and Due Diligence Certificate The SME-issuer making a public/rights issue of specified securities should not file the draft offer document with the SEBI. A copy of the offer document should be filed with the SEBI through a merchant banker simultaneously with the filing of the prospectus with the **SME exchange** (i.e. a trading platform of a recognised stock exchange having nationwide trading terminals permitted by the SEBI to list the specified securities issued by SMEs and including a stock exchange granted recognition for this purpose but does not include the Main Board) and the ROCs or letter of offer with SME Exchange. **Main Board** means a recognised stock exchange having nationwide trading terminals other than SME exchange. Moreover, the SEBI would not issue any observation on the offer document. The merchant banker should submit a due diligence certificate in the prescribed format including the specified addition confirmation along with the offer document to the SEBI **in Form H of Appendix 7-E on the website**. The offer document should be displayed from the date of filing on the website of the SEBI/issuer/merchant banker/the SME exchange where the securities are proposed to be listed.

Underwriting by Merchant Bankers/Underwriters The **entire** issue (and not restricted to the minimum subscription level) should be underwritten. At least 15 per cent of the issue size should be underwritten by the merchant banker(s) on his/their own account(s). The issuer in consultation with the merchant banker may appoint SEBI-registered underwriters. The merchant banker may enter into an agreement with a **nominated investor** indicating the number of securities which they agree to subscribe at issue price in case of undersubscription. A **nominated investor** means a QIB/private equity fund (i.e. a fund registered with any regulatory authority or a fund established by any person registered with any regulatory authority) who enters into an agreement with the merchant banker to subscribe to the issue in case of undersubscription or to receive/deliver the securities in the market making process. The merchant banker would fulfil the underwriting obligation in case of failure of other underwriters/nominated investors to fulfil their underwriting/subscription obligations. The underwriters/nominated investors cannot subscribe to the issue in any manner other than fulfilling their obligations under their respective agreements in this regard. All the underwriting/subscription arrangements should be disclosed in the offer document. An undertaking to the effect that the issue has been 100 per cent underwritten along with the list of underwriters/nominated investors should be filed by the merchant banker with the SEBI one day before the opening of the issue.

Minimum Application Value/Number of Allottees The minimum size would be ₹1 lakh per application and should be disclosed in the offer document. The minimum number of prospective allottees is 50.

Listing and Migration to SME Exchange/Main Board The specified securities would be listed on SME exchange. Securities of the issuer listed on any other stock exchange would have to migrate on the SME exchange. A listed issuer whose post-issue face value capital is less than ₹25 crore may migrate its securities to the SME exchange if its non-promoter shareholders approve it by a special resolution with a two-thirds majority. Similarly, such an issuer may migrate its securities from an SME exchange to the main board. Where the post-issue face value capital of an issuer listed on SME exchange is likely to exceed ₹25 crore by virtue of further issues of capital by way of rights/preferential/bonus issue(s), the issuer should migrate such listed securities to, and seek their listing on, the Main Board. He would be able to make further issues of capital only if **(i)** the non-promoter shareholders approve by a two-thirds majority in a special resolution through postal ballot and **(ii)** in-principle approval from the Main Board is obtained for listing of the entire securities.

Market Making The merchant banker should ensure compulsory market making through the SME exchange brokers in the manner specified by the SEBI for at least three years from the date of **(i)** listing of the securities on the SME exchange or **(ii)** migration from the main board. He should also enter into an agreement with nominated investors for receiving/delivering the securities in the market making subject to the SME exchange's prior approval. The details of the market making arrangement should be disclosed in the offer document. Such securities may be transferred to, or from, the concerned nominated investor. The minimum inventory of the market maker on the date of allotment should be 5 per cent of the securities proposed to be listed. The market maker should buy the entire holding in one lot of a shareholder whose holding is less than the minimum contract size for trading but he cannot sell in lots less than the minimum contract size. Moreover, he cannot buy shares from the promoter(s)/persons belonging to the promote group of the issuer or any person who has acquired shares from them during the compulsory market making period. Similarly, the promoters holding would not be eligible for offering to the market maker. However, such holding which is not locked-in can be traded with the prior permission of the SME exchange in a manner specified by the SEBI. Subject to arrangement with the issuer, the merchant banker responsible for market making may be represented on the Board of the issuer.

Directions by SEBI

Subject to the power under Sections 11, 11-A/B/D, 12(3), 24 and Chapter VI-A of the SEBI Act and Section 621 of the Companies Act, the SEBI may either *suo motu* or on receipt of information/completion/pendency of an inspection/inquiry/investigation, in the interest of investors/securities market issue directions/orders it deems fit including **(i)** directing the person concerned not to access the securities market for a specified period/to sell or divest the securities, **(ii)** any other direction which it may deem fit/proper in the circumstances of the case.

Listing on Institutional Trading Platform The provisions discussed below apply to entities which seek listing of their specified securities exclusively on the institutional trading platform either pursuant to a public issue or otherwise. The SEBI regulations in respect of the matters not specifically dealt or excluded below would apply *mutatis mutandis* to any listing of these specified securities. The **institutional trading platform** means the trading platform for listing/trading of specified securities of **(a)** an entity which is intensive in the use of technology, information technology, intellectual property, data analytics, bio-technology or nano-technology to provide products, services or business platforms with substantial value addition and at least 25 per cent of its pre-issue capital is held by qualified institutional buyer(s), **(b)** any other entry in which at least 50 per cent of the pre-issue capital is held by qualified institutional buyers as on the date of filing of draft information/offer document with the SEBI. No person, individually/collectively with persons acting in concert, should hold 25 per cent or more of the post-issue share capital in the entity. The main elements of the SEBI regulations **(i)** listing without/with public issue, **(ii)** lock-in, **(iii)** trading lot, **(iv)** exit and **(v)** migration to main board are discussed below.

Listing Without Public Issue The entity seeking listing of its specified securities without making a public issue should file a draft information document along with the necessary documents with the SEBI along with the specified fee. The draft information document should contain the specified disclosure. The regulations relating to the following would not be applicable in case of listing without public issue: **(i)** allotment, **(ii)** issue opening/closing, **(iii)** advertisement, **(iv)** underwriting, **(v)** the stipulation relating to initial public offer, if there are outstanding convertible securities/any other right entitling any person to receive equity shares, **(vi)** pricing, **(vii)** dispatch of issue material, and **(viii)** and other such provisions related to offer of specified securities to public. The entity should obtain in-principle approval from and list its securities on the recognised stock exchange(s) within 30 days from the **(a)** date of issuance of observations by the SEBI, **(b)** expiry of the stipulated period if the SEBI has not issued any observation. The provisions relating to minimum public shareholding would not apply to these entities. The draft and final information document should be approved by the Board of Directors of the entity and signed by all the directors, the chief executive officer, that is, the managing director/manager and the chief financial officer, that is, the whole-time finance director or any other person heading the finance function and discharging that function. The signatories should also certify that all disclosures made in the information document are true and correct. In case of mis-statement in the information document or any omission, any person who has authorised the issue of information document would be liable in accordance with the provisions of the SEBI Act/regulations.

Listing Pursuant to Public Issue An entity seeking issue and listing of its specified securities should file a draft offer document along with the necessary documents with the SEBI along with the specified fees. The minimum application size should be ₹10 lakh and the number of allottees should be more than 200. The allocation in the net offer to public category should be 75 per cent to institutional investors (without specific allocation for anchor investors), 25 per cent to non-institutional investors. **Institutional investor** means QIBs, family trust, RBI-registered systematically important NBFCs, SEBI-registered intermediaries with minimum networth of ₹500 crore. Any under-subscription in the non-institutional investor category would be available for subscription under the institutional category. The allotment to institutional investors may be on a discretionary basis whereas the allotment to non-institutional investors should be on a proportionate basis. The mode of allotment to institutional investor (whether discretionary or proportionate) should be disclosed prior to or at the time of filing of the red-herring prospectus. In case of discretionary allotment, no institutional investor should be allotted more than 10 per cent of the issue size. The offer document should disclose the broad objects of the issue. The basis of issue price may include disclosures, except projections, as deemed fit by the issuers in order to enable investors to take informed decisions and the disclosures should suitably caution the investors about the basis of valuation.

Lock-in The entire pre-issue capital of the shareholders should be locked-in for 6 months from the date of allotment in case of listing pursuant to public issue or date of listing in case of listing without public notice. The specified securities held by promoters and locked-in may be pledged with any bank/public financial institution as collateral security for loan if the pledge of the specified securities is one of the terms of sanction of the loan. The locked-in securities may be transferrable in accordance with the SEBI regulations. All specified allotted on a discretionary basis should be locked-in in accordance with the specified requirements for lock-in by anchor investor on the main board of the stock exchange.

Trading Lot The minimum trading log would be ₹10 lakh.

Exit of Entities Listed Without Making a Public Issue The entity whose specified securities are listed on the institutional trading platform without making a public issue may exit from that platform, if **(a)** it is approved by its shareholders by passing a special resolution through postal ballot where 90 per cent of the total votes and the majority of non-promoter votes have been cast in favour of such proposal and **(b)** the recognised stock exchange approves of such an exit. The recognised stock exchange may delist the specified securities upon non-compliance of the conditions of listing and in the specified manner. No delisted entity promoted by promoters and directors would be permitted to list on institutional trading platform for 5 years from the date of delisting.

Migration to Main Board An entity that has listed its specified securities on institutional trading platform may at its option migrate to the main board after three years from the date of listing subject to compliance with the eligibility requirements of the concerned stock exchange.

Listing of Securities on Stock Exchanges The main elements of the regulation are: in-principle approval, application for listing, listing agreement and obligation of stock exchanges.

In-principle Approval of Recognised Stock Exchange(s) The issuer/issuing company should obtain in-principle approval **(a)** in case of an initial public offer/an issue of IDRs from all the recognised stock exchange(s) on which the specified securities are proposed to be listed and **(b)** in case of other issues, before issuance of further securities where they are **(i)** listed only on recognised stock exchange(s) having nationwide trading terminals, from all such stock exchange(s), **(ii)** not listed on any recognised stock exchange having nationwide trading terminals, from all the stock exchange(s) on which they are proposed to be listed, **(iii)** listed on recognised stock exchange(s) having nationwide trading terminals as well as on the recognised stock exchange(s) not having nationwide trading terminals, from all recognised stock exchange(s) having nationwide trading terminals.

Application for Listing The issuer/issuing company should complete the pre-listing formalities within the SEBI-specified time lines. It should make an application for listing within 20 days from the date of allotment, to recognised stock exchange(s) along with the documents specified by them, failing which it should pay penal interest to allottees for each day of delay at the rate of atleast 10 per cent per annum from the expiry of 30 days from date of allotment till the listing of securities to the allotees. In the event of non-receipt of listing permission from the stock exchange(s), or withdrawal of observation letter issued by the SEBI, the securities would not be eligible for listing and the issuer/issuing company would be liable to refund the subscription monies, to the respective allotees immediately alongwith interest at the rate of 10 per cent per annum from the date of allotment.

Listing Agreement Every issuer/issuing company desirous of listing its securities should execute a listing agreement with the recognised stock exchange.

Obligation of Stock Exchange(s) The stock exchange(s) should grant in-principle approval/list the securities or reject the application for in-principle approval/listing by the issuer/issuing company within 30 days from the later of the date of receipt of **(i)** application for in-principle approval/listing, **(ii)** satisfactory reply from the issuer/issuing company, in cases where the stock exchange(s) has sought any clarification from them.

Directions by the SEBI The SEBI may either *suo moto* or on receipt of information or on completion of any inspection, inquiry or investigation, in the interest of investors or the securities market, issue such directions or orders as it deems fit including any or all of the following: directing the persons concerned not to **(a)** access the securities market for a specified period, **(b)** to sell or divest the securities, **(c)** any other direction which it deems fit and proper in the circumstances of the case.

SEBI ISSUE AND LISTING OF DEBT SECURITIES REGULATION 2008

These regulations are applicable to **(i)** public issues of debt securities and **(ii)** listing of debt securities through public offer or on private placement basis on a recognised stock exchange. **Debt securities** means non-convertible securities which create/acknowledge indebtedness and include debentures/bonds and other securities of a body corporate/any statutory body constituted by virtue of a legislation, whether constituting a charge on its assets but excludes **(i)** bonds issued by Government/other bodies specified by the SEBI, **(ii)** security receipts and **(iii)** securitised debt instruments. **Public issue** means an offer/invitation by a issuer to public to subscribe to debt securities. **Private placement** is an offer/invitation to less than 50 persons to subscribe to debt securities. **Recognised stock exchange** means a stock exchange which is recognised by the SEBI under the provisions of the Securities Contracts (Regulation) Act. The main elements of the regulations **(i)** issue requirements for public issues, **(ii)** listing of debt instruments, **(iii)** conditions for continuous listing and trading, **(iv)** obligations of intermediaries and issuers, **(v)** procedure for action for violation and **(vi)** miscellaneous are discussed in this Section.

Issue Requirements for Public Issues

Any **issuer** (i.e., a company/public sector undertaking/statutory corporation which **(i)** makes/proposes to make an issue of debt securities, **(ii)** has listed/seeks to list its securities on a recognised stock exchange) cannot make public issue of debt securities if on the date of filing of draft/final offer document, the issuer/persons in control of the issuer/its promoter **(a)** has been restrained/prohibited/debarred by the SEBI from accessing the securities market/dealing in securities, **(b)** is a willful defaulter/is in default of payment of interest/repayment of principal in respect of debt securities issued to public for more than 6 months. **Offer document** means prospectus and includes any such document/**advertisement** (i.e. notices/brochures/pamphlets/circulars/ show cards/catalogues/hoardings/placards/ postcards/insertions in newspaper/pictures/films/cover pages of offer documents or any other print media/radio/television programme through any electronic medium), whereby subscription to debt securities are invited from the public. To make a public issue of such securities, the following condition must be satisfied on the date of filing of draft/final offer document. It has: **(a)** made an application to a recognised stock exchange(s) for their listing, one of which would be chosen as the designated stock exchange for the particular issue; **(b)** obtained in-principle approval for their listing; **(c)** obtained credit rating from at least one SEBI-registered credit agency which should be disclosed in the offer document. All the ratings including the unaccepted ratings must also be disclosed in the offer document; and **(d)** entered into an arrangement with a SEBI-registered depository for their dematerialisation.

The issuer should appoint **(1)** SEBI-registered merchant bankers at least one of whom would be the lead manager, **(2)** debenture trustees, and **(3)** not issue debt securities to provide loan to, acquisition of shares of, any person who is part of the same group/under the same management.

Disclosures in/Filing of Offer Document The offer document should contain all **material** (i.e. anything likely to impact investors investment decision) disclosures necessary for subscribers to take an informed investment decision. The issuer/lead merchant banker should ensure that it contains the following:

- Disclosures specified in Schedule II of the Companies Act;
- Disclosures/additional disclosures specified by the SEBI.

A draft offer document should be filed with the designated stock exchange (DSE) through the lead merchant banker. It should be made public by posting on the website of the DSE for public comments for 7 days. It may also be displayed on the website of the issuer/merchant banker/stock exchange(s) where the securities are proposed to be listed. The lead merchant banker should ensure that **(i)** it clearly specifies the names and contact particulars of the compliance officer of the merchant banker/issuer, **(ii)** all comments received are suitably addressed prior to its filing with the Registrar of Companies (ROCs). A copy of the draft/final offer document should also be forwarded to the SEBI for its records. Prior to filing the offer document with the ROCs, the merchant banker should furnish to the SEBI a due diligence certificate. The debenture trustees should, prior to the opening of the issue, furnish to the SEBI a due diligence certificate. The draft/final offer document should be displayed on the website of stock exchanges. It should be filed with the designated stock exchange, and the ROCs simultaneously for dissemination on the website before the opening of the issue. If required, a physical copy of the offer document should be made available to any person.

Advertisement for Public Issues The issuer should make an advertisement in a national daily with wide circulation on/before the issue opening date containing the specified disclosures. The advertisement should **(i)** not be misleading in material particular/contain information in a distorted manner or which is manipulative/deceptive, **(ii)** be truthful/fair/clean and not contain an untrue/misleading statement/promise/forecast, **(iii)** not contain any extraneous matters to the contents of the offer document, and **(iv)** urge the investors to invest only on the basis of the information contained in the offer document. Any corporate/product advertisement during the subscription period should not make any reference to the issue or be used for solicitation.

Abridged Prospectus/Application Forms The issuer/lead merchant banker should ensure that **(1)** every application form is accompanied by a copy of the abridged prospectus which should not contain extraneous mattes and **(2)** adequate space would be provided in the application form to enable the investors to fill in various details. The facility for subscription of application in electronic mode may be provided. The issue through the on-line system of the DSE should comply with the relevant applicable requirements as may be specified by the SEBI.

Price Discovery Through Book Building The issuer may determine the price of the securities in consultation with the lead merchant banker. It may be a fixed price or may be determined through book building process in accordance with procedure specified by the SEBI. **Book building** means a process undertaken prior to filing of prospectus with the ROCs by means of circulation of a notice/circulars/advertisement/other document by which the demand for the securities proposed to be issued is elicited and their price and quantity is assessed.

Minimum Subscription The amount of minimum subscription sought to be raised should be disclosed in the offer document. If the minimum subscription is not received, all application money received should be refunded forthwith to the applicants.

Allotment of Securities/Payment of Interest The debt securities offered to the public should be allotted/application money refunded within 30 days of the closure of the issue failing which the issuer should undertake to pay 15 per cent interest per annum. The demat account of allottees should be credited within two working days from the date of allotment.

Underwriting The issue may be undertaken by SEBI-registered underwriter(s). Adequate disclosures regarding the underwriting arrangement should be made in the offer document.

Prohibition of Mis-Statement The offer document should not omit disclosure of any material facts which may make the statement misleading. The offer document/abridged prospectus/any advertisement should not contain any false/misleading statement.

Trust Deed A trust deed securing the issue of debt securities should be executed in favour of the debenture trustees within 3 months of the closure of the issue. It should contain the clauses prescribed under Section 117-A of the Companies Act and those mentioned in the SEBI Debenture Trustees Regulation (**discussed in Chapter 6**). Moreover, it should not contain clauses which have the effect of **(i)** limiting/extinguishing the obligations/liabilities of trustees/issuer(s) in relation to right(s)/interest(s) of the investors, **(ii)** limiting/restricting/waiving the provisions of the SEBI Act/these regulations and circulars/guidelines issued by the SEBI, **(iii)** indemnifying the trustees/issuer(s) for loss/damage caused by their act of negligence/commission/omission.

Debenture Redemption Reserve (DRR) The issuer should create a DRR in accordance with the provisions of the Companies Act and circulars issued by the Government. Any distribution of dividend would require the approval of the trustees if the issue has defaulted in payment of **(i)** interest, **(ii)** redemption, **(iii)** creation of security.

Creation of Security The proposal to create a charge/security in respect of the debt securities should be disclosed in the offer document along with its implications. The issuer should give an undertaking that the assets in which charge is created are free from any encumbrances and if they are already charged to secure a debt, the permission/ consent to create second or ***pari passu*** charge on the assets have been obtained from the earlier creditor(s). The issue proceeds should be kept in an escrow account until the documents for creation of security are executed.

Right to Recall/Redeem Prior to Maturity The issuer may **(i)** recall the debt securities at his call option, **(ii)** provide right of (put) redemption to all/**retail investors** (i.e. holders of securities upto ₹2 lakh) at their option prior to maturity date. The right to recall/redeem should be exercised in terms of the issue and detailed disclosures in the offer document including date, period of exercise (at least 3 working days), and redemption amount including premium/discount. These rights may be exercised with respect to all/a part of the securities held/issued. The partial exercise should be done on proportionate basis only. The rights would be exercisable after 24 months from date of their issue. The issuer should **(i)** send a notice to all eligible holders at least 21 days before the exercise date, **(ii)** provide a copy of the notice to the concerned stock exchange for wider dissemination and advertise in a national daily having wide circulation indicating details of the rights and eligibility of the entitled holders, **(iii)** pay the redemption proceeds to the investors with interest due within 15 days from the last date within which the right can be exercised and **(iv)** pay 15 per cent interest for the period of delay. After the completion of the exercise, the issuer should submit a detailed report to the stock exchange regarding the redeemed securities and their redemption.

Redemption and Roll-Over The securities should be redeemed in terms of the offer document. Their rollover would require a special resolution of their holders and 21-days notice to them. The notice should contain disclosures with regard to credit rating and rationale for the roll-over. The issuer should, prior to sending the notice to the securityholders, file a copy of it and proposed resolution with the concerned stock exchange for dissemination to the public on its website. The roll-over would be subject to the following: **(i)** approval by a special resolution passed through postal ballot having consent of at least 75 per cent of the secuirtyholders, **(ii)** at least one rating within 6 months prior to the date of redemption, **(iii)** execution of a fresh trust deed at the time of the roll-over or the existing trust deed may continue if it has provision to this effect and **(iv)** creation/maintenance of adequate security in respect of securities to be rolled-over. The securities of all the securityholders who have not given their positive consent should be redeemed.

Listing of Debt Securities

The SEBI requirements relating to listing of debt securities are as follows:

Mandatory Listing The issuer of debt securities to the public should make an application for listing to a recognised stock exchange(s). It should comply with the conditions of listing as specified in the listing agreement with the concerned stock exchange. For listing of debt securities issued on private basis, the issuer should forward the listing application along with the specified disclosures to the concerned stock exchange within 15 days from the date of their allotment. The issuer should execute an agreement with the stock exchange. The conditions of listing of securities issued on a private placement basis on a recognised stock exchange are as follows: The issues is in compliance with the provisions of the Companies Act/rules and other applicable laws; credit rating has been obtained from at least one SEBI registered agency; the securities are listed in demat form; and the specified disclosures have been made.

The issuer should comply with the conditions of listing as specified in the listing agreement with the concerned stock exchange.

Consolidation/Re-issue An issuer may carry out consolidation/re-issuance of its debt securities if **(i)** the articles contain and enabling provision, **(ii)** the issue is through private placement, **(iii)** fresh credit has been obtained for re-issuance to be revalidated periodically disclosing any changes and **(iv)** appropriate disclosures are made in the term sheet.

Disclosures in Respect of Private Placements The issuer should make the specified disclosures in a disclosure document. These should be made on the website of the concerned stock exchange. The issuer may file a shelf disclosure document containing the specified disclosures. While making subsequent private placement within 180 days from its filing, filing disclosure document would not be required.

Relaxation of Rule 19 Securities Contracts (Regulation) Rules The SEBI has relaxed the strict enforcement of the rules relating to **(i)** the documents to be forwarded along with the application to the stock exchange for listing and the conditions precedent to listing relating to listing of debt securities by way of public issue/private placement [Rules 19 **(1) and (3)**] and **(ii)** minimum amount of public offer **[Rule (19)(b)]** in relation to listing of debt securities **(a)** by way of private placement and, **(b)** issued to public by an infrastructure company/ Government company/a statutory authority/corporation/any special purpose vehicles set up by any of the them which is engaged in infrastructure sector.

Conditions for Continuous Listing/Trading of Debt Securities

The conditions are listed below.

Continuous Listing All the issuers making public issue of debt securities/seeking their listing issued on a private placement basis should comply with the conditions of listing specified in the respective listing agreement(s).

Trading The debt securities issued to public or on a private placement basis should be traded and such trades should be cleared/settled in recognised stock exchanges subject to conditions specified by the SEBI. In case of securities made over-the-counter, the trades should be reported on a recognised stock exchange having a nationwide trading terminal/other platform specified by the SEBI. The SEBI may specify conditions for reporting of all such trades.

Obligations of Intermediaries/Issuers

The obligations of the debenture trustees/issuers/lead merchant bankers are listed below:

Debenture Trustee They should

- Be vested with the requisite powers for protecting the interests of the securityholders including the right of a nominee director on the Board of Directors of the issuer in consultation with the institutional secuirtyholders;
- Carry out their duties and perform their functions under the regulations/the SEBI Debenture Trustee Regulations/trust deed/offer document with due care, diligence and loyalty;
- Ensure disclosure of all material events on an ongoing basis; and
- Supervise the implementation of the conditions regarding creation of security and debenture redemption reserve.

Issuer/Lead Merchant Banker The issuer should disclose all the material facts in the offer document and ensure that all the disclosures are true, fair and adequate and there is no misleading/untrue statement/misstatement. The merchant banker should verify and confirm that such disclosures are true, fair, adequate and ensure that the issuer is in compliance with the regulations as well as transactions specific required disclosures and the Companies Act. The issuer should treat the applicants in a fair and equitable manner as per the SEBI-specified procedures. The intermediaries would be responsible for the due diligence in respect of assignments undertaken by them in respect of the issue, offer and distribution of securities to the public. No person should employ any device/scheme/artifice to defraud in connection with the issue/subscription/distribution of securities which are listed/proposed to be listed. The issuer and the merchant banker should ensure that the security created is adequate to ensure 100 per cent asset cover for the debt securities.

Action in Case of Violation of Regulations

Inspection by SEBI The SEBI may *suo moto* or upon information received by it, appoint a person(s) to undertake the inspection of books of account/records/documents of the issuer/merchant banker/other intermediary associated with the issue/disclosure/listing of securities for any of the following purposes:

- To verify where the **(i)** provisions of the SEBI Act/Securities Contracts (Regulation) Act/Depositories Act and the rules/regulations, **(ii)** requirement specified in these regulations in respect of issue of securities, and **(iii)** requirement of listing conditions and continuous disclosure has been complied with;

- To inquire into **(i)** the complaints received from the investors/other market participants/ any other person on any matter of issue/transfer of securities, **(ii)** the affairs of the issuer in the interest of the investor protection or the integrity of the market, **(iii)** whether any direction issued by the SEBI has been complied with.

While undertaking an inspection, the inspecting authority/SEBI should follow the SEBI specified procedure for inspection of intermediaries.

Directions by SEBI The SEBI may *suo moto* on receipt of information on completion or pendency of inspection, in the interests of the securities market, issue/pass such directions as it may deem fit including the following:

- Direct the issuer to refund the application money,
- Direct the person concerned not to **(i)** further deal in securities in any particular manner, **(ii)** access the securities market for a particular period,
- Restraint the issuer/promoters/directors from making further issues of capital,
- Direct the person concerned to sell/divest the securities,
- Direct the issuer/depository not to give effect/transfer or further freeze of transfer of securities.
- Any other direction which the SEBI may deem fit and proper in the circumstances of the case.

Appeal Any person aggrieved by an order of the SEBI/Adjudicating Officer under the SEBI Act/ these regulations may prefer an appeal to the Securities Appellate Tribunal (SAT).

Power of SEBI to Issue General Order/Circular

The SEBI may by a general/specific order/circular specify any conditions/requirements in respect of issue of debt securities. In particular, they may provide for the following matters: **(i)** Electronic issuances and other procedures including the procedure for price discovery, **(ii)** Conditions governing trading/reporting/clearing and settlement of trade and **(iii)** Listing conditions. In case of a special order, the affected person should be given an opportunity to represent his case.

ISSUE AND LISTING OF NON-CONVERTIBLE REDEEMABLE PREFERENCE SHARES (NCRPSs) 2013

These regulations apply to **(i)** public issue of NCRPSs, **(ii)** listing of NCRPSs issued by public companies through public issue/on private placement basis and **(iii)** issue/listing of perpetual non-cumulative preference shares (PNPSs) and perpetual debt instruments (PDIs) issued by banks on private placement basis in compliance with the RBI guidelines. The main elements of the regulations are: issue requirements for public issues, listing of NCRPSs, conditions for their continuous listing/trading, obligations of intermediaries/issuers, issue/listing of non-equity regulatory capital instruments by banks and miscellaneous.

Issue Requirements for Public Issues

The issue requirements for public issue are: general conditions, disclosures in the offer document, filing of draft offer document, mode of disclosure, advertisements, electronics issuances, price discovery through book building, redemption, minimum subscription, underwriting and prohibition of mis-statements in offer document.

General Conditions No issuer can make any public issue of NCRPSs if as on date of filing of draft/final offer document, the issuer/promoter **(i)** has been restrained/ prohibited/debarred by the SEBI from accessing the securities market/dealing in securities, **(ii)** is a willful defaulter or is in default of payment of interest/repayment of principal for more than 6 months and the following conditions are satisfied: It has **(a)** made an application to one/more stock exchange for listing of securities. Where the application is made to more than one stock exchange, the issuer should choose one of them as the designated stock exchange. Where any of such stock exchanges have notionwide trading terminals, the issuer should choose one of them as the designated stock exchange; **(b)** obtained in-principle approval for listing; **(c)** obtained a credit rating from at least one SEBI-registered credit rating agency and disclosed in the offer document. Where credit ratings are obtained from more than one credit rating agency, all the ratings, including the unaccepted ratings, should be disclosed; **(d)** entered into an arrangement with a SEBI-registered depository for dematerialisation of the NCRPSs proposed to be issued to the public; **(e)** the minimum tenure of the NCRPSs should not be less than three years; and **(f)** the issue has been assigned a rating of not less than "**AA**" or equivalent.

The issuer should create a capital redemption reserve in accordance with the provisions of the Companies Act. The issue should not be for providing loan to or acquisition of shares of any person who is part of the same group or who is under the same management other than to subsidiaries of the issuer. The issuer should appoint merchant bankers at least one of whom should be a lead merchant banker.

Disclosures in the Offer Document The offer document should contain all **material disclosures** (i.e. **Material disclosures** anything which is likely to impact an investor's investment decision), which are necessary for the subscribers to take an informed investment decision. The issuer and the lead merchant banker should ensure that it contains the specified disclosures in the Companies Act and SEBI regulations.

Filing of Draft Offer Document A draft offer document should be filed with the designated stock exchange through the lead merchant banker and made public by posting the same on its website for seeking public comments for 7 working days from the date of its filing. It may also be displayed on the website of the issuer, merchant banker and the concerned stock exchanges.

The lead merchant banker should ensure that the draft offer document clearly specifies the names and contact particulars of its compliance officer and the issuer including the postal and *e-mail* address, telephone and fax numbers and all comments received on the draft offer document are suitably addressed prior to the filing of the offer document with the Registrar of Companies (ROCs). A copy of draft and final offer document should also be forwarded to the SEBI for its records along with specified fee simultaneously with filing of these documents with stock exchange. The non-refundable fee for public issues and private placements is 0.0025 per cent and 0.00025 per cent respectively of the issue size. The lead merchant banker should, prior to filing of the offer document with the ROCs furnish to the SEBI a due diligence certificate.

Mode of Disclosure of Offer Document The draft and final offer document should be displayed on the websites of stock exchange simultaneously with filing with the ROCs, for dissemination on its website prior to the opening of the issue. A physical copy of the offer document should be provided to any person on request by the issuer/lead merchant banker.

Advertisement for Public Issue The issuer should make an advertisement in one English national daily newspaper and one Hindi national daily newspaper with wide circulation at the place where the registered office of the issuer is situated, on or before the issue opening date containing, among others, the SEBI- specified disclosures. No issuer should issue an advertisement which is misleading in material particulars or which contains any information in a distorted manner or which is manipulative or deceptive. The advertisement should be truthful, fair and clear and not contain a statement, promise or forecast which is untrue or misleading. The credit rating should be prominently displayed in the advertisement. It should not contain any matters which are extraneous to the contents of the offer document and urge the investors only on the basis of information contained in the offer document. Any corporate or product advertisement issued by the issuer during the subscription period should not make any reference to the issue of NCRPSs or be used for solicitation.

Abridged Prospectus and Application Forms The issuer and lead merchant banker should ensure that: **(a)** every application form issued by the issuer is accompanied by a copy of the abridged prospectus. It should not contain matters which are extraneous to the contents of the prospectus. Adequate space should be provided in the application form to enable the investors to fill the in various details like name, address, etc. The issuer may provide the facility for subscription of application in electronic mode.

Price Discovery Through Book Building The issuer may determine the price of NCRPSs in consultation with the lead merchant bankers and the issue may be at fixed price or the price may be determined throughout book building process.

Redemption The issuer should redeem the NCRPSs in terms of the offer document.

Minimum Subscription The issuer may decide the amount of minimum subscription which it seeks to raise by public issue of NCRPSs in accordance with the provisions of Companies Act, and disclose the same in the offer document. In the event of non-receipt of minimum subscription, all application moneys received should be refunded forthwithstanding to the applicants. In the event of the application monies are refunded beyond eight days from the last day of the offer, such amount should be refunded together with interest at such rate as may be set out in the offer document but in no case be less than 15 per cent per annum.

Underwriting A public issue of NCRPSs may be underwritten and adequate disclosures regarding underwriting arrangements should be made in the offer document.

Prohibition of Mis-statements in the Offer Document The offer document should not omit disclosure of any material fact which may make the statement misleading. The offer document or abridged prospectus or any advertisement issued in connection with a public should not contain any false or misleading statement.

Mandatory Listing of Non-Convertible Redeemable Preference Shares (NCRPSs)

An issuer of NCRPSs to the public should make an application for listing and comply with conditions of listing as specified in the listing agreement with the concerned stock exchange.

An issuer of NCRPSs on private placement basis should forward the SEBI-specified disclosures to the recognised stock exchange within fifteen days from the date of their allotment. The listing of NCRPSs issued by way of private placement would be subject to the following conditions:

(a) the issue is in compliance with the provisions of the Companies Act/rules and other applicable laws; **(b)** credit rating has been obtained from at least one SEBI-registered credit rating agency. Where credit ratings are obtained from more than one credit trading agencies, all the ratings should be disclosed in the offer document; **(c)** the NCRPSs are in dematerialised form; **(d)** the specified disclosure (**discussed later**) have been made; **(e)** the minimum application size for each investor is not less than ₹10 lakh; **(f)** the issue is in compliance with requirements pertaining to creation of capital redemption reserve and prohibition on loan to/acquisition of shares of a group entity (**discussed earlier**), and **(g)** where the application is made in more than one stock exchange, the issuer should choose one of them as the designated stock exchange.

The issuer should comply with conditions of the listing as specified in the listing agreement with the concerned stock exchange. The designated stock exchange should collect a regulatory fee from the issuer at the time of listing of NCRPSs issued on private placement basis. The issuer making a private placement of NCRPSs should also make the specified disclosures accompanied by the latest annual report. They should be made on the websites of the concerned stock exchanges.

The requirement of Rule 19(1) and (3) of the Securities Contracts (Regulations) Rules relating to submission of documents and allotments are not applicable to the listing of NCRPSs.

Conditions for Continuous Listing and Trading of Non-Convertible Redeemable Preference Shares

Continuous Listing Conditions The issuers should comply with the conditions of listing specified in the respective listing agreement for non-convertible redeemable preference shares. It should also be promptly disseminated to investors and prospective investors in such manner as the concerned stock exchange may determine. The issuer and stock exchange should disseminate all information and reports including compliance reports filed by the issuer to the investors and the general public by placing them on their websites.

Trading of Non-Convertible Redeemable Preference Shares The listed non-convertible preference shares issued to the public or on a private placement basis should be traded/cleared and settled subject to conditions specified by the SEBI. Trades of NCRPSs made over-the-counter should be reported on a recognised stock exchange having a nation-wide trading terminal or such other platform specified by the SEBI.

Obligations of Intermediaries and Issuers

The issuer should disclose all the material facts in the offer documents issued or distributed to the public and ensure that they are true, fair and adequate and there is no mis-leading or untrue statements or mis-statement in the offer document.

The merchant banker should verify and confirm that the disclosures are true, fair and adequate and ensure that the issuer is in compliance with the SEBI regulations as well as all transaction specific disclosures required in these and the Companies Act.

The issuer should treat the applicant in a public issue in a fair and equitable manner as per the SEBI-specified procedure. The intermediaries would be responsible for diligence in respect of assignments undertaken by them in respect of issue, offer document and distribution of securities to the public.

No person should employ any device, scheme or artifice to defraud in connected with their listed/proposed to be listed issue or subscription or distribution.

Issuance and Listing of Non-Equity Regulatory Capital Instruments by Banks

The above provisions would apply to the issuance and listing of perpetual debt instruments by banks subject to the prior approval and in compliance with the guidelines issued by the RBI.

If a bank is incorporated as a company under Companies Act, it should, in addition, comply with the provisions of Companies Act and/or other applicable statutes. It should also comply with the terms and conditions specified by the SEBI and make adequate disclosures in the offer document regarding the features of these instruments and relevant risk factors and if such instruments are listed comply with the listing requirements.

Miscellaneous

Inspection by the Board Without prejudice to the provision of Section 11 and 11-C of the SEBI Act and Section 209-A of the Companies Act, the SEBI may *suo moto* or upon information received by it, appoint one or more persons to undertake the inspection of the books of account, records and documents of the issuer or merchant banker or any other intermediary associated with the public issue, disclosure or listing of non-convertible redeemable preference shares for any of the purposes specified below:

- To verify whether **(a)** the provisions of the SEBI/Companies/Securities Contracts (Regulation)/Depositories Act/rules and regulations in respect of issue of securities; **(b)** the requirement in respect of issue of securities as specified in these regulations; **(c)** the requirements of listing conditions and continuous disclosure requirement have been complied with;
- To inquire into **(i)** the complaints received from investors, other market participants or any other persons on any matter of issue and transfer of securities; **(ii)** the affairs of the issuer in the interest of investor protection or the integrity of the market governed; **(iii)** whether any direction issued by the SEBI has been complied with.

Power to Issue Directions Without prejudice to its powers under Chapter VI-A and Section 24 of the SEBI Act, the SEBI may, in the interest of investors in securities market, issue such directions as it deems fit under Section 11, 11-A, 11-B, 11-D of the SEBI Act including: **(a)** Directing the **(i)** issuer to refund the application money, **(ii)** persons concerned not to further deal in securities in any particular manner/not to access the securities market for a particular period; **(iii)** persons concerned to sell/direct securities, **(iv)** issue/depository not to give effect transfer/directing further freeze of transfer of securities, **(b)** Restraining the issuer/promoter(s)/directors from making further issues of securities. The SEBI may also issue any other direction which it may deem fit and proper in the circumstances of the case.

Power of the SEBI to Issue General Order or Circular The SEBI may by a general or special order or circular specify any condition or requirement in respect of issue of non-convertible redeemable preference shares to provide for all or any of the following matters: **(a)** electronic issuances and other issue procedures including the procedure for price discovery; **(b)** conditions governing trading, reporting, clearing and settlement of trade; **(c)** listing conditions.

CONCLUDING OBSERVATIONS

- The activities in/procedures of the primary market organisation in India have to conform to the SEBI regulatory framework. The framework currently applicable has two main elements: **(i)** Issue of Capital and Disclosure Requirements (ICDR) Regulation 2009 and **(ii)** Issue and Listing of Debt Securities (ILDS) Regulations, 2008.
- The ICDR regulations relate to **(i)** common conditions for public and rights issues, **(ii)** provisions as to public issues, **(iii)** rights issues, **(iv)** manner of disclosures in offer documents, **(v)** general obligations of issuers/ intermediaries, **(vi)** preferential issues, **(vii)** qualified institutional placement, **(viii)** issue of Indian depository receipts, **(ix)** issue of securities by small and medium enterprises and (**x**) SEBI directions.
- While public issue means an initial public offer (IPO) or a further public offer (FPO), a rights issue means an offer of equity shares and convertible securities by a listed issuer to its shareholders as on the record date. The common conditions for public/rights issues are: general conditions, appointment of intermediaries, filing of offer document, documents submitted before issue opening, draft offer documents made public, issue pricing, draft offer documents made public, fast track issues, issue opening, despatch of material, underwriting, minimum subscription, oversubscription, monitoring agency, manner of calls, allotment/refund, restrictions on further issues, additional requirements for issue of convertible debt instruments (CDIs), rollover, conversion, issue of CDIs for financing and alteration of rights of holders of securities.
- The general conditions to be satisfied by an issuer at the time of filing/registering the draft/final offer documents (in case of public issue) and letter of offer (in case of rights issue) with the SEBI/ROCs/DSE are: **(i)** The issuer/its promoters/promoter group/person(s) in control are not debarred from accessing the capital market, **(ii)** The issuer of CDIs is not in the list of RBI's willful defaulters/in default for more than 6 months; has made an application for listing on a RSE; and has entered into an agreement with a depository for demat of securities; **(iii)** All existing partly paid-up shares are fully paid up/forfeited, **(iv)** Firm arrangements for 75 per cent of the stated means of finance excluding the amount from the proposed issue/internal accruals have been made.
- The issuer should appoint (lead) merchant banker(s)/intermediaries to carry out the issue-related obligations. It should also appoint syndicate members in book-built issues, bankers to an issue at all mandatory collection centres and registrars to an issue who have connectivity with all the depositories. Book building is the process to elicit demand/assess the price to determine quantum/value of securities/IDRs.
- An offer document together with the specified fee should be filed with the SEBI not less than 30 days before registering the prospectus/red herring prospectus/shelf prospectus with the ROCs or letter of offer with the DSE. Any changes/observations by the SEBI should be complied with before filing them with the ROCs/DSE/SEBI.
- Issues must obtain in-principle approval for listing of the securities from the concerned RSEs having nation-wide trading terminals.
- The lead merchant banker should submit to the SEBI along with the offer document **(i)** copy of the agreement with the issuer, **(ii)** *inter se* allocation of responsibilities of each merchant banker, **(iii)** due diligence certificates from the concerned lead merchant banker/debenture trustees, **(iv)** statements certifying all changes/observations by SEBI have been incorporated in the offer document/certificate from a Chartered Accountant in respect of promoters contribution and Board of Directors resolution for allotment of securities to promoters. The issuer should submit PAN/bank account/passport number of its promoters.

- The offer document should be hosted on the website of the SEBI/concerned RSEs/merchant bankers for public comment for not less than 21 days. A public announcement should also be made in English/Hindi regional newspapers.
- The above requirements relating to filing of offer documents, in-principle approval for listing and submission of documents before issue opening would not apply if the **(i)** issuers (**fast track issue**) shares have been listed for at least 3 years, **(ii)** the average market capitalisation of its public shareholding is at least ₹10,000 crore, (**(iii)** the annualised turnover of its shares has been at least 2 per cent of weighted average number of shares listed during the last 6 months, **(iv)** it has redressed at least 95 per cent of its investors grievances/complied with the equity listing agreement for at least 3 years, **(v)** the impact of the auditor's qualification on its accounts does not exceed 5 per cent of its net profits/loss after tax, **(vi)** no show cause notice has been issued/proceedings initiated/pending against it/promoters/whole time directors and **(vii)** the entire promoters holding is in demat form.
- An issue should open within **(a)** 12 months from the date of the SEBI's observations on the offer document, **(b)** 3 months after 30 days in case of no observation from the SEBI.
- The offer document/other issue material should be despatched to the DSE/syndicate members/ underwriters/banker to an issue/investors association/ **SCSBs** in case of **ASBA** in advance.
- Issues can be underwritten only by SEBI-registered underwriters/book runners (syndicate members). But securities compulsorily allotted to QIBs cannot be underwritten. The lead merchant banker/book runner must undertake a minimum underwriting of the lower of the 5 per cent of the total commitment or ₹25 lakh.
- The minimum subscription in an issue should be 90 per cent of the offer. In case of its on-receipt the entire application money received should be refunded within 15 days and seven days from the date of closure of the issue in non-underwritten and underwritten issues respectively.
- For issue size exceeding ₹500 crore, a PFI/bank should be appointed to monitor the use of the issue proceeds. Where a monitoring agency is not appointed, the outstanding subscription must be called within 12 months of allotment. Shares with calls in arrear should be forfeited. Within 15 days of the failure of an issue, the application money must be refunded failing which the specified interest would have to be paid.
- In addition to the other requirements, an issuer of CDIs should comply with the following conditions: **(i)** obtain credit rating, **(ii)** appoint debenture trustees, **(iii)** create debenture redemption fund, **(iv)** assets on which charge is proposed are sufficient to discharge the liability and free from encumbrances. They should be redeemed in terms of the offer document.
- The non-convertible portion of the partly CDIs can be rolled over without change in the interest rate if 75 per cent of the holders approve it; an auditors certificate on its liquidity position has been sent to them; the holding of all holders who have not agreed would be redeemed; credit rating has been obtained and communicated to them before rollover.
- Positive consent of the holders would be necessary for conversion of optionally CDIs into shares. The holders should be given the option not to convert them if the conversion price was not determined/disclosed to the investors at the time of the issue.
- The terms of issue of securities adversely affecting the investors can be altered with the consent/sanction in writing of at least 75 per cent/special resolution of the holders.
- The provisions as to public issues are: eligibility requirements, pricing, promoters contribution, lock-in and minimum offer to public/reservations.
- The eligibility conditions relate to IPOs and FPOs. An IPO can be made by an issuer who has **(i)** net tangible assets of at least ₹3 crore in the preceding 3 years not more than 50 per cent

of which should be monetary assets, **(ii)** a track record of distributable profits for at least 3 out of immediately preceding five years; in case of a partnership converted into a company/ company formed out of a diversion, their track record would be considered only if their financial statements fro the respective years are revised to conform to the format prescribed by the Companies Act and certified by a chartered accountant to that effect, **(iii)** net wroth of at least rupees one crore in the preceding 3 years, **(iv)** the aggregate of all issues in one financial year does not exceed 5 times of its pre-issue networth and **(v)** at least 50 per cent of the revenue of the preceding year has been earned from the activity indicated by the new name in case of change of its name within the last one year.

An issuer who does not satisfy any of the above five conditions can make an IPO if it alternatively satisfies the following two conditions: **(a)** it is through book building with at least 50 per cent of the net offer to the public allotted to QIBs or at least 15 per cent of the project cost is contributed by PFIs/banks of which a minimum 10 per cent is from appraisers and 10 per cent of the net offer to the public is allotted to QIBs, **(b)** its minimum post-issue face value of capital is ₹10 crore or there would be compulsorily market making for at least 2 years from the date of listing of the securities provided the minimum depth of securities for buy and sell quotes is 300, the bid-ask spread never exceeds 10 per cent and the inventory of the market is not less than 5 per cent of the issue.

An IPO of CDIs can be made without a prior issue/listing of shares. The minimum number of allottees in a public issue is 1,000. An IPO cannot be made if there are outstanding convertible securities/rights entitling a person the option to receive shares after the IPO. Shares held for at least one year prior to the filing of the draft offer document with the SEBI may be offered for sale. An IPO grading from a SEBI-registered rating agency is mandatory.

- A FPO can be made if the issuer satisfies the two requirements of an IPO, namely, the aggregate of the issue size in one year (i.e. 5 times its pre-issue net worth) and the minimum revenue (i.e. 50 per cent) from the activity indicated by the new name in case of change within the last one year. If these two conditions are not satisfied, a FPO can be made in a manner similar to an IPO when the issuer does not satisfy the five conditions.
- The price of specified securities/coupon rate/conversion price of CDIs should be determined by the issuer in consultation with the merchant banker(s) or through the book building process.
- The lead merchant banker would act as the lead book runner and be primarily responsible for book building. Other merchant bankers would act as co-book runners/syndicate members. The issue should be compulsorily underwritten by the book runner(s) and sub-underwritten by the syndicate members. The book runners/syndicate members should appoint SEBI-registered brokers and the self certified syndicate banks in case of **ASBA** would act as bidding, collection centres.

If the issue size is issued, the red-herring prospectus may not contain the price/number of securities but the floor price/price band may be mentioned. In case of its non-disclosure, the price should be disclosed at least one/two working days before the bid opening in an IPO and FPO respectively. In case of opting price band by the issuer, the cap should not be more than 120 per cent of the floor. In case of revision of price, the bidding period should be extended by three days.

The minimum application value of an anchor investor should be ₹10 crore in a public issue. Upto 30 per cent available to QIBs may be allocated them, one-third of which to mutual funds. The bidding for them should open one day before the issue opening date and they should pay at least 25 per cent margin on application and the balance within two days of the closure of the issue. The margin money from non-QIB category should be uniform for each category. The QIBs would have to pay 10 per cent.

The bidding should be through an electronically-linked transparent facility of a RSE. All non-ASBA investors can revise their bids and the QIBs cannot withdraw their bids after the closure of the issue.

The issue price should be fixed on the basis of the bids received and the number of securities to be offered. All the successful bidders whose bids are above the final/cut-off price would be entitled for allotment. The retail individual investor may bid at the cut-off rate.

The allotments to categories except anchor investors should be made proportionately and the unsubscribed portion in any category should be allocated as per the disclosures in the red-herring prospectus.

- The securities maybe offered at differential prices **(i)** to retail individual investors/shareholders and **(ii)** in a composite issue on public-cum-rights basis. A price/price band (in draft prospectus) and floor price/price band (in red herring prospectus) may be mentioned and the (one) price/specific coupon rate on CDIs may be determined at a later stage. The cap on the price band/coupon rate can be upto 120 per cent of the floor price/rate. The floor/final price should not be less than the face value. The face value of shares should be between ₹10 and 1 and ₹10 per share in case of issue prices being ₹500 and above and below ₹500 respectively.
- The minimum promoters contribution in a public issue should be at least 20 per cent of the post-issue capital (in IPO)/proposed issue size/post issue capital (in FPO) and composite issue excluding the rights component. It should be by way of shares/subscription to convertible securities. In case of an IPO of CDIs without a prior public issue, it should be 20 per cent of the project cost in the form of shares and at least 20 per cent of the issue size should be from their own funds. Any excess contribution should be at the higher of the price applicable to preferential issues (**discussed later**) and the issue price. The contribution should be brought in at least one day before the issue opening date.
- The specified securities held by promoters and others are not transferable. The lock-in of securities held by promoters in a public issue would be **(i)** 3 years from the date of commencement of commercial production and allotment in public issue whichever is earlier in respect of minimum contribution and one year in case of excess contribution. In case of an IPO, the entire pre-issue capital held by other investors would be locked-in for one year. Securities lent to a stabilising agent under green shoe option would be subject to lock-in for the remaining period from the date of their return to the lender. The lock-in securities may be pledged by the promoters with a bank/PFI for loan for financing the object(s) of the issue. Promoters as well non-promoter holders of lock-in securities can transfer them respectively to another promoter/person. The lock-in will continue till the remaining period with the transferee till its expiry.
- The minimum/net offer to public should be 10 and 25 per cent of the post-issue capital (in an IPO) and issue size (in FPO). Reservations on competitive proportionate basis out of the issue size (excluding promoters contribution and net offer to public) can be made: **(a)** in a book-built issue, to employees, shareholders and persons associated with the issuer as depositors/bondholders/subscribers to its services upto 5 per cent of the issue size; **(b)** in a non-book-built issue to employees and shareholders; and **(c)** in case of FPO (other than a composite issue) to retail individual shareholders. The unsubscribed portion in a reserved category may be added to the other and the unsubscribed portion after the *inter se* adjustment should be added to the net offer to the public category. The allocation to the net offer to the public would be: **(a)** in a book-built issue, **(i)** retail individual investors, at least 35 per cent **(ii)** non-institutional investors, at least 15 per cent **(iii)** QIBs, not more than 50 per cent of which 5 per cent to mutual funds who would also be eligible for allocation under the balance available for QIBs;

upto 35 per cent of the QIB share to an anchor investor making an application for at least ₹10 crore **(iv)** issuer who does not satisfy the five eligibility conditions, at least 50 per cent to QIBs **(v)** where the issuer is required to allocate 60 per cent to the QIBs, to retail individual investors, 30 per cent and non-institutional investors, 10 per cent; **(b)** in a non-bank built issue, at least 50 per cent to retail individual investors, the balance to other individual/institutional investors. An issuer may provide a safety net to purchase upto a maximum of 1,000 securities at the issue price per allottee within six months from the date of dispatch of security certificates/ credit of demat amount.

An issuer may provide green shoe option for stabilisation of the post-listing price of its securities by allotting excess shares. Upto 15 per cent of the issue size may be borrowed by the stabilising agent from the promoters/pre-issue shareholders holding more than 5 per cent of the securities. The stabilisation would be available upto 30 days from the date on which permission for trading is given by the RSE. The securities should be returned within two working days after the stabilisation period. If the stabilising agent is unable to buy the securities from the market to the extent of the overallotment, the issuer would allot securities at the issue price to the extent of the shortfall within 5 days of the stabilisation period. These would be returned to the promoters/pre-issue shareholders in lieu of those borrowed from them.

A public issue should be open for a minimum of 3 and a maximum of 10 days. The pre-issue advertisement should be made in one English/Hindi national daily and one regional language newspaper. The minimum application value is in the range of ₹5,000 – ₹7,500. Applicants should be invited in multiples of this value. The minimum application should be 25 per cent of the issue price. The entire issue price in an offer for sale should be brought in as application money. The allotment of securities to non-anchor investors should be on proportionate basis within the specified categories.

- The main elements of the framework of rights issues are record date, restrictions, letter/abridged letter of offer, pricing and subscription period, pre-issue advertisement and utilisation of funds.
- To determine the eligibility of the shareholders, a record date should be announced after which a rights issue cannot be withdrawn. Rights issue can be made only after reserving shares of the same class in favour of holders of outstanding fully/partly CDIs in proportion to the convertible part. The abridged letter of offer together with the application form should be sent to the all the existing shareholders at least three days before the opening of the issue. Applications can also be made on plain offer. Such applicants cannot renounce their rights. Applications by shareholders on application form as well as on plain paper would be rejected. The issue price should be determined before the record date and the issue should be open for a minimum of 15 days and a maximum of 30 days. The pre-issue advertisement in one English/Hindi/regional newspaper should be made at least 3 days before the date of opening of the issue. The funds collected can be utilised after the finalisation of the basis of allotment.
- The general obligations of issuers/intermediaries with respect to public/rights issues are: prohibition on payment of incentive; public communications, publicity materials, advertisements and research reports; copies of offer document made available to public; redressal of investors grievances, appointment of compliance officer; due diligence; post-issue reports; post-issue advertisement; coordination with intermediaries; audited financial statements in the offer document and; other responsibilities.
- All public communications including advertisements/publicity materials/research reports should contain only factual information and not projections/conjectures/ matters extraneous to the offer document. They should be consistent with the past practices. They should also be truthful/fair and not **(i)** manipulative/deceptive distorted, **(ii)** contain any untrue/misleading statements/ promises/forecasts.

The issuer should **(i)** make prompt/true/fair disclosures of all material developments relating to its business/securities and those of its subsidiaries/group companies and **(ii)** not release any information which is not contained in the offer document, **(iii)** not use extensive technical/legal terminology, complex language and excessive details/display models/celebrities/fictional characters/landmarks etc, **(iv)** not use crawlers on televisions or contain slogans/expletives/non-factual and unsubstantial titles, and **(v)** highlight risk factors prominently.

The advertisement should not **(i)** give the impression that the issue has been fully subscribed/oversubscribed during the period it is open for subscription and an announcement regarding closure should be made only after 90 per cent of the offer has been subscribed, **(ii)** contain any offer of direct/indirect incentives in cash/kind/services and so on.

- The contents of the offer document hosted on the website should be the same as the printed version filed with the ROCs/SEBI/DSE. Copies of the offer documents should be made available to the public on request for a reasonable charge. The post-issue lead merchant banker should be actively associated with the post-issue activities and regularly monitor redressal of the associated investor grievances. The compliance officer would be responsible for redressal of investor grievances and compliance with the securities laws.
- The lead merchant banker should exercise due diligence and satisfy about all the aspects of the issue and call upon the issuer (s) to fulfil their obligations. He should submit to the SEBI the initial post-issue report within 3 days of the closure of the issue and final report within 15 days of finalisation of basis of allotment/refund of money in case of failure of issue. The post-issue merchant banker would continue to be responsible for post-issue activities till the subscribers receive the security certificate/created to their demat account or refund of application money and the listing/trading permission is obtained.

  He should ensure that post-issue advertisement is released within 10 days from the completion of the various activities giving details relating to over-subscription, basis of allotment and so on. He should also **(i)** maintain close coordination with the various intermediaries after the closure of the issue, **(ii)** ensure that notice for devolvement on underwriters is issued within 10 days from the date of closure, **(iii)** furnish information to the SEBI in respect of underwriters who have failed to meet their devolvements and **(iv)** confirm to the bankers to the issue that all formalities have been completed and the banker is free to release the money to the issuer/for refund in case of failure of the issue.
- The merchant banker should ensure that **(i)** all the information contained in the offer document is not more than 6 months old, **(ii)** payment of interest to the applicants for delayed despatch of allotment letters/refund orders is made as per the disclosures in the offer document, **(iii)** the issue is kept open for the required number of days to avoid any dispute by the underwriters in respect of their liability.
- Dissenting shareholders mean shareholders who have voted against the resolution for change in objects/variations in terms of a contract referred to in the prospectus of the issuer. The main elements of the SEBI regulations are: **(i)** conditions for exit offer, **(ii)** eligibility of shareholders for availing of the exit offer, **(iii)** exit offer price, **(iv)** manner of providing exit to dissenting shareholders and **(v)** offer not to exceed maximum permissible non-public shareholding.

  The promoters/shareholders in control should make the exit offer if **(i)** 10 per cent dissenting shareholders voted in the general meeting and **(ii)** the amount to be utilised for the object for which the prospectus was issued is less than 75 per cent of the amount raised.

  Only dissenting shareholders who hold shares on the **relevant date** (i.e. date of the meeting of the Board of Directors in which the proposal for change in objects/variation in terms of a contract is approved) can avail of the offer.

The exit price payable to the dissenting shareholders would be the highest of the following: the volume weighted average price paid/payable for acquisition during 52 weeks immediately preceding the relevant date; the highest price paid/payable for any acquisition during the 26 weeks immediately preceding the relevant date; the volume weighted average market price for frequently traded shares for 60 trading days immediately preceding the relevant date as traded on the stock exchange where the maximum volume of trading are recorded; and in case of infrequently traded shares, the price determined by the promoter/shareholders having control and the merchant banker taking into valuation parameters including book value, comparable trading multiples and other customary parameters.

The promoter/shareholders in control would have to bring down the non-public shareholding to the specified level within the permitted time under the **Securities Contract (Regulation)** Rules if the completion of the exit offer results in these shareholdings exceeding the maximum permissible non-public shareholding.

- Preferential issue is an issue of specified securities by a listed issuer to any select group/ group of persons on a private placement basis. The main elements of such issues are: conditions, disclosures, allotments, tenure of convertible securities, pricing of shares payment of consideration, lock-in and transferability of lock-in securities/warrants.
- The conditions for preferential issues are a special resolution by the shareholders, all shares held by the proposed allottees are in demat form and the issuer **(i)** is in compliance with the conditions for continuous listing and **(ii)** has obtained the PAN of the allottees.
- The issuer should disclose in the explanatory statement to the notice for the special resolution **(i)** objects of the issue, **(ii)** shareholding pattern before/after issue, **(iii)** the time-frame for the issue, **(iv)** identity of the proposed allottees, **(v)** undertaking relating to recomputation of prices of the securities and lock-in till the payment of the recomputed prices by the allottees. The resolution should specify the relevant date to calculate the share prices. A copy of the certificate of the statutory auditors should also be placed before the general body meeting. The valuation of the assets other than cash in consideration for which shares are being issued should be done by an independent qualified valuer.
- The allotment should be completed within 15 days from the date of passing the resolution failing which a fresh special resolution would be necessary.
- The tenure of convertible securities should not exceed 18 months from the date of their allotment.
- If shares have been listed for 6 months and more, they should be allotted at a price higher of the average of the weekly high and low of the quoted closing prices of the related shares during the **(i)** 6 months, **(ii)** 2 weeks preceding the relevant date. If listed for less than 6 months, the shares should be allotted at a price higher than **(a)** the average of the weekly high and low of the closing prices during **(i)** the shares have been listed and **(ii)** 2 weeks preceding the relevant date and **(b)** the price at which they were issued in the IPO. On completion of the 6 months, the price should be recomputed with reference to the average of the weekly high and low of the closing prices during those months and the allottees would have to pay the difference between the recomputed price and the allotment price. Preferential issues to the QIBs should be made not below the average of the weekly high and low of the closing prices of the related shares during the two weeks preceding the relevant date.
- Full price of the securities other than warrants should be paid by the allottees at the time of allotment. At least 25 per cent of the price should be paid against each warrant on the date of their allotment and the balance 75 per cent on allotment of shares pursuant to exercise of option.

- The allotted securities to promoters and others should be locked-in for three and one year(s) respectively. Partly-paid shares would be locked-in for one year of becoming fully paid-up. The entire pre-preferential allotment shareholding of allottees would be lock-in from the relevant date upto 6 months from the date of such allotment.
- The lock-in securities held by promoters may be transferred among them or new promoters/persons in control of the issuer. The lock-in would continue for the remaining period with the transferee.
- The qualified institutional placement (QIP) is the allotment of shares/CDIs/warrants and other convertible securities by a listed issuer to QIBs on private placement basis. The main elements of QIP are: conditions, placement document, pricing, allotment restrictions, minimum number of allottees, validity of the special resolution, tenure and transferability.
- The QIP should satisfy the following conditions: **(i)** a special shareholders resolution, **(ii)** listing of shares of the same class on a stock exchange for at least one year and **(iii)** is in compliance with the requirement of minimum public shareholding. It should be made on the basis of a placement document containing all the specified material information.
- The QIP should be made at a price not below the average of the quoted weekly high and low of the closing prices of shares of the same class during the two weeks preceding the relevant date. Partly paid-up eligible securities should not be allotted. Equity shares allotted on exercise of option attached to a warrant should be fully paid-up.
- A minimum of 10 per cent of the eligible securities should be allotted to mutual funds. Direct/indirect allotment cannot be made to a promoter-QIB/a person related to the promoter. Bids by applicants cannot be withdrawn after the closure of the issue.
- The minimum number of allottees for each placement should be a least two for issue size upto ₹250 crore and five for more than ₹250 crore. No single allottee can be allotted more than 50 per cent of the issue size.
- The allotment of securities should be completed within 12 months from the date of the resolution. There should be a gap of at least six months between each placement in case of multiple placements. The aggregate of the QIP together with all the QIPs in one financial year should not exceed 5 times the networth of the issuer. The maximum tenure of convertible/exchangeable securities would be five years. The allottees can sell the securities for one year **only** on a recognised stock exchange.
- The provisions discussed below relate to issuance of fresh and/or offer for sale of shares in a listed issuer for achieving the minimum public shareholding in terms of Section 19(2)(b) and 19-A of the Securities Contracts (Regulation) rules.

  An **IPP** (i.e. a further public offer of eligible securities, that is, equity shares of same class listed/traded in the stock exchange, by an eligible seller, that is, listed issuer, promoter/promoter group of listed issuer, in which the offer/allocation/allotment of the securities is made only to the QIBs) requires a special resolution by the shareholders in terms of Section 81(1A) of the Companies Act. Partly-paid shares cannot be offered. In-principle approval from a stock exchange should also be obtained. A SEBI-registered merchant banker should manage the IPP and exercise due diligence.

  The eligible seller should announce a floor price/price band at least one day before the opening of the IPP.

  The promoter/promoter group should not purchase/sell the eligible securities during the 12 weeks **(a)** prior to **(b)** after the date of the IPP. The allocation/allotment of the securities would be subject to the condition that **(i)** at least 25 per cent to mutual funds/insurance companies, the unsubscribed portion being offered to other QIBs, **(ii)** a QIB-promoter/any person related to the promoter (i.e. who has rights **(1)** to appoint any nominee director, **(2)** under a shareholders/visiting agreement), and **(3)** veto rights.

The minimum number of allottees would be ten and a maximum of 25 per cent of the offer size can be allotted to a single allottee. The QIBs belonging to the same group/under same control would be deemed to be a single allottee.

The aggregate of all the tranches of the IPP of any eligible seller should not result in increase in pubic shareholding by more than 10 per cent and in case of oversubscription, allotment should be restricted to 10 per cent of the offer size.

- An IDR means an instrument in the form of a depository receipt created by a domestic depository in India against the underlying equity shares of the issuing company incorporated outside India. The issue of IDRs should conform to **(a)** Companies IDR Rules and **(b)** SEBI ICDR regulations.
- The main elements of the IDR rules are: eligibility, procedure, other conditions, registration documents, conditions for issue of prospectus, listing, transfer/redemption, continuous disclosures, distribution of corporate benefits and penalty.
- The eligibility conditions for the issuing company are a specified minimum pre-issue capital and reserves/dividend payment record, debt-equity ratio and fulfilment of SEBI-prescribed criteria. Prior permission from the SEBI would be necessary to raise funds. There is a ceiling on IDRs of 15 per cent of the paid-up capital and reserves of the issuer in a financial year. The IDRs should be denominated in Indian rupees. The merchant banker to the IDR issue should deliver for registration to the SEBI/ROCs the specified documents. The IDRs should be listed and can be purchased/possessed/freely transferred by a person resident in India. The issuer should comply with the continuous disclosure requirements specified by the SEBI. Contravention of these rules by the company/any other person for which no punishment is provided in the Companies Act would be punishable with a fine upto the IDR amount and a further fine of ₹5,000 per day during the period of the contravention.
- All the provisions of the SEBI ICDR regulations are applicable in case of IDRs excepting the disclosure requirements with respect to public/rights issues and other specified provisions. The elements of the SEBI framework of issue of IDRs are: eligibility, conditions for issue, minimum subscription, fungibility, filing of draft prospectus/due diligence certificate/payment of fee and issue advertisement, display of bid data, post-issue reports, unsubscribed reports and basis of allotment.
- The issuer should be **(i)** listed in its home country, **(ii)** not prohibited to issue securities by a regulatory body and **(iii)** has track record of compliance with securities market regulations, in its home country.

The issue conditions are: minimum issue size, ₹50 crore; minimum application amount, ₹20,000; at least 50 per cent of the issue allotted to QIBs and the balance allotted to non-institutional/retail individual investors on a proportionate basis and; only one denomination of IDRs at a time

If the issuer does not receive 90 per cent of subscription money, the entire subscription money should be refunded within 15 days failing which 15 per cent penal interest for the period of delay would have to be paid.

The issuing company should enter into a agreement with a merchant banker and the mutual rights/obligations/responsibilities should be disclosed in the prospectus. It should also file a draft prospectus with the SEBI with the requisite fee and submit all the due diligence and other certificates. It should also make arrangements for mandatory collection centres and issue an advertisement in one English/Hindi national daily. The prospectus should contain all material disclosures prescribed by the IDR rules and the SEBI.

The merchant banker should submit to the SEBI the initial post-issue report within 3 days of the closure of the issue and the final report within 15 days of the finalisation of the basis of allotment/refund of money. The basis of allotment should be fair and proper.

- The listed issuer offering IDR through a rights issue should, at the time of filing the offer document, satisfy the conditions specified below.

  The issues should **(i)** not be in breach of ongoing material obligation under the IDR listing/deposit agreement, **(ii)** apply to the concerned stock exchange(s) for listing of issue and chose one of them as the designated stock exchange;

  The domestic depository should take the necessary steps to enable the IRD holders to have entitlements under the rights offering and issue additional IDRs, to distribute the rights to them, arrange for their renunciation/subscription for any additional rights available due to lack of take-up of other holders.

  The issuer should announce a record date for determining the eligible shareholders. Withdrawal of the rights issue after announcing the record date should be notified to **(i)** the SEBI, **(ii)** in one **(a)** English/Hind national and **(b)** regional language daily newspaper with wide circulation at the place of the principal office of the issuer. The issuer would be eligible to apply for IDR offering on a rights basis only after 12 months from the record date.

  An issuer, on satisfying the following conditions, can fast track an issue and file the offer document/addendum with the SEBI only for record purposes: **(a)** he is in compliance in all material respects with the provisions of the deposit/listing agreement for at least 3 years immediately preceding the date of its filing, **(b)** the offer document has been filed/reviewed by the securities regulator in his home country, **(c)** there are no pending show-cause notices/prosecution proceedings against him/promoters/directors on the reference by the SEBI/regulatory authorities in the home country restricting them from accessing the capital market and, **(d)** the issuer has redressed at least 95 per cent of the IRD holders complaints before the end of 3 months immediately preceding the month of date of filing the letter of offer with the designated stock exchange.

  The subscription period would in no case be less than 10 days.

  The pre-issue advertisement should be made in at least **(i)** one English/Hindi national daily newspaper with wide circulation and **(ii)** on regional language daily with wide circulation at the place of the principal office of the issuer in India at least 3 days before the issue opening.

  The issuer can utilise the funds only upon completion of the allotment process.

- The main elements of the issue procedure by the SMEs (i.e. issuers whose post-issue face value capital is between ₹10–25 crore) are: **(i)** filing of offer document and due diligence certificate, **(ii)** underwriting by merchant bankers/underwriters, **(iii)** minimum application value/number of allottees, **(iv)** listing of securities, migration to SME exchange/main board, and **(v)** market making.
- A copy of the offer document should be filed with the SEBI through a merchant banker simultaneously with the filing of the prospectus with the SME exchange/ROCs or letter of offer to the SME exchange. The SEBI would not issue any observations on the offer document and a due diligence in the prescribed format should be filed by the merchant banker.
- The entire issue must be underwritten of which 15 per cent by the merchant banker. In case of undersubscription, a nominated investor, that is, a QIB/private equity fund, may agree to subscribe at the issue/deliver or receive securities in the market making process. Any shortfall would devolve on the merchant banker. The fact of 100 per cent underwriting should be filed with the SEBI one day before issue opening.

- The minimum application value is ₹1 lakh per application and the minimum number of allottees is 50.
- The specified securities should be listed on the SME exchange. Securities of the issue listed on any other exchange would have to migrate on the SME exchange with the approval of two-thirds of the non-promoter shareholders and *vice versa*.
- The merchant banker should ensure compulsory market making through the SME exchange brokers for at least 3 years. The securities may be transferred to, or from, the concerned nominated investor(s). The inventory of the market maker on the date of allotment should be 5 per cent of the securities proposed to be listed. The market maker cannot buy shares from the promoter/persons belonging to the promoter group/any person who has acquired shares from them during the compulsory market making period. However, promoter holdings which are not locked-in can be traded with the approval of the SME exchange in a manner specified by the SEBI. The market maker may seek representation on the Board of the SME-issuer.
- The **institutional trading platform** means the trading platform for listing/trading of specified securities of **(a)** an entity which is intensive in the use of technology, information technology, intellectual property, data analytics, bio-technology or nano-technology to provide products, services or business platforms with substantial value addition and at least 25 per cent of its pre-issue capital is held by qualified institutional buyer(s), **(b)** any other entry in which at least 50 per cent of the pre-issue capital is held by qualified institutional buyers as on the date of filing of draft information/offer document with the SEBI. No person, individually/collectively with persons acting in concert, should hold 25 per cent or more of the post-issue share capital in the entity. The main elements of the SEBI regulations **(i)** listing without/with public issue, **(ii)** lock-in, **(iii)** trading lot, **(iv)** exit and **(v)** migration to main board are discussed below.
- The entity seeking listing of its specified securities without making a public issue should file a draft information document along with the necessary documents with the SEBI along with the specified fee. The regulations relating to the following would not be applicable in case of listing without public issue: **(i)** allotment, **(ii)** issue opening/closing, **(iii)** advertisement, **(iv)** underwriting, **(v)** the stipulation relating to initial public offer, if there are outstanding convertible securities/any other right entitling any person to receive equity shares, **(vi)** pricing, **(vii)** dispatch of issue material, and **(viii)** and other such provisions related to offer of specified securities to public. The entity should obtain in-principle approval from and list its securities on the recognised stock exchange(s) within 30 days from the **(a)** date of issuance of observations by the SEBI, **(b)** expiry of the stipulated period if the SEBI has not issued any observation. The provisions relating to minimum public shareholding would also not apply to these entities.
- An entity seeking issue and listing of its specified securities should file a draft offer document along with the necessary documents with the SEBI along with the specified fees. The minimum application size should be ₹10 lakh and the number of allottees should be more than 200. The allocation in the net offer to public category should be 75 per cent to institutional investors (without specific allocation for anchor investors), 25 per cent to non-institutional investors. **Institutional investor** means QIBs, family trust, RBI-registered systematically important NBFCs, SEBI-registered intermediaries with minimum networth of ₹500 crore. Any under-subscription in the non-institutional investor category would be available for subscription under the institutional category. The allotment to institutional investors may be on a discretionary basis whereas the allotment to non-institutional investors should be on a proportionate basis.
- The entire pre-issue capital of the shareholders should be locked-in for 6 months from the date of allotment in case of listing pursuant to public issue or date of listing in case of listing without public notice. The minimum trading log would be ₹10 lakh.
- The entity whose specified securities are listed on the institutional trading platform without making a public issue may exit from that platform, if **(a)** it is approved by its shareholders by

passing a special resolution through postal ballot where 90 per cent of the total votes and the majority of non-promoter votes have been cast in favour of such proposal and **(b)** the recognised stock exchange approves of such an exit.

- An entity that has listed its specified securities on institutional trading platform may at its option migrate to the main board after three years from the date of listing subject to compliance with the eligibility requirements of the concerned stock exchange.
- The main elements of the regulation pertaining to listing of securities on stock exchanges are: in-principle approval, application for listing, listing agreement and obligation of stock exchanges.

  The issuer/issuing company should obtain in-principle approval **(a)** in case of an initial public offer/an issue of IDRs from all the recognised stock exchange(s) on which the specified securities are proposed to be listed and **(b)** in case of other issues, before issuance of further securities where they **(i)** are listed only on recognised stock exchange(s) having nationwide trading terminals, from all such stock exchange(s), **(ii)** are not listed on any recognised stock exchange having nationwide trading terminals, from all the stock exchange(s) on which they are proposed to be listed, **(iii)** are listed on recognised stock exchange(s) having nationwide trading terminals as well as on the recognised stock exchange(s) not having nationwide trading terminals, from all recognised stock exchange(s) having nationwide trading terminals. It should make an application for listing within 20 days from the date of allotment, to recognised stock exchange(s) along with the documents specified by them, failing which it should pay penal interest to allottees for each day of delay at the rate of atleast 10 per cent per annum from the expiry of 30 days from date of allotment till the listing of securities to the allottees.

  Every issuer/issuing company desirous of listing its securities should execute a listing agreement with the recognised stock exchange.

  The stock exchange(s) should grant in-principle approval/list the securities or reject the application for in-principle approval/listing by the issuer/issuing company within 30 days from the later of the date of receipt of **(i)** application for in-principle approval/listing, **(ii)** satisfactory reply from the issuer/issuing company, in cases where the stock exchange(s) has sought any clarification from them.
- Debt securities mean non-convertible securities which create/acknowledge indebtedness including bonds/debentures and other securities of a body corporate/any statutory body but excluding bonds issued by Government/other bodies specified by the SEBI, security receipts and securitised debt instruments. Private placement is an offer to less than 50 persons, while public issue is an offer/ invitation to public to subscribe to debt securities. The main element of the SEBI regulations relating to issue and listing of debt securities are: issue requirements; listing; conditions for continuous listing and trading; obligations of intermediaries/issuers; procedure for action for violation; and powers of the SEBI to issue general order.
- Any issuer who has been restrained/prohibited/debarred by the SEBI from accessing the securities market/dealing in securities cannot make public issue of debt securities. To make such an issue the conditions to be satisfied on the date of filing of draft/final offer document are in-principle approval for their listing, credit rating from at least one SEBI-registered rating agency and agreement with a SEBI-registered depository for their dematieralisation. The issuer should appoint merchant bankers/trustees and not issue such securities to provide loan to, acquisition of shares of, any person who is a part of the same group/under the same management. The issuer should make an advertisement in a national daily with wide circulation on/before the issue opening date. The application forms should be accompanied by a

copy of the abridged prospectus. The issue could be fixed-price or book-built. The minimum subscription and underwriting arrangement should be disclosed in the offer document and it should not certain any false/misleading statement. A trust deed must be executed and debenture redemption reserve should be created. The creation of security should be disclosed in the offer document.

- The listing of debt securities is mandatory. The issuer should comply with the conditions of listing specified in the listing agreement.
- The debt securities issued to public or on private placement basis should be traded/cleared/settled in a recognised stock exchange subject to conditions specified by the SEBI including conditions for reporting of all such trades.
- The debenture trustees, issuers and merchants should comply with their obligations specified by the SEBI.
- In case of violation of any regulation(s), the SEBI may carry out inspection of books of accounts/records/documents of the issuers/intermediaries. It can issue such directions as it may deem fit. An aggrieved party may prefer an appeal with the SAT.
- The main elements of the SEBI regulations relating to issue and listing of non-convertible redeemable preference share regulations are: issue requirements for public issues, listing of NCRPSs, conditions for their continuous listing/trading, obligations of intermediaries/issuers, issue/listing of non-equity regulatory capital instruments by banks and miscellaneous.
- The issue requirements for public issue are: general conditions, disclosures in the offer document, filing of draft offer document, mode of disclosure, advertisements, electronics issuances, price discovery through book building, redemption, minimum subscription, underwriting and prohibition of mis-statements in offer document.
- No issuer can make any public issue of NCRPSs if as on date of filing of draft/final offer document, the issuer/promoter has been restrained/ prohibited/debarred by the SEBI from accessing the securities market/dealing in securities and such direction or order is in force.
- The offer document should contain all **material disclosures** (i.e. **Material disclosures** anything which is likely to impact an investor's investment decision), which are necessary for the subscribers to take an informed investment decision. The issuer and the lead merchant banker should ensure that it contains the specified disclosures in the Companies Act and SEBI regulations.
- The draft and final offer document should be displayed on the websites of stock exchange simultaneously with filing with the ROCs, for dissemination on its website prior to the opening of the issue. A physical copy of the offer document should be provided to any person on request by the issuer/lead merchant banker.
- The issuer should make an advertisement in one English national daily newspaper and one Hindi national daily newspaper with wide circulation at the place where the registered office of the issuer is situated, on or before the issue opening date containing, among others, the SEBI- specified disclosures.
- The issuer may determine the price of NCRPSs in consultation with the lead merchant bankers and the issue may be at fixed price or the price may be determined throughout book building process.
- The issuer may decide the amount of minimum subscription which it seeks to raise by public issue of NCRPSs in accordance with the provisions of Companies Act, and disclose the same in the offer document.

- A public issue of NCRPSs may be underwritten and adequate disclosures regarding underwriting arrangements should be made in the offer document.
- The offer document should not omit disclosure of any material fact which may make the statement misleading. The offer document or abridged prospectus or any advertisement issued in connection with a public should not contain any false or misleading statement.
- An issuer of NCRPSs to the public should make an application for listing and comply with conditions of listing as specified in the listing agreement with the concerned stock exchange.
- The issuers should comply with the conditions of listing specified in the respective listing agreement for non-convertible redeemable preference shares. Each rating obtained by an issuer should be reviewed by the registered credit rating agency atleast once a year and any revision promptly disclosed by the issuer to the concerned stock exchange(s). It should also be promptly disseminated to investors and prospective investors in such manner as the concerned stock exchange may determine. The issuer and stock exchange should disseminate all information and reports including compliance reports filed by the issuer to the investors and the general public by placing them on their websites.
- The listed non-convertible preference shares issued to the public or on a private placement basis should be traded/cleared and settled subject to conditions specified by the SEBI.
- The issuer should disclose all the material facts in the offer documents issued or distributed to the public and ensure that they are true, fair and adequate and there is no mis-leading or untrue statements or mis-statement in the offer document.

  The merchant banker should verify and confirm that the disclosures are true, fair and adequate and ensure that the issuer is in compliance with the SEBI regulations as well as all transaction specific disclosures required in these and the Companies Act.

  The issuer should treat the applicant in a public issue in a fair and equitable manner as per the SEBI-specified procedure. The intermediaries would be responsible for diligence in respect of assignments undertaken by them in respect of issue, offer document and distribution of securities to the public.

  No person should employ any device, scheme or artifice to defraud in connected with their listed/proposed to be listed issue or subscription or distribution.

CHAPTER 8

Secondary/Stock Market Organisation

INTRODUCTION

Like the primary market, the secondary market in India has also shown maturity by registering enormous growth in the recent years in terms of the number of listed companies, market capitalisation, market value of listed companies to gross national product, number of shareholders, and so on. There are 23 recognised stock exchanges in the country. For regulation and control of transactions, each stock exchange has bye-laws and regulations which are more or less uniform in all stock exchanges.

Until 1988, the stock exchanges were more or less self-regulatory organisations supervised by the Ministry of Finance under SCRA. Stock exchange regulations covered the entire gamut of operations, namely, the enrolment of members and their authorised assistants, enlistment of securities of companies and disciplining their activities besides exercising regulation and control over trading. The stock exchanges could subject the members to various forms of disciplinary action like warning, reprimand, censure, fine, or withdrawal of all or any membership rights. In the case of errant listed companies, the stock exchanges are empowered to suspend dealings in securities and delist securities.

Regulation on trading was largely confined to specified shares in which the transactions could be carried forward from one settlement period to another. To ensure systematic trading and unhindered settlements, margin, limits on business, prohibition of further dealing, floor and ceiling prices, prohibition of speculative transactions, closing the market, and circuit breakers were used.

However, the stock exchanges had not been discharging their self-regulatory role well as the result of which malpractices had crept into trading adversely affecting the investors' interests. Several committees examined and made recommendations to reform the organisations of the stock exchanges: G.S.Patel Committee (1985), L.C. Gupta Committee (1991), Pherwani Committee (1991), G.S. Patel Committee (1995) and Varma Committee (1997). The SEBI has been setup to ensure that the stock exchanges discharge their self-regulatory role properly. To prevent malpractices in trading and to protect the rights of investors, the SEBI has assumed the monitoring function, requiring brokers to be registered and stock exchanges to report on their activities.

While the broad regulatory framework of the stock exchanges is described in Chapter 5, the notable developments relating to their organisation are discussed in this Chapter. These include the major organisational reforms in respect of brokers, custodial services, depository system and short selling and securities lending and borrowing scheme. **The stock market organisation in India is portrayed in Exhibit 8.1.** Some concluding observations are given in the last Section.

STOCK BROKING

This Section dwells on the organisation of stock broking in India with reference to stockbrokers, sub-brokers and clearing members.

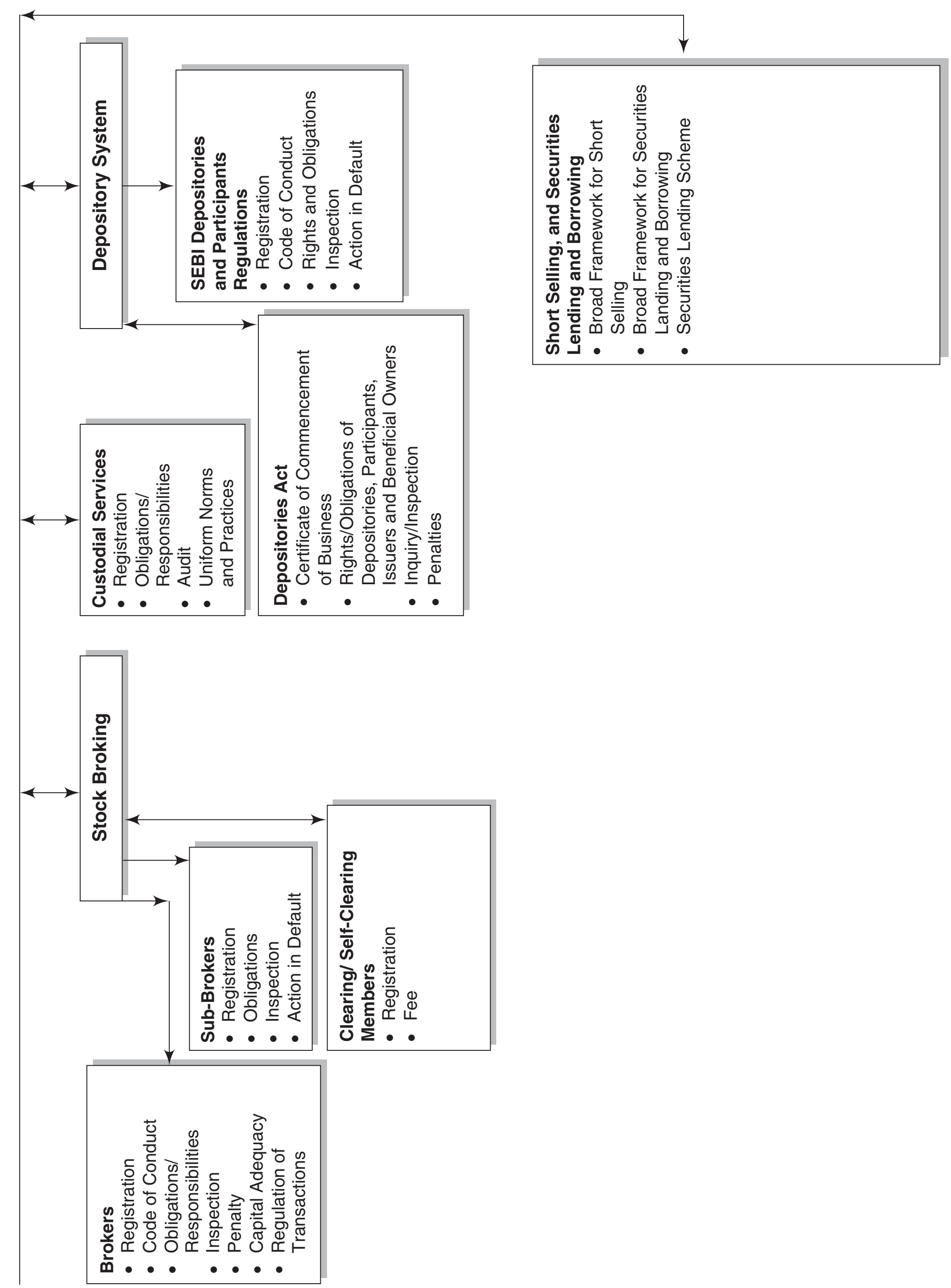
Stock Brokers

A **stock broker** means a person having trading rights in any recognised stock exchange including a trading member. A certificate of registration from the SEBI is mandatory to act as a broker. No separate registration is required for a SEBI-registered broker to operate in more than one stock exchange subject to the approval of the concerned stock exchange. A SEBI-registered **clearing member** (i.e. a person having clearing and settlement rights in any recognised clearing corporation including a person having clearing and settlement rights on a commodity derivative exchange) would also not require a separate registration to act as a broker in the concerned stock exchange with its approval. A **clearing corporation** is an entity that undertakes clearing and settlement of trade in securities, other instruments/products dealt with/traded on a stock exchange and includes a clearing house.

Registration A broker seeking registration with the SEBI has to apply through the stock exchange of which he is a member. The application must be forwarded by the exchange to the SEBI within 30 days from the date of receipt. The application should be accompanied by a nonrefundable fee of ₹50,000. For granting registration to the broker, the SEBI takes into account all matters relating to trading/settling/dealing in securities and in particular whether or not he is eligible to be admitted as a member of a stock exchange, has the necessary infrastructure including manpower to effectively discharge his activities, has past experience in the business of buying, selling or dealing in securities and is subject to disciplinary proceedings under the rules, regulations and bye-laws of the stock exchange with respect to his business, is a fit and proper person, has financial liability due/payable in terms of the SEBI Act, Securities (Regulation) Act/rules/regulations, has obtained certification in terms of SEBI Certification of Associated Persons in the Securities Market Regulation, and satisfies the minimum networth and deposit requirements. Networth means paid-up capital, free reserves and other SEBI-approval securities but not include fixed assets, pledged securities, value of a member's card, unlisted securities, bad deliveries, doubtful debts and advances overdue for more than 90 days or given to associates, prepaid expresses, losses, intangible assets and 30 per cent value of marketable securities. The net worth requirement is ₹1 crore for currency derivatives segment and ₹50 lakh for debt segment. For determining whether an applicant/stock broker, is a fit and proper person, the SEBI may take into account the criteria specified in the **SEBI Intermediaries Regulation**, 2008.

Conditions of Registration The registration of a broker with the SEBI would be subject to conditions that he **(i)** holds the membership of any stock exchange, **(ii)** would abide by all

Exhibit 8.1 Stock Market Organisation in India



the applicable rules/regulations and bye-laws of the stock exchange, **(iii)** would obtain SEBI's prior approval to act as a broker after a change in control, **(iv)** pay the requisite fee to the SEBI, **(v)** would take adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keep the SEBI informed about the number, nature and other particulars of investors complaints, **(vi)** at all times abid by the code of conduct (**discussed in the chapter later**), and **(vii)** maintain the specified minimum networth.

A SEBI-registered stock broker/clearing member who desires to operate in any other stock exchange or any other segment of the stock exchange can seek membership of the concerned stock exchange in a manner specified by the SEBI who would inform the SEBI about its grant of approval for the same. **Change in control** in case of a body corporate **(i)** if its shares are listed means control in terms of the SEBI Act, **(ii)** in any other case means a change in its controlling interest. In case of a non-body corporate, it means any change in its legal formation/ownership **Controlling interest** means an interest to the extent of at least 51 per cent of its voting rights. A SEBI-registered stock broker can operate in any other stock exchange/any other segment with the SEBI's approval.

Payment of Fee A stock broker has to pay a registration fee of ₹5,000 for each financial year on annual turnover upto ₹1 crore, ₹5000 plus one-hundredth of 1 per cent of the turnover in excess of ₹1 crore. To keep registration in force, after five years from the date of initial registration, he would have to pay ₹5000 for every block of five years commencing from the sixth year after registration. Every stock broker has to pay to the SEBI a fee in respect of securities transactions including off-market transaction undertaken by him as specified below:

Cash Segment: 0.0002 per cent (i.e. ₹20 per crore) of the price at which securities (other than debt securities) are purchased/sold;

Equity and Currency Derivatives Segment: 0.0002 per cent of turnover (i.e. value of all trades executed and settled on the expiration of the contracts);

Interest Rate Derivative Segment: 0.00005 per cent (i.e. ₹5 per crore) of turnover. In case of option contracts, turnover would be computed on the basis of premium traded and where the option is exercised/assigned, it should be additionally computed in the basis of notional value.

Debt Segment: 0.00002 per cent (i.e. ₹2 per crore) of turnover (i.e. aggregate value of trades executed including both sale and purchase including proprietary trading member).

Code of Conduct Registered stockbrokers have to abide by a code of conduct specified as follows:

General First, a stockbroker has to maintain high standards of integrity, promptness and fairness with due skills, care and diligence in the conduct of all his business. He should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting the market equilibrium or making personal gains. He should not create a false market either singly or in collusion with others, indulge in any act detrimental to investors' interests or which leads to interference with the fair and smooth functioning of the market and not involve himself in excessive speculative business in the market beyond reasonable levels, but commensurate with his financial soundness. Finally, he has to abide by all the provisions of the SEBI Act, and the rules and regulations issued from time to time by the Government, the SEBI and the stock exchanges.

Duty to the Investors The duties of a broker to the investors are: **(1)** In his dealings with clients and the general investing public, he should faithfully execute the orders for buying and selling of securities at the best available market price and not refuse to deal with a small investor merely on the grounds of the volume of business involved. He should promptly inform his client about the execution or non-execution of an order, make prompt payment in respect of securities sold and arrange for prompt delivery of securities purchased by clients; **(2)** He should issue his clients, or clients of the broker, without delay, a contract note for all transactions in the form specified by the stock exchange; **(3)** To avoid breach of trust, he should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature regarding his clients, which he comes to know in the course of his business; **(4)** Merely for generating business, with the sole objective of earning commission and brokerage, he should not encourage sales or purchases of securities and/or furnish false or misleading quotations or give any other false or misleading advice or information to the clients; (5) He should avoid dealing or transacting business knowingly, directly or indirectly with a client who has failed to carry out his commitments in relation to securities with another stockbroker; (6) When dealing with a client, he is required to disclose whether he is acting as a principal or as an agent and should ensure, at the same time, that no conflict of interest arises between him and the client. In the event of such a conflict, he must inform the client accordingly and not seek to gain a direct or indirect personal advantage from the situation, and not consider the client's interest inferior to his own; (7) He should not give investment advice to any client who might be expected to rely thereon to acquire, dispose of, retain any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investment. The stockbroker should seek such information from clients whenever he feels it is appropriate to do so; (7-A) A stockbroker or any of his employees should render investment advice directly or indirectly, about any security in the publicly accessible media, whether real-time or non-real-time, only after disclosing his interest/interest of his independent family members and the employer, including their short/long position in the security, while rendering such advice. The employee should also disclose the interest of his dependent family members and the employer including their short/long position; and (8) A stockbroker should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients.

Stockbrokers vis-a-vis Other Stockbrokers The code of conduct of stockbrokers in relation to other brokers are related to/covers the following aspects:

Conduct of Dealings A broker should cooperate with other brokers in comparing unmatched transactions. He should not, knowingly and wilfully, deliver documents which constitute bad delivery and should cooperate with other brokers for prompt replacement of documents that are declared as bad delivery.

Protection of Clients' Interests He should extend full cooperation to other brokers in protecting the interests of his clients regarding their rights to dividends, bonus shares, rights issues and any other rights related to such securities.

Transactions with Stockbrokers While carrying out his transactions with other brokers, he should comply with his obligations in completing the settlement of transactions with them.

Advertisement and Publicity A stockbroker should not advertise his business publicly unless permitted by the stock exchange.

Inducement of Clients He should not resort to unfair means to induce clients from other stockbrokers.

False or Misleading Returns A stockbroker should not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to the SEBI and the stock exchange.
A stock broker should enter into an agreement specified by the SEBI with his client as also with the client by the sub-broker.

General Obligations and Responsibilities Every stock broker is required to keep and maintain the following books of accounts, records and documents: **(a)** Register of transactions (*sauda* book); **(b)** Client ledger; **(c)** General ledger; **(d)** Journals; **(e)** Cash book; **(f)** Bank pass book; **(g)** Documents register containing, *inter alia*, particulars of securities received and delivered in physical form and the statement of account and other records relating to receipt and delivery of securities provided by the depository participant in respect of dematerialised (demat) securities; **(h)** Member's contract books showing details of all contracts entered into by him with other members of the same exchange, or counterfoils of duplicates of confirmation memos issued to such other members; **(i)** Counterfoils or duplicates of contract notes issued to clients; **(j)** Written consent of clients in respect of contracts entered into as principals; **(k)** Margin deposit book; **(l)** Registers of accounts of sub-brokers; **(m)** An agreement with a sub-broker specifying the scope of mutual authority and responsibilities. These books of accounts and other records should be preserved for at least five years, **(n)** An agreement with the sub-broker and with the client of the sub-broker to establish priority of contract between the stock broker and the client of the sub-broker.

Appointment of Compliance Officer Every stock broker should appoint a compliance officer to monitor the compliance of the SEBI Act/rules/regulations/notifications/ guidelines instructions issued by the SEBI/Government and for redressal of investors' grievances. He should immediately and independently report any non-compliance observed by him to the SEBI.

Stock Broker Not to Deal with Unregistered Sub-broker A stock broker should not deal with any person as a sub-broker unless he has obtained a certificate of registration from the SEBI.

Procedure for Inspection The SEBI is empowered to appoint one or more persons as inspection authority to inspect the books of accounts, other records and documents of the stockbroker: **(a)** to ensure that the books of accounts and other books are being maintained in the required manner and in accordance with the provisions of the SEBI Act, rules, regulations and the provisions of the SCRA; **(b)** to investigate into the complaints received from investors, other stockbrokers, sub-brokers or any other person on any matter having a bearing on the activities of the stockbroker; and **(c)** to investigate, *suo moto*, in the interest of the securities business or in the investors' interest, into the affairs of stockbrokers.

The SEBI can also appoint a qualified auditor to carry out inspection/investigation into the records of the brokers. On the basis of the inspection report, SEBI can take action in case of default as specified below.

Liability for Contravention of the SEBI Act, Rules/Regulations A stock broker or a sub-broker who contravenes any of the provisions of the SEBI Act, rules or regulations would be liable for any one or more of the following actions:

(i) Monetary penalty under chapter VI-A of the SEBI Act.

(ii) Penalties as specified under SEBI Intermediaries Regulation, 2008, including suspension or cancellation of certificate of registration.

(iii) Prosecution under section 24 of the SEBI Act.

Liability for Monetary Penalty A stock broker or a sub-broker would be liable for monetary penalty in respect of the following violations, namely:

(i) Failure to file any return or report with the SEBI.
(ii) Failure to furnish any information, books or other documents within 15 days of issue of notes by the SEBI.
(iii) Failure to maintain books of account or records as per the SEBI Act, rules or regulations.
(iv) Failure to redress the grievances of investors within 30 days of receipts of notice from the SEBI.
(v) Failure to issue contract notes in the form and manner specified by the stock exchange of which such broker is a member.
(vi) Failure to deliver any security or make payment of the amount due to the investor within 48 hours of the settlement of trade unless the client has agreed in writing otherwise.
(vii) Charging of brokerage which is in excess of brokerage specified in the regulation or the bye-laws of the stock exchange.
(viii) Dealing in securities of a body corporate listed on any stock exchange on his own behalf or on behalf of any person on the basis of any unpublished price sensitive information.
(ix) Procuring or communicating any unpublished price sensitive information except as required in the ordinary course of business or under any law.
(x) Counselling any person to deal in securities of any body corporate on the basis of unpublished price sensitive information.
(xi) Indulging in fraudulent and unfair trade practices relating to securities.
(xii) Failure to maintain client account opening form.
(xiii) Failure to segregate his own funds or securities from the client's funds or securities or using the securities or funds of the client for his own purpose or for purpose of any other client.
(xiv) Acting as an unregistered sub-broker or dealing with unregistered sub-brokers.
(xv) Failure to comply with directions issued by the SEBI under the SEBI Act or the regulations.
(xvi) Failure to exercise due skill, care and diligence.
(xvii) Failure to seek prior approval of the SEBI in case of any change in its control.
(xviii) Failure to satisfy the net worth or capital adequacy norms, if any, specified by the SEBI.
(xix) Extending use of trading terminal to any unauthorised person or place.
(xx) Violations for which no separate penalty has been provided.

Liability for Action Under the Enquiry Proceeding Regulations A stock broker or a sub-broker would be liable for any action as specified in the SEBI Intermediaries Regulation, including suspension or cancellation of his certificate of registration, if he:

(i) Ceases to be a member of a stock exchange; or
(ii) Has been declared defaulter by a stock exchange and not readmitted as a member within a period of six months; or
(iii) Surrenders his certificate of registration to the SEBI; or
(iv) Has been found to be not a fit and proper person by the SEBI under these or any other regulations; or
(v) Has been declared insolvent or order for winding up has been passed in the case of a broker or sub-broker being a company registered under the Companies Act; or

(vi) Any of the partners or any whole-time director in case a broker or sub-broker is a company registered under the Companies Act, has been convicted by a court of competent jurisdiction for an offence involving moral turpitude; or

(vii) Fails to pay the prescribed fee; or

(viii) Fails to comply with the rules, regulations and bye-laws of the stock exchange of which he is a member; or

(ix) Fails to cooperate with the inspecting or investigating authority; or

(x) Fails to abide by any award of the Ombudsman or decision of the SEBI under the SEBI (Ombudsman) Regulations, 2003; or

(xi) Fails to pay the penalty imposed by the adjudicating officer; or

(xii) Indulges in market manipulation of securities or index; or

(xiii) Indulges in insider trading in violation of SEBI (Prohibition of Insider Trading) Regulations, 1992;

(xiv) Violates SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003; or

(xv) Commits violation of any of the provisions for which monetary penalty or other penalties could be imposed; or

(xvi) Fails to comply with the circulars issued by the SEBI; or

(xvii) Commits violations specified pertaining to liability for monetary penalty which in the opinion of the SEBI are of a grievous nature.

Liability for Prosecution A stock broker or a sub-broker would be liable for prosecution under Section 24 of the SEBI Act for any of the following violations, namely:-

(i) Dealing in securities without obtaining certificate of registration from the SEBI.

(ii) Dealing in securities or providing trading floor or assisting in trading outside the recognised stock exchange in violation of provisions of the Securities Contract (Regulation) Act, or rules made or notifications issued thereunder.

(iii) Market manipulation of securities or index.

(iv) Indulging in insider trading in violation of SEBI (Prohibition of Insider Trading) Regulations, 1992.

(v) Violating the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003.

(vi) Failure without reasonable cause

- **(a)** to produce the investigating authority or any person authorised by him in this behalf, any books, registers, records or other documents which are in his custody or power; or
- **(b)** to appear before the investigating authority personally or to answer any question which is put to him by the investigating authority; or
- **(c)** to sign the notes of any examination taken down by the investigating authority.

(vii) Failure to pay penalty imposed by the adjudicating officer or failure to comply with any of his directions or orders.

Registration of Clearing Members

To act as a clearing member, a certificate of registration should be obtained from the SEBI. However, any SEBI-registered broker who acts as clearing member with the approval of the clearing corporation would not require a separate registration. Similarly a separate registration would not be required for a SEBI-registered clearing member to operate in more than one clearing corporation.

The application for registration accompanied by non-refundable fee of ₹50,000 should be submitted in the prescribed form through the concerned clearing corporation which should forward it to the SEBI within 30 days of the receipt.

Applicability of Provisions Applicable to Stock Brokers Except as other wise provided, *the provisions relating to registration* of brokers are applicable ***mutatis mutandis*** to registration of a clearing member.

Payment of Fee A **clearing/self clearing member** (i.e. a broker member of a clearing corporation who clears/settles trades on its own account or on account of its clients only) would pay ₹50,000 as fee is respect of transactions including off-market transactions undertaken by them. Such members should also satisfy the minimum net worth and deposit requirement for the segment for which membership is sought as specified below:

Equity Derivative Segment: (a) clearing member, networth ₹3 crore and deposit, ₹50 lakh, **(b)** self clearing member, net worth, ₹1 crore, and deposit, ₹50 lakh.

Currency Derivatives Segment: (a) clearing member, net worth, ₹10 crore and deposit ₹50 lakh, **(b)** self clearing member, networth, ₹5 crore and deposit ₹50 lakh, (c) stock broker, net worth, ₹1 crore.

Debt Segment: (a) clearing member, net worth, ₹3 crore, **(b)** self clearing member, net worth, ₹1 crore.

Commodity Derivatives on National Commodity Derivative Exchanges: (a) self-clearing member, net worth, ₹1 crore; deposit, ₹50 lakh; **(b)** clearing member, net worth, ₹3 crore and deposit, ₹50 lakh.

Operation in other Clearing Corporations/Segments Any SEBI-registered broker/clearing member who desires to operate in another clearing corporation/segment would require approval in SEBI-specified manner by the concerned clearing corporation/segment which should inform the SEBI of the grant of approval.

The provisions relating to general obligations/responsibilities, procedure for inspection and action in case of default applicable to brokers would *mutatis mutandis* apply to clearing /self-clearing members. A self-clearing member of clearing corporation who is also a stock broker and clears/settles trades on own account/on account of its clients only including a person having clearing/settlement rights on commodity derivative exchange.

Sub-Brokers

A **sub-broker** acts on behalf of a stockbroker as an agent or otherwise for assisting investors in buying, selling or dealing in securities through such brokers, but he is not a member of a stock exchange. To act as a sub-broker, a certificate of registration from the SEBI is required. It grants a registration certificate to a sub-broker subject to the condition that he **(a)** pays the prescribed fee, **(b)** takes adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keeps the SEBI informed about the number, nature and other particulars of the complaints and **(c)** is authorised in writing by a broker for affiliation in buying, selling or dealing in securities.

Sub-brokers wanting to do business with more than one broker need to be separately registered with the SEBI for each broker. Consequent to a broker having corporatised his membership, all sub-brokers affiliated to him would need to apply to the SEBI for transfer for their affiliation.

A sub-broker would have to mandatorily disclose the names of all sub-brokers/brokers with whom he has direct/indirect interest in the same firm that he/any of his relative being a sub-broker/broker or partner hold substantial stake in. The agreement between a sub-broker and broker can be terminated only after giving prior written notice of at least six months by either party. Sub-brokers are obliged to enter into agreements and maintain the data base of their client as per the SEBI format. It would be the responsibility of the broker to report the default, if any, of his sub-broker to all other brokers with whom the sub-broker is affiliated.

Registration of Sub-Brokers A sub-broker should hold a certificate of registration from the SEBI. However, he would not require a fresh certificate where a registered sub-broker **(i)** changes his affiliation from one broker to another, **(ii)** in affiliated to a broker who is eligible to trade on a SME exchange/platform **(discussed in Chapter 11)**. According to the SEBI regulations currently in force, a sub-broker is required to submit along with the application **(1)** a recommendation from a stockbroker with whom he will be affiliated and **(2)** two references, including one from his banker. The application has to be submitted to the concerned stock exchange, which has to verify the information contained in it. It has also to certify that the applicant is eligible for registration as per the specified eligibility criteria, namely, an individual applicant is not less than 21 years of age, has not been convicted of any offence involving fraud or dishonesty, has passed the equivalent of at least 12th standard examination from a recognised institution and is a fit and proper person. The educational qualification may be relaxed by the SEBI on the basis of merit and subject to the experience of the applicant. Similar eligibility criteria apply to the partners of a firm or the directors of a body corporate. In addition, the applicant **(i)** has the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge his activities and **(ii)** should be a person recognised by the stock exchange as a sub-broker affiliated to a member broker of the stock exchange. The stock exchanges should forward the application in the prescribed form with the recommendation letter in the prescribed form issued by the stock broker with whom he is affiliated and also the recognition letter in the prescribed from issued by the stock exchange to the SEBI within 30 days from the date of the receipt of the application.

Conditions of Registration In addition to the conditions applicable to the stock brokers, the sub-broker should be authorised in writing by a broker for affiliation in buying/selling/dealing in securities.

General Obligations

Payment of Fee The annual fee payable by a sub-broker is ₹20,000 for an initial period of five years. After the expiry of five years, an annual fee of ₹10,000 is payable for every subsequent block of five financial years.

Agreement There should be an agreement with the broker and the sub-broker specifying the scope of his authority and responsibilities.

The sub-brokers should **(i)** comply with the rules, regulations and bye-laws of the stock exchange and **(ii)** not be affiliated to more than one stock broker of one stock exchange.

Books of Accounts The same books of accounts and documents as are required to be maintained/ by brokers except those specified in clause **(h)** to **(m)** should be maintained by sub-brokers also.

Code of Conduct The sub-brokers have to follow the code of conduct as detailed below:

General A sub-broker should maintain high standards of integrity, promptness and fairness and act with due skill, care and diligence in the conduct of all investment business.

Duty to the Investors A sub-broker, in his dealings with the clients and the general investing public, should faithfully execute the orders for buying and selling of securities at the best available market price and promptly inform his client about the execution or non-execution of an order.

He should render necessary assistance to his client in obtaining the contract note from the stock broker.

A sub-broker should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of confidential nature about the client, which he comes to know in the course of his business.

He should not encourage sales or purchases of securities with the sole object of generating brokerage or commission, and not furnish false or misleading quotations or give any other false or misleading advice or information to the client with a view to inducing him to do business in particular securities, enabling himself to earn brokerage or commission thereby. He should also not charge from his clients a commission exceeding one and one-half of one per cent of the value mentioned in the respective sale or purchase notes.

A sub-broker should not deal or transact business knowingly, directly or indirectly, or execute an order for a client who has failed to carry out his commitments in relation to securities and has defaulted against another broker or sub-broker.

When dealing with a client, he should disclose that he is acting as an agent and should issue appropriate purchase/sale notes ensuring at the same time that no conflict of interest arises between him and the client. In the event of a conflict of interest, he should inform the client accordingly and should not seek to gain a direct or indirect personal advantage from the situation and should not consider the clients' interest inferior to his own.

The employee should also disclose the interest of his dependent family members and the employer, including their short/long position in the security, while rendering such advice.

A sub-broker should not make a recommendation to any client who might be expected to rely thereon to acquire, dispose off or retain any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client, as to his own security holdings, financial situation and objectives of such investment. The sub-broker should seek such information from clients wherever he feels it is appropriate to do so.

A sub-broker or any of his employees should not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-real time, unless a disclosure of his interest, including his short/long position, in the security is made. The employee should also disclose the interest of his dependent family members and the employer, including their short/long position, in the security while rendering such advice.

He should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients and continuous compliance with the regulatory system.

Sub-Broker vis-a-vis Stockbrokers

Conduct of Dealings A sub-broker should cooperate with his broker in comparing unmatched transactions. He should not knowingly and wilfully deliver documents that constitute bad delivery. He should also cooperate with other contracting party(ies) for prompt replacement of documents that are declared as bad delivery.

Protection of Clients' Interests A sub-broker should extend full cooperation to his stockbroker in protecting the interests of the clients regarding the latter's rights to dividends, bonus shares, or any other rights related to such securities.

Transactions with Brokers A sub-broker should not fail to carry out his stockbroking transactions with his broker nor should he fail to meet his business liabilities or show negligence in completing the settlement of transactions with them.

Legal Agreement between Brokers A sub-broker should execute an agreement or contract with his affiliating brokers that would clearly specify the rights and obligations of the sub-brokers and the principal broker.

Advertisement and Publicity A sub-broker should not advertise his business publicly unless permitted by the stock exchange.

Inducement of Clients A sub-broker should not resort to unfair means to induce clients from other brokers.

Sub-Brokers vis-a-vis Regulatory Authorities A sub-broker should not indulge in dishonourable, disgraceful, disorderly or improper conduct on the stock exchange nor should he wilfully obstruct the business of the stock exchange. He should comply with its rules, bye-laws and regulations.

He should not neglect or fail or refuse to submit **(i)** to the SEBI or the stock exchange with which he is registered, such books, special returns, correspondence, documents and papers or any part thereof as may be required, **(ii)** the required returns, and not make any false or misleading statement on any returns required to be submitted to the SEBI or the stock exchanges.

In addition, a sub-broker should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting the market equilibrium or making personal gains.

Finally, he should not create a false market, singly or in concert with others, or indulge in any act detrimental to public interest or which interferes with the fair and smooth functioning of the market mechanism of the stock exchanges. He should not involve himself in excessive speculative business in the market, beyond a reasonable level not commensurate with his financial soundness.

No director of a stock broker should act as a sub-broker to the same stock broker.

General Obligations and Responsibilities, Procedure for Inspection/Action in Default The regulations applicable to stockbrokers in this respect are also applicable to sub-brokers.

CUSTODIAL SERVICES

The provision of efficient **custodial services** forms an important element in the evolution of a matured stock market system. The custodians of securities who provide custodial services play a critical role in the secondary market. Recognising their importance in the securities market, the SEBI Custodian of Securities Regulations, 1996 was framed for the proper conduct of their business. According to the SEBI regulations, custodial services in relation to securities of a client or gold/gold related instrument held by a mutual fund or title deeds of real estate assets held by a real estate mutual fund mean safe-keeping of such securities or gold/gold related instruments or title deeds of real estate assets and providing services incidental thereto, including **(i)** maintaining their accounts, **(ii)** collecting the benefits/rights to the client in respect of them,

(iii) keeping the client informed of the action(s) taken/to be taken by the issuer having a bearing on the benefits/rights accruing to the client and **(iv)** maintaining and reconciling records of services referred to above.

- Maintaining accounts of the securities of a client;
- Collecting the benefits/rights accruing to him in respect of securities;
- Keeping him informed of the actions taken/to be taken by the issuer of securities, having a bearing on the benefits/rights accruing to him; and
- Maintaining and reconciling records of the services referred to above.

The main elements of the SEBI framework of regulations for custodians of securities, briefly discussed in this section, are: **(i)** their registration, **(ii)** their general obligations and responsibilities, **(iii)** inspection and audit, **(iv)** action in case of default and **(v)** uniform norms and practices.

Registration

Registration of custodians of securities with the SEBI is mandatory. The application for registration should be made in the prescribed form accompanied by an application fee of ₹5,00,000. While granting registration, the SEBI would consider all matters relevant to the activities of a custodian of services with particular reference to whether the applicant **(a)** fulfils the requirement of net worth (paid-up capital plus free reserves) of ₹50 crore; **(b)** has the necessary infrastructure, including adequate office space, vaults for the safe custody of securities and computer systems capability required to effectively discharge his activities as a custodian; (ba) has the requisite approvals to provide custodial services in respect of gold/gold-related instruments of mutual funds; or title deeds of a real estate asset held by a real estate mutual fund; **(c)** has in employment adequate and competent persons who have the experience, capacity and ability to manage the business of a custodian; **(d)** has prepared a complete manual, setting out the systems and procedures to be followed by him for the effective/efficient discharge of his functions, and an arms' length relationship to be maintained with his other business(es); **(e)** is not a person who has been refused registration by the SEBI/whose registration has been cancelled by the SEBI; **(f)** his director/principal officer/any of his employees is involved in litigation connected with the securities market or has at any time been convicted of any offence involving moral turpitude/economic offence; **(g)** the registration is in the interest of investors; and **(h)** the applicant is a fit and proper person. For determining whether an applicant/custodian of securities is a fit and proper person, the SEBI would take into account the criteria specified in the SEBI Intermediaries Regulation, 2008. The applicant should be a body corporate. It has to pay a registration fee of ₹50,00,000. The registration would require renewal after every three years.

The registration of a custodian is subject to certain conditions. It **(a)** would not commence any custodial activities without fulfilment of capital requirement of ₹50 crore, **(b)** has to abide by the provisions of the SEBI Act and regulations in the discharge of its functions, **(c)** has to enter into a valid agreement with its clients for providing such services, and **(d)** has to pay an annual fee of ₹10,00,000 or 0.0005 per cent of the assets under custody (i.e. the value of the assets held by the custodian whichever is higher). Moreover, if any information submitted to the SEBI is found to be false/misleading in any material particular or if there is any change in such information, the SEBI should be forthwith informed in writing. Finally, in addition to providing custodial services, it would carry on activities relating to rendering of financial services only. The SEBI may restrict the certificate of registration to provide custodial services either in respect of securities or gold/gold-related instruments of a client or title deeds of a real estate asset held by a real estate asset mutual fund.

General Obligations/Responsibilities

Included in the general obligations and responsibilities of custodians are: **(i)** code of conduct, **(ii)** segregation of activities, **(iii)** monitoring/review/evaluation/inspection of systems/controls, **(iv)** separate custody account, **(v)** internal controls and **(vi)** maintenance of records.

Code of Conduct The custodians of securities should abide by the code of conduct set out below. He should

- maintain the highest standard of integrity, fairness and professionalism in the discharge of his duties.
- be prompt in distributing dividends/interest/any such accruals of income received/collected by him on behalf of his clients, on the securities held in custody.
- be continuously accountable for the movement of securities in/out of custody account, deposit and withdrawal of cash from the clients accounts and provide complete audit trail whenever called by the client/SEBI.
- establish and maintain adequate infrastructural facility to discharge custodial services to the satisfaction of clients and the operating procedures/systems should be well-documented and backed by operation manuals.
- maintain client confidentiality in respect of his affairs.
- take precautions to ensure that, where records are electronically maintained, continuity in record keeping is not lost/destroyed, and sufficient back-up of the records is available.
- create and maintain records of securities in such a manner that the tracing of securities/obtaining duplicate documents is facilitated in the event of loss of original records for any reason.
- extend to other custodial entities/depositories/ clearing organisations, all cooperation necessary for conduct of business in the areas of inter-custodial settlements and transfer of securities/funds. Ensure an arms' length relationship from other businesses, both in terms of staff and systems. Exercise due diligence in safekeeping/administration of assets of clients in custody.
- a custodian of securities or any of his employees should not directly/indirectly render any investment advance about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest, including long/short position in the security, has been made while rendering such advice. In case an employee is rendering such advice, he should also disclose the interest of his dependent family members and employer, including their short/long position.

Segregation of Activities The activities relating to his business as the custodian of securities should be separate and segregated from his all other activities. Similarly, its officers/employees engaged in custodial services should not be engaged in any other activity carried out by him.

Monitoring/Review/Evaluation/Inspection of Systems/Controls The custodian should have adequate mechanism for the purposes of reviewing, monitoring and evaluating the custodian's controls/systems/procedures and safeguards. It should be inspected annually by an expert. The inspection report should be sent to the SEBI within three months of inspection.

Prohibition of Assignment A custodian can assign/delegate its functions only to another custodian. It can, however, engage a non-custodian person for physical safekeeping of a mutual fund client having a gold exchange traded fund scheme provided **(i)** it would remain responsible for safekeeping including any associated risks, **(ii)** all books/documents/records would be maintained in its premises or made available if required by the SEBI, and **(iii)** it would continue to fulfill all duties to the client except for physical safekeeping.

Separate Custody Account and Agreement with Clients A separate custody account for each client should be opened by the custodian and the assets of one client should not be mixed with those of others. The custodian should enter into an agreement with each client providing for the circumstances under which he would **(i)** accept/release securities, asses/documents and money from the custody account, and **(ii)** receive rights/entitlement on the securities of the client. It should also include circumstances and the manner of registration of securities in respect of each client and details of insurance to be provided for by the custodian.

Internal Controls The custodians should have **(i)** adequate internal control to prevent the manipulation of records/documents including audit for securities and rights/ entitlements arising from securities held on behalf of clients and **(ii)** appropriate safekeeping measures to ensure that securities, assets and documents are protected from theft and natural hazards.

Maintenance of Records The custodians should maintain records/documents on behalf of/for each client containing details of: securities, assets/documents received/released, money received/ released, rights/entitlements arising from the securities held, registration of securities, ledger, instructions received from/to clients, and all reports submitted to the SEBI. These records should be maintained for at least five years and the place where they are maintained to the SEBI should be intimated.

Appointment of Compliance Officer Every custodian of securities should appoint a compliance officer to monitor the compliance of the SEBI Act/regulations/notifications/ guidelines/instructions and so on issued by the SEBI/Government and for redressal of investors' grievances. He should immediately and independently report to the SEBI any non-compliance observed by him.

Information to SEBI The SEBI can, at any time, ask for any information with respect to any matter relating to the activities of a custodian. Such information must be provided within such reasonable period as the SEBI may specify.

Inspection and Audit

The SEBI is empowered to conduct inspection/investigation, including inspection by an auditor of the books, of accounts/records/documents/of custodians for any of the following purposes:

- To ensure that they are being maintained in the manner specified in these regulations.
- To investigate into complaints received from the investors/clients/any other person on any matter having a bearing on his activities.
- To ascertain compliance with the provisions of the SEBI Act and these regulations.

On the basis of the inspection/investigation report, the SEBI can call upon the custodian to take such measures as it deems fit.

Action in Case of Default

In case of default, the SEBI can suspend/cancel registration of a custodian.

Suspension of Registration The registration of the custodians is liable to be suspended by the SEBI for the following reasons:

- Contravention of the provisions of the SEBI Act, rules framed under it and these regulations.

- Failure to furnish any information required by the SEBI/furnishing false/misleading information in any material particular.
- Non-submission of periodic returns/reports required by the SEBI.
- Non-cooperation in any enquiry/inspection by the SEBI.
- Failure to update its systems/procedures as recommended by the SEBI.
- Failure to resolve complaints of clients or give a satisfactory reply to the SEBI in this behalf.
- Guilty of misconduct/breach of code of conduct.
- Failure to pay annual fees.

Cancellation of Registration The SEBI can cancel the registration of a custodian when **(i)** it is guilty of fraud or has been found convicted of an offence involving moral turpitude, and **(ii)** it has been guilty of repeated defaults of the nature, leading to suspension.

DEPOSITORY SYSTEM

A major reform of the Indian stock markets has been the introduction of the **depository system** and scripless trading mec hanism, since 1996. This system of trading based on physical transfer/custody of securities militated against the efficient functioning of markets, particularly in the context of the large scale entry of Foreign Institutional Investors (FIIs). The main problems faced the investors in general and FIIs in particular were:

- Inordinate delays in transfer of securities,
- Return of share certificates as bad deliveries on account of forged signatures/mismatch of signatures or fake certificate/forged transfer deed,
- Delay in the receipt/non-receipt of securities after allotment/refund orders to non-allottees,
- Delay in getting duplicate shares/debentures certificates, and
- Inadequate infrastructure in banking and postal segments to handle a large volume of application and storage of share certificates.

To overcome the problem of a large number of transfer deeds and share certificates, the concept of jumbo transfer deed and jumbo certificate had been introduced. In a jumbo transfer deed only one transfer deed is to be executed for a large number of transfers, while a jumbo certificate reflects a large number of certificates. However, physical dealing in securities had to be completely eliminated to bring the Indian stock markets at par with the international markets, through scripless trading in which transactions in securities take place by a book entry method, without the physical delivery of securities or movement of cheques for payment. The essential part of scripless trading is the dematerialisation of share certificates through depositories. All certificates are surrendered to the issuer company that has issued the securities. On the receipt of the certificates through the depository participants and on the advice of the depository with whom the company has already entered into an agreement, the certificates are cancelled. The depositories' name is entered in the Register of Members of the company in respect of these securities, and the name of the beneficial owners whose name is recorded as such with a depository are deleted. The depository system in India operates within the framework of Depositories Act, 1996 and the SEBI Depositories and Participants Regulation, 1996.

Depositories Act

The objective of the Depositories Act is to provide for the regulation of depositories in securities and connected/incidental matters.

Certificate of Commencement of Business To act as a depository, a certificate of commencement of business from the SEBI, under regulations framed by it, is necessary. Before granting a certificate, the SEBI must satisfy that the depository has set up a company that has adequate systems and safeguards to prevent the manipulation of records in the form of books/store in a computer or in such other forms and transactions.

Rights/Obligations of Depositories, Participants, Issuers and Beneficial Owners A depository should enter into an agreement with depository participant(s) [DPs] as its agent. Any person can avail of depository services connected with the recording of allotment or transfer of securities in the record of a depository, through a DP, by surrendering the certificate of security to the issuer company in the specified manner. The issuer would cancel the certificate and substitute, in its records, the name of the depository as a registered owner in respect of that security. The depository would record the name of the person surrendering the certificate as the beneficial owner.

On receipt of information from any DP, a depository would register the transfer of security in the name of the transferee. Similarly, a depository would register any transfer of security in favour of an asset reconstruction company along with/consequent upon transfer/assignment of financial assets of a bank/financial institution. On intimation from a DP, it would register issue of new shares in favour of a bank/financial institution/asset reconstruction company/ their assignees by conversion of debt into shares pursuant to reconstruction of debts agreed between them. If a beneficial owner/transferee seeks to have the custody of such security, the depository would inform the issuer company. Persons subscribing to securities have the option either to receive the certificates or hold them with a depository. In the latter case, the company should inform the depository about the details of allotment and the depository should enter in its record the name(s) of the allottee(s) as the beneficial owners of that security. All securities held by the depository would be dematerialised and would be in fungible form. A depository would be deemed to be the registered owner for the purposes of transfer of ownership of a security on behalf of a beneficial owner, though he would not have any voting rights in respect of the securities held. The beneficial owner is entitled to all rights/benefits and subjected to all liabilities in respect of such securities. Every depository should maintain a register and an index of beneficial owners in the manner provided by the Companies Act.

A beneficial owner, with the prior approval of the depository, can create a pledge/hypothecation held in a depository that would make entries in its records accordingly. This entry would be evidence of a pledge/hypothetication.

The depository should furnish to the issuing company with information about the transfer of securities in the name of the beneficial owners at intervals and in a manner specified by its bye-laws. The issuer should make copies of the relevant records (with respect to the securities held by it) available to the depository.

A beneficial owner can opt out of a depository. Within 30 days of receipt of information to this effect from the depository, and on fulfilment of conditions and on the payment of fee specified by the SEBI regulations, the issuer would issue a certificate for the securities to the beneficial owner/transferee. Depositories would be treated as banks in terms of Section 2 of the Bankers Book Evidence Act, 1891. The depository would indemnify the beneficial owner(s) for any loss caused to him due to negligence of the depository/DP. It would have the right to recover the loss from the DP. Subject to the provisions of the Depositories Act, the rights/obligations of depositories/participants/ issuers and the eligibility criterion for the admission of securities into the depository would be specified by the SEBI regulations.

Enquiry and Inspection On being satisfied that it is necessary in public interest/in the interest of the investors, the SEBI can call for information from, or make an enquiry or inspection in relation to the affairs of, the issuer/beneficial owner/depository participant. It may also give appropriate directions to any depository/participant/person associated with the securities market/ investor **(i)** in the interest of investors or orderly development of the securities market or **(ii)** to prevent the affairs of any depository/participant being conducted in a manner detrimental to the interest of the investors or securities market. The power to issue directions includes power to direct any person who made profit/averted loss by indulging in any transaction/activity in contravention of the Depositories Act/regulations to disgorge an amount equivalent to the wrongful gain made/loss averted by the contravention. Any person aggrieved by an order of the SEBI may like to appeal to the SAT.

Penalty for failure **(a)** by a person to **(i)** furnish any information/document/book/ returns/ report to the SEBI within the specified time, **(ii)** file any return/furnish any information, books, other documents within the time specified by the regulations/bye-laws, **(iii)** maintain books of accounts/records; **(b)** by a depository participant, issuer/agent/any person registered with the SEBI as an intermediary to enter into an agreement under the SEBI Act/regulations/redress inventors' grievances/dematerialise or issue the security certificate on opting out of depository by the investors within the specified time or abetment in delaying the process of dematerialisation/rematerialisation/reconcile the records of dematerialised recurities, **(c)** by any depository/ participant/issuer/agent/any person (intermediary) to redress investors grievances, **(d)** delay in dematerialisation/issue of certificate of securities, **(e)** reconcile records, and **(f)** comply with directions issued by the SEBI is minimum ₹1 lakh but may extend to ₹1 lakh each day during which the failure continues subject to a maximum of ₹1 crore for each failure.. Penalty for contravention where no separate penalty has been provided would not be less than ₹1 lakh but may extend to ₹1 crore.

The SEBI would appoint an adjudicating officer to hold an enquiry for imposing any penalty. He would give the concerned person reasonable opportunity of being heard. He would have powers to summon/enforce attendance of any person acquainted with the facts/circumstances of the case to give evidence/produce relevant/useful documents. On being satisfied about the failure of compliance, he would impose the penalty. He will have due regards to the amount of **(i)** disproportionate gain/fair advantage, **(ii)** loss to the investors as a result of the default and the repetitive nature of the default. The SEBI may enhance the quantum of penalty if circumstances justify.

The concerned person may approach the SEBI for a settlement of the proceedings for the default. After taking into consideration the nature/gravity/impact of defaults, the SEBI may agree for settlement on payment of a sum by the defaulter determined by it or on similar other terms. The concerned person would be debarred from filing an appeal with the Securities Appellate Tribunal.

If the concerned person fails to pay the penalty any fee due to the SEBI, a recovery officer would recover the amount by one/more mode, namely, **(i)** attachment/sale of his movable/immovable property/bank accounts, **(ii)** arrest/detention in prison, **(iii)** appoint a receiver for the management of his movable/immovable properties. The recovery of the amount by him would have precedence over any other claim against the person concerned. All the sums realised by way of penalties would be credited to the Consolidated Fund of India.

Penalties Contravention/attempt to or abatement of contravention of the provisions of this Act/any regulations/bye-laws is punishable with imprisonment for a term up to 10 years or with fine upto ₹25 crore, or with both. Failure by any person to pay penalty imposed by the adjudicating officer/comply with any of his directions/orders would be punishable with imprisonment of at least one month but may extend to 10 years or with fine upto ₹25 crore or both.

In case of an offence under the Depositories Act by a company, the company as well as every person who was in charge of/responsible for the conduct of business would be deemed guilty and liable for punishment.

Power of the SEBI To carry out the purposes of this Act, the SEBI can make regulations, in particular, to provide for **(i)** the form in which the record is to be maintained/certificate of commencement of business issued, **(ii)** the manner of surrendering a security certificate/creating pledge, hypothecation by beneficial owners, **(iii)** conditions/fee payable for the issue of certificate of securities, **(iv)** rights/obligations of depositories/participants/issuers and **(v)** eligibility criteria for the admission of securities into the depository **(vi)** terms determined by the SEBI for settlement of civil/administrative proceedings and **(vii)** any other matter.

Powers of Depositories to Make Bye-laws With the prior approval of the SEBI, the depositories can make bye-laws consistent with the provisions of this (Depositories) Act/SEBI regulation, and in particular to provide for:

(a) The eligibility criteria for admission and removal of securities in depositories;
(b) The conditions subject to which the securities would be dealt with;
(c) The eligibility criteria for admission of any person as a depository participant;
(d) The manner and procedure for the dematerialisation of securities;
(e) The procedure for transactions within the depository;
(f) The manner in which securities would be dealt with or withdrawn from a depository;
(g) The procedure for ensuring safeguards to protect the interest of participants and beneficial owners;
(h) The conditions of admission into, and withdrawal from a participant, by a beneficial owner;
(i) The procedure for conveying information to the participants and beneficial owners on dividend declaration, shareholders meetings and other matters of interest to the beneficial owners;
(j) The manner of distribution of dividends, interest and monetary benefits received from the company among beneficial owners;
(k) The manner of creating pledge or hypothecation in respect of securities held with a depository;
(l) Inter se rights and obligations among the depository, issuer, participants and beneficial owners;
(m) The manner and the periodicity of furnishing information to the SEBI, issuer and other persons;
(n) The procedure for resolving disputes involving the depository, issuer, company or a beneficial owner;
(o) The procedure for proceeding against participants committing breach of regulations, provisions for the suspension and expulsion of participants from the depository and cancellation of agreements entered with the depository and
(p) Internal control standards including procedure for auditing, reviewing and monitoring.

Where the SEBI considers it expedient so to do, it may, by order in writing, direct a depository to make any bye-laws or to amend or revoke any bye-laws already made within such a period as it may specify in this behalf. If the depository fails or neglects to comply with such an order within the specified period, the SEBI may make the bye-laws or amend or revoke the bye-laws made either in the form specified in the order or with such modifications thereof as the it thinks fit.

SEBI Depositories and Participants Regulation

The main provisions of the SEBI regulation are as follows:

Registration of Depository Depositories must be registered with the SEBI. The application for the grant of certificate of registration, in the prescribed form, should be accompanied by an application fee of ₹5,00,000 payable by the sponsor and ₹15,000 payable by participant together with draft bye-laws of the proposed depository. The sponsors of depositories who act alone or in combination with others proposing to establish a depository and undertaking to perform the obligations under these regulations can be: a **(i)** public financial institution, **(ii)** bank, **(iii)** foreign bank operating in India with RBI's approval, **(iv)** recognised stock exchange, **(v)** body corporate engaged in financial services, at least 75 per cent of whose capital is held by institutions in categories **(i)** to **(iv)** jointly or severally, **(vi)** body corporate constituted/recognised in a foreign country for providing custodial, clearing or settlement services in the securities market and approved by the Government and **(vii)** an institution engaged in financial services outside India and approved by the Government. The applicant should be a fit and proper person. For determining whether an applicant/depository and participant is a fit and proper person, the SEBI would take into account the criteria specified in the **SEBI Intermediaries Regulation, 2008**.

Eligibility for Acquiring/Holding Shares Only a fit and proper person can directly/indirectly acquire/hold shares/voting rights of a depository. Acquisition of shares directly/indirectly individually or together with person(s) acting in concert resulting in his shareholding in excess of 2 per cent of the paid-up capital of the depository would require SEBI's approval within 15 days. The excess would have to be divested forthwith in case of non-approval by the SEBI. Person(s) holding more than 2 per cent of the equity capital should file a declaration within 15 days from the end of the financial year to the depository that he complies with the fit and proper person criteria. Any instrument directly/indirectly held/owned/controlled by any person entitling him/providing for entitlement to the voting rights or equity shares or any other rights over equity shares at any future date would also be included for determining his shareholding.

Conditions for Registration The certificate of registration of a depository would be subject to the following:

- Payment of a registration fee of ₹1,00,00,000 payable by depository and ₹2,00,000 payable by participant within 15 days;
- Compliance with the provisions of the Depositories Act/bye-laws/agreements/these regulations;
- Prohibition on carrying on any activity other than that of a depository, unless it is incidental to the depository;
- Compliance with the shareholding and governance structure requirements **(discussed later)**;

- At least 51 per cent of the equity capital of the depository should be held by the sponsor(s). No participant can hold more than 5 per cent. However, stock exchange-sponsor cannot hold more than 24 per cent;
- A DP can hold upto 5 per cent of the capital of the depository;
- No resident/non-resident person, other than a sponsor would at any time individually or together with persons acting in concert hold more than 5 per cent of the equity capital for a depository;
- Subject to limits prescribed by Government, the combined holdings of all non-resident persons in the equity capital of a depository could be upto a maximum of 49 per cent.
- A foreign portfolio investor **(i)** can acquire shares of a depository only through the secondary market and **(ii)** would have no representation on the Board of Directors of the depository;
- The depository should immediately inform the SEBI if any information previously submitted by the sponsor/depository is found to be false/misleading or if there is any change in such information;
- Redressal of grievances of participants/beneficial owners within, 30 days and keep the SEBI informed about the number and nature of redressals;
- Within one year of registration, apply for commencement of business;
- Amendment of bye-laws from time to time, as may be directed by the SEBI; and
- Any other condition as the SEBI may deem fit in the interest of the securities market.

The annual fee is payable by depository ₹50,00,000 and payable by participant ₹1,000. The annual charges payable by the depository are 2 per cent of annual custody charges collected by them from issuers.

Governance of Depositories The elements of the regulatory framework are: **(i)** governing board, disclosures and corporate governance, **(ii)** conditions of appointment of directors, **(iii)** appointment of managing director, **(iv)** code of conduct for directors and key management personnel, **(v)** compensation and tenure of key management personnel and **(vi)** segregation of regulatory departments.

Governing Board, Disclosures and Corporate Governance The governing board of a depository should include **(a) shareholder directors** (i.e. a director who represents the interest of shareholders and is elected/nominated by them), **(b) public interest director** (i.e. an independent director who represents the interests of investors in securities market and does not have direct/indirect association which is in conflict with his role) and **(c)** managing director. With the SEBI's prior approval, the governing board would elect the chairperson from amongst the public interest directors, whose member should not be less than that of the shareholders directors. The managing director would be an *ex-officio* director and not included in categories **(a)** and **(b)** above. An employee director would be deemed to in category **(a)**. Quorum would require at least one director in category **(b)**. The disclosure requirements/corporate governance norms applicable to listed companies would *mutatis mutandis* apply to a depository.

Conditions of Appointment of Directors While the public interest directors would be nominated by the SEBI for a three year/extend period subject to retirement and re-appointment, its prior approval would be necessary for appointment/re-appointment of shareholder directors. The public interest directors would be entitled only to sitting fee specified in the Companies Act. Upon completion of their one term, they may be re-nominated after a cooing-off period of one year/a period as SEBI deems fit in the interest of the securities market. Its decision would be final on question of conflict of interest with their role.

Appointment of Managing Director Prior approval of SEBI would be required for his appointment/renewal of appointment/termination of service. Subject to the SEBI guidelines, a depository would determine qualifications/manner and terms and conditions of appointment and other related procedural formalities. The tenure would be 3-5 years. He should not be **(a)** **(i)** shareholder/associate of a shareholder of depository/associate of depository, **(ii)** depository participant (DP)/his associate/agent shareholder of a depository participant/shareholder of an associated/agent of a DP, **(b)** hold any position concurrently in the subsidiary of a depository/any other associated entity. He can, however, be appointed the director of a subsidiary/its associate. With its prior approval, the governing board can remove/terminate his services for failure to give effect to the SEBI's directions/guidelines/orders or the rules/instructions/articles of association/bye-laws of depository. The SEBI may *suo moto* remove/terminate his appointment if deemed fit in the interest of the securities market.

Code of Conduct for Directors/Key Management Personnel The directors of a depository should abide by the code of conduct specified below.

(i) Meetings and Minutes A director of the depository should **(a)** not participate in discussions on any subject-matter in which in any pecuniary or otherwise, conflict of interest exists or arises and it should be disclosed and recorded in the minutes of the meeting; **(b)** not encourage the circulation of agenda papers during the meeting unless circumstances so require; **(c)** offer their comments on the draft minutes and ensure that they are incorporated in the final minutes; **(d)** insist on the minutes of the previous meeting being placed for approval in the subsequent meeting; **(e)** endeavour to have the date of next meeting fixed at each governing board meeting in consultation with other broad members; **(f)** endeavour that in case of all the items of the agenda of a meeting were not covered for want of time, the next meeting is held within 15 days for considering the remaining items.

(ii) Code of Conduct for the Public Interest Directors In addition to the conditions stated above, public interest directors should **(a)** endeavour to attend all the governing board meetings and would be liable to vacate office if they remain absent for three consecutive meetings or do not attend 75 per cent of the total meetings in a calendar year, **(b)** meet separately, at least once in six months, to exchange views on crucial issues.

(iii) Strategic Planning Every director of the depository should: **(a)** participate in the formulation and execution of strategies in the best interest of the depository and contribute towards pro-active decision-making at the governing board level; **(b)** give benefits of their experience and expertise to the depository and provide assistance in strategic planning and execution of decisions.

(iv) Regulatory Compliances They should: endeavour **(a)** to ensure that the depository abides by all the provisions of the SEBI/Depositories Act/rules/regulations/circulars/ directions; **(b)** compliance at all levels so that the regulatory system does not suffer any breaches; **(c)** to ensure that the depository takes commensurate steps to honour the time limit prescribed by SEBI for corrective action; and **(d)** not support any decision in the meeting of the governing body which may adversely affect the interest of investors and report forthwith any such decision to the SEBI.

(v) General Responsibility They should **(a)** place priority for redressing investors grievances; **(b)** endeavour to analyse and administer the depository issues with professional competence, fairness, impartiality, efficiency and effectiveness; **(c)** submit the necessary disclosures/statement

of holdings/dealings in securities as required by the depository as per their bye-laws/articles of association; **(d)** unless otherwise required by law, maintain confidentiality and not divulge/ disclose any information obtained in the discharge of their duties and no such information should be used for personal gains; **(e)** maintain the highest standards of personal integrity, truthfulness, honesty and fortitude in discharge of their duties in order to inspire public confidence and not engage in acts discreditable to their responsibilities; **(f)** perform their duties in an independent and objective manner and avoid activities that may impair, or may appear to impair, their independence or objectivity or official duties; **(g)** perform their duties with a positive attitude and constructively support open communication, creativity, dedication and compassion; and **(h)** not engage in any act involving moral turpitude, dishonesty, fraud, deceit, or misrepresentation or any other act prejudicial to the administration of the depository.

Similarly, every director and **key management personnel** (i.e. a person serving as head of any department or in such senior executive position that stands higher in hierarchy to the head(s) of department(s) in, or any other position as declared by the depository) should **(i)** abide by the code of conduct specified below and **(ii)** satisfy the fit and proper person criteria.

The code of ethics for directors and key management personnel is aimed at improving the professional and ethical standards in the functioning of depository thereby creating better investor confidence in the integrity of the market.

(i) Objectives and Underlying Principles The code of conduct for directors and key management personnel seeks to establish a minimum level of business/professional ethics to be followed by them towards establishing a fair and transparent marketplace. It is based on the following fundamental principles: **(a)** fairness and transparency in dealing with matters relating to the depository and the investors, **(b)** compliance with all laws/rules/regulations laid down by regulatory agencies/depositories, **(c)** exercising due diligence in the performance of duties, and **(d)** avoidance of conflict of interest between their self interest and interests of depository and investors.

(ii) Ethics Committee For overseeing implementation of the code, an ethics committee should be constituted by every depository under the governing board.

(iii) General Standards Directors and key management personnel should endeavour to promote greater awareness and understanding of ethical responsibilities and in the conduct of their business observe high standards of commercial honour and just and equitable principles of trade. Their conduct in business life should be exemplary. They should not use their position to give/get favours to/from the executive or administrative staff of the depository, suppliers of the depository, or any issuer company admitted to the depository, commit any act which will put the reputation of the depository in jeopardy. They should also comply with all rules and regulations applicable to the securities market.

(iv) Disclosure of Dealings in Securities by Key Management Personnel of the Depository They should disclose on a periodic (say, monthly) basis as determined by the depository, all their direct/indirect dealings in securities to the governing board/ethics/committee/compliance officer. The dealings in securities (exclusive of mutual fund units) should also be subject to trading restrictions for securities about which may have non-public price sensitive information. All transactions must be of an investment and not speculative in nature. All securities purchases must be held for a minimum period of 60 days before they are sold. However, in specific/exceptional circumstances, sale can be effected anytime by obtaining pre-clearance from the compliance office to waive this condition after recording in writing his satisfaction in this regard.

(v) Disclosure of Dealings in Securities by Directors of the Depository All transactions in securities by the directors and their family should be disclosed to the governing board of the depository. They should also disclose the trading conducted by firms/corporate entities in which they hold 20 per cent or more beneficial/a controlling interest to the ethics committee. However, Government nominee or nominees of statutory financial institutions governed by their own codes would be exempt from this requirement.

(vi) Avoidance of Conflict of Interest No director/member of any committee should participate in any decision-making/adjudication in respect of any person/matter in which he is directly or indirectly concerned or interested. Whether there is any conflict of interest or not, should be decided by the governing board.

(vii) Disclosure of Beneficial Interest All directors and key management personnel should disclose to the governing board, upon assuming office and during their tenure in office, the following: **(a)** any fiduciary relationship/directorship/partnership of self and family members in any depository participant or registrar and transfer agent; **(b)** shareholding in excess of 5 per cent or in any listed company or in other entities related to the securities market; and **(c)** any other business interests.

(viii) Role of the Chairman and Directors in the Day-to-Day Functioning of the Depository They should not interfere in the day-to-day functioning and should limit their role to decision-making on policy issues and to issues as the governing board may decide and abstain from influencing the employees in conducting their day-to-day activities. They should also not be directly involved in the function of appointment and promotion of employees unless specifically so decided by the governing board.

(ix) Access to Information The directors should call for information only as part of specific committees or as may be authorised by the governing. There should also be **(i)** prescribed channels through which information should move and **(ii)** audit trail of the same. Any retrieval of confidential documents/information should be properly recorded. All such information, especially non-public and price sensitive, should be kept confidential and not be used for any personal consideration/gain. Any information relating to the business/operations of the depository, which may come to their knowledge during performance of their duties should be held in strict confidence, not divulged to any third party and not used in an manner except for the performance of their duties.

(x) Misuse of Position Directors/committee members should not use their position to obtain business or any pecuniary benefit in the organisation for themselves or family members.

(xi) Ethics Committee to Lay Down Procedures The ethics committee should lay down procedures for the implementation and prescribe reporting formats for the disclosures required under the code. The compliance officer should execute the requirements laid down by the ethics committee.

While the objective of this code is to enhance the level of market integrity and investor confidence, it is emphasised that a written code of ethics may not completely guarantee adherence to high ethical standards. This can be accomplished only if directors and key management personnel of the depository commit themselves to the task of enhancing the fairness and integrity of the system in letter and spirit.

The SEBI, *suo moto,* or upon a reference from the depository may take appropriate action including removal/termination of the appointment of a director for failure to abide by the SEBI regulations/code of conduct/ethics or in case of a conflict of interest.

Compensation/Tenure of Key Management Personnel The depositories should constitute a compensation committee comprising a majority of public interest directors including the chairman to determine their compensation in terms of policy in accordance with the SEBI norms. The compensation payable to the managing director as well as any change in the terms/conditions would be approved by the SEBI. The compensation committee would decide the fixed tenure of the key management personnel and their compensation should be disclosed in the report of the depository under Section 217 of the Companies Act.

Segregation of the Regulatory Department The depository should segregate its **regulatory department** (i.e. department entrusted with regulatory powers/duties including a SEBI-specified department) from other departments in the manner of specified below.

In order to ensure the segregation of regulatory departments, every depository should adopt a "Chinese wall" policy which separates the **regulatory departments** (i.e. departments maintained by law/entrusted with regulatory powers/duties including departments performing the following functions: risk management; surveillance; depository participant registration; issuer/securities admission; compliance; inspection; enforcement; arbitration, investor protection/services) from the other departments. The employees in the regulatory departments should not communicate any information concerning regulatory activity to any one in other departments. They may be physically segregated from the employees in other departments including with respect to access controls. In exceptional circumstances, employees from other departments may be given confidential information on "need to know" basis, under intimation to the compliance officer.

Certificate of Commencement of Business Within a year of registration with the SEBI, the depository is required to apply for a certificate of commencement of business. While granting the certificate, the SEBI would consider all matters relevant to the efficient and orderly functioning of the depository and in particular the following, namely, whether:

(a) The depository has a net worth of not less than ₹100 crore;

(b) The bye-laws of the depository have been approved by the SEBI;

(c) The automatic data processing systems of the depository have been protected against unauthorised access, alteration, destruction, disclosure or dissemination of records and data;

(d) The network, through which means of continuous electronic communication are established between the depository, participants, issuers and issuers' agents is secure against any unauthorised entry or access;

(e) The depository has established standard transmission and encryption formats for the electronic communication of data between the depository, participants, issuers and issuers' agents;

(f) The physical or electronic access to the premises, facilities, automatic data processing systems, data storage sites and facilities including back-up sites and facilities and the electronic data communication network connecting the depository, participants, issuers and issuers' agents is controlled, monitored and recorded;

(g) The depository has a detailed operations manual explaining all aspects of its functioning, including the interface and method of transmission of information between the depository, issuers, issuers' agents, participants and beneficial owners;

(h) The depository has established adequate procedures and facilities to ensure that its records are protected against loss or destruction and arrangements have been made for maintaining back-up facilities at a location different from that of the depository;

(i) It has made adequate arrangements, including insurance, for indemnifying the beneficial owners for any loss that may be caused to them by the wrongful act, negligence or default of the depository or its participants or of any employee of the depository or participant and

(j) The grant of certificate of commencement of business is in the interest of investors in the securities market.

Before granting the certificate, the SEBI would make a physical verification of the infrastructure facilities and systems established by the depository.

Networth Certificate Every depository should submit an audited **networth** [i.e. paid-up capital **plus** free reserves (excluding statutory/benefits funds and reserves created out of revaluation) **minus** related/unrelated investments in business, aggregate value of accumulated losses and deferred expenditure (including miscellaneous expenses) not written off] certificate from the statutory auditors on a yearly basis by September 30 of every year for the preceding financial year. It should also within one month of its annual general meeting furnish to the SEBI a copy of its audited balance sheet/profit and loss account for the preceding financial year.

Code of Conduct The depository holding a certificate of commencement of business should always abide by the code of conduct specified below:

A depository should always **(i)** abide by the provisions of the SEBI/Depositories Act/rules/regulations/circulars/guidelines and any other directions issued by the SEBI; **(ii)** take appropriate measures towards investor protection and education of investors; **(iii)** treat all its applicants/participants in a fair and transparent manner; **(iv)** promptly inform the SEBI of violations of the provisions of the SEBI/Depositories Act/rules/regulations/circulars/ guidelines or any other directions by any of its participants or issuer's agent; **(v)** take a pro-active and responsible attitude towards safeguarding the interests of investors, integrity of the depository system and the securities market; **(vi)** make endeavours for introduction of best business practices amongst self and its participants; **(vii)** act in utmost good faith and shall avoid conflict of interest in the conduct of its functions; **(viii)** not indulge in unfair competition, which is likely to harm the interests of other depository, participants or investors or is likely to place them in a disadvantageous position while competing for or executing any assignment; **(ix)** be responsible for the acts or omissions of its employees in respect of the conduct of its business; and **(x)** monitor the compliance of the rules and regulations by the participants and further ensure that their conduct is in a manner that will safeguard the interest of investors and the securities market.

Registration of Participants An application for initial registration as a participant should be made to the SEBI in the prescribed form together with a fee of ₹5,000, through the depository. The depository should forward the application to the SEBI within 30 days along with its recommendations and certifying that the participant-applicant complies with the eligibility criteria, including adequate infrastructure, as provided for in the regulations and the bye-laws of the depository.

Consideration of Application for Initial Registration All matters which are relevant to or related to the efficient and orderly functioning of a participant would be taken into account by the SEBI for granting registration. In particular, the SEBI insist that the applicant:

1. Must belong to one of the following categories:

(i) a public financial institution

(ii) a bank
(iii) a foreign bank
(iv) a State Financial Corporation (SFC)
(v) a financial services institution promoted by any of the institutions listed in **(i)** to **(iv)**, jointly or separately
(vi) a custodian of securities registered with the SEBI
(vii) a clearing corporation/house of a stock exchange
(viii) a registered stock broker who has a minimum net worth of ₹50 lakh and the aggregate value of the portfolio of securities of the beneficial owners held in a dematerialised form in a depository through him should not be more than 100 times the networth. However, where the stock broker has a minimum networth of ₹10 crore, the limits on the aggregate value of the portfolio of securities of the beneficial owners held in a dematerialised form in a depository through him would not be applicable. Moreover, if he seeks to act as a participant in more than one depository, he should comply with these stipulations separately for each depository,
(ix) a non-banking finance company (NBFC) with a net worth of at least ₹50 lakh can act as a participant only on behalf of itself. It may act on behalf of others only if its net worth is ₹50 crore in addition to the net worth specified by any other authority.
(x) a registrar to an issue or share transfer agent who has a minimum networth of ₹10 crore.

2. Is eligible to be admitted as a participant of the depository through which it has applied;
3. Has adequate infrastructure, systems, safeguards and trained staff to carry on as a participant;
4. Is registered in the interest of the investors and the securities market and
5. Is a fit and proper person.
6. Grant of certificate of initial registration is in the interest of investors in the securities market.

Conditions The initial registration of a participant with the SEBI is subject to the undermentioned conditions. The participant should pay a registration fee of ₹1,00,000 within 15 days and comply with the provisions of the Depositories Act, bye-laws, agreements and regulations. The depository, through whom the registration is obtained, holds a certificate of commencement of business from the SEBI. The participant should obtain prior approval of the SEBI for continuing to act after change in its control. He should forthwith inform the SEBI if any information already submitted to it is found to be false/misleading in any material respect or if there is any change in such information. The grievances of beneficial owners should be redeemed within 30 days and the depository kept informed about the number/nature of redressals of complaints. The participant has to pay the SEBI an annual fee of ₹1,000. The registration of a depository participant is valid for five years. It can be renewed on payment of a fee of ₹l0,00,000, for a period of five years.

Certificate of Permanent Registration Three months before the expiry of the period of initial registration, the participant should apply for permanent registration through the concerned depository together with the specified fee and accompanied by details of changes that have taken place in the information submitted to the SEBI while seeking initial registration and a declaration that no other changes have taken place. On being satisfied about the eligibility of the applicant, the SEBI would grant permanent registration on payment of the requisite fee within 15 days. The participant would also pay the requisite annual fee.

Code of Conduct for Participants

The participant holding a certificate of initial/permanent registration should abide by the code of conduct specified below: A participant should:

1. Make all efforts to protect the interests of investors.
2. Always endeavour to **(a)** render the best possible advice to the clients having regard to the client needs and the environments and his own professional skills; **(b)** ensure that all professional dealings are affected in a prompt, effective and efficient manner; **(c)** inquiries from investors are adequately dealt with; **(d)** grievances of investors are redressed without any delay.
3. Maintain high standards of integrity in all its dealings with its clients and other intermediaries, in the conduct of its business.
4. Be prompt and diligent in opening of a beneficial owner account, dispatch of the dematerialisation request form, rematerialisation request form and execution of debit instruction slip and in all other activities undertaken by him on behalf of the beneficial owners.
5. Endeavour to resolve all the complaints against it or in respect of the activities carried out by it as quickly as possible, and not later than one month of receipt.
6. Not increase charges/fees for the services rendered without proper advance notice to the beneficial owners.
7. Not indulge in any unfair competition, which is likely to harm the interests of other participants or investors or is likely to place such other participants in a disadvantageous position while competing for or executing any assignment.
8. Not make any exaggerated statement, whether oral or written; to the clients either about its qualifications or capability to render certain services or about its achievements in regards to services rendered to other clients.
9. Not divulge to other clients, press or any other person any information about its clients which has come to its knowledge except with the approval/authorisation of the clients or when it is required to disclose the information under the requirements of any Act, rules or regulations.
10. Cooperate with the SEBI as and when required.
11. Maintain the required level of knowledge and competency and abide by the provisions of the SEBI Act/rules/regulations and circulars and directions issued by the SEBI. He should also comply with the award of the Ombudsman under the SEBI (Ombudsman) Regulations, 2003.
12. Not make any untrue statement or suppress any material fact in any documents, reports, papers or information furnished to the SEBI.
13. Not neglect or fail or refuse to submit to the SEBI or other agencies with which it is registered, such books, documents, correspondence, and papers or any part thereof as may be demanded/requested from time to time.
14. Ensure that the SEBI is promptly informed about any action, legal proceedings, etc., initiated against it in respect of material breach or non-compliance by it, of any law, rules, regulations, directions of the SEBI or of any other regulatory body.
15. Maintain proper inward system for all types of mail received in all forms.
16. Follow the maker-checker concept in all of its activities to ensure the accuracy of the data and as a mechanism to check unauthorised transaction.
17. Take adequate and necessary steps to ensure that continuity in data and record keeping is maintained and that the data or records are not lost or destroyed. It should also ensure that for electronic records and data, up-to-date back up is always available with it.

18. Provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.

19. Ensure that it has satisfactory internal control procedures in place as well as adequate financial and operational capabilities which can be reasonably expected to take care of any losses arising due to theft, fraud and other dishonest acts, professional misconduct or omissions.

20. Be responsible for the acts or omissions of its employees and agents in respect of the conduct of its business.

21. Ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

22. Ensure that good corporate policies and corporate governance are in place.

A participant may act as a participant of another depository without a separate certificate of registration. The other depository would grant approval to the applicant-participant subject to the payment of the specified registration fee within 15 days of the intimation from the depository who would also inform the SEBI. The participant would pay the specified annual fee separately for each depository. To keep the registration in force, the concerned participant would pay the specified registration fee for every five years from the sixth year of the date of grant of approval by the depository.

Rights/Obligations of Depositories/Participants/Issuers/Surrender of Certificate of Security and Creation of Pledge/ Hypothecation The depositories, participants, issuers and their agents have, in addition to the rights and obligations laid down in the Depositories Act and the bye-laws, all the rights and obligations arising from the agreements entered into by them.

Depositories They should state, in the bye-laws, the specific securities eligible for being held in dematerialised form in the depository, namely: **(a)** shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in/or of any company, **(b)** units of mutual funds, rights under collective investment schemes and venture capital funds, commercial papers, certificates of deposit, securitised debt, money market instruments, Government securities and unlisted securities, and **(c)** any other security specified by the SEBI from time to time.

The issuers should enter into an agreement with the depository to enable the investor to dematerialise the securities except where the depository itself is an issuer of securities. Where the issuer has appointed a SEBI approved registrar to the issue and share transfer agent (RISTA), the depository would enter into a tripartite agreement with the issuer, the RISTA, with respect to the securities to be declared by the depository as eligible to be held in dematerialised form.

The depository should have systems/procedures to coordinate and reconcile the records of ownership of securities with the issuer/its agent and the participants on a daily basis. It should also maintain means of continuous electronic communication with all its participants/issuers or their agents, clearing houses/corporations of stock exchanges and with other depositories. Moreover, a depository should:

- Satisfy the SEBI that it has a mechanism in place to ensure that the interests of persons buying and selling securities held in the depository are adequately protected;
- Allow any participant to withdraw/transfer its account in accordance with the stipulations in the bye- laws of the depository;
- Have an adequate mechanism for reviewing, monitoring and evaluating the depository's controls, systems, procedures and safeguards and cause their inspection annually and forward a copy of the same to the SEBI;

- Should have adequate business continuity plan for data and electronic records to prevent, prepare for, and recover from disaster.
- Devise/maintain a wind-down plan in accordance with the SEBI specified guidelines. The **window-down plan** means a process/plan of action for transfer of beneficial owner accounts/other operational powers of the depository to an alternative institution to take over its operations in scenarios such as erosion of its net worth, insolvency/bankruptcy/inability to provide critical depository operations/services.
- Take adequate measures, including insurance, to protect the interest of the beneficial owners against risks likely to be incurred on account of its activities as a depository;
- Ensure, where records are stored electronically by it, that the integrity of the automatic data processing system is always maintained, and all precautionary measures to ensure that the records are not lost/destroyed/tampered with and, in the event of loss/ destruction, ensure that sufficient back-up of records is available at all times at a different place;
- Maintain the undermentioned records/documents: **(a)** records of securities dematerialised/rematerialised, **(b)** name of transferors/transferees and the date of transfer of securities, **(c)** a register and index of beneficial owners; details of their holdings at the end of each month, **(d)** records of instructions received from and sent to participants, issuers and their agents and beneficial owners, **(e)** records of approval, notice, entry and cancellation or pledge/hypothecation, **(f)** details of participants and securities declared to be eligible for dematerialisation in the depository and **(g)** such other records as may be specified by the SEBI from time to time to carry on activities as a depository. These records must be maintained for at least five years. The depository must inform the SEBI of the place where the records/documents are maintained;
- Extend such cooperation to beneficial owners/issuers and their agents/custodians/other depositories/clearing organisations as is necessary for effective, prompt and accurate clearance/ settlement of securities transactions and conduct of business;
- Not assign/delegate to any other person its functions as a depository without the SEBI's prior approval.
- Enter with necessary agreements for sharing information regarding generation of a consolidated statement for the use of a beneficial owner is respect of all demat assets held by him.

Participants Every participant should enter into an agreement with a beneficial owner before acting as a participant on his behalf in a manner specified by the bye-laws of the depository.

Separate accounts should be opened by the participants for each beneficial owner and his securities segregated and not mixed up with those of others, including participants. The transfer of securities to or from a beneficial owners' account should be registered by the participants only on instructions from him, and the same should be confirmed in a manner specified by the bye-laws of the depository. Every entry in his account should be supported by electronic instructions or any other mode of instruction from him in accordance with the agreement with him. Every participant should:

(i) Provide a statement of accounts in a form/manner and at such time, as per the agreement with the beneficial owner;

(ii) Allow him to withdraw/transfer from his account as per agreement with him;

(iii) Maintain continuous electronic means of communication with each depository in which it is a participant;

(iv) Have an adequate mechanism for reviewing, monitoring and evaluating its internal accounting controls and systems;

(v) Reconcile his records with every depository in which it is a participant on a daily basis;

(vi) Submit periodic returns to the SEBI and to every depository in a format specified by them;

(vii) Maintain the following records/documents:

- Record of transactions with depositories and beneficial owners,
- Details of securities dematerialised/rematerialised on behalf of beneficial owners,
- Records of instructions received from and statements of accounts provided to them,
- Records of approvals, notice, entry and cancellation of pledge.

All these records should be made available to the depository for inspection and persons authorised by the depository should be allowed entry in its premises for such inspection during normal office hours. These records should be preserved for five years and the SEBI should be intimated about the place where they are being maintained.

(viii) Ensure that the **(a)** integrity of the data processing system is always maintained and **(b)** records are not lost, destroyed or tampered with, and in the event of loss/destruction sufficient back-up of record is available at a different place and

(ix) Not assign or delegate its functions as a participant to any other person without prior approval of the depository.

Issuers All issuers whose securities have been declared as eligible to be held in a dematerialised form should enter into an agreement with a depository. However, no such agreement would be required where the issuer of securities is **(i)** the depository itself or **(ii)** the Central/State Government.

All matters relating to transfer of securities; maintenance of records of holders of securities, handling of physical securities and establishing connectivity with the depositories should be handled and maintained at a single point, that is, either in-house by the issuer or by SEBI-registered share transfer agent.

Every issuer/agent/any person registered as an intermediary under the SEBI Act should redress the grievances of the beneficial owners within 30 days of the date of receipt of the complaint and keep the depository informed about the number and nature of grievances redressed by it/pending before it.

Every depository should establish/maintain an investor protection fund **(fund)** for the protection of interest of beneficial owners but it cannot be used to indemnify them for any loss caused due to the negligence of the depository/participant. Five per cent profits of the depository every year should be credited to the fund. The contribution and utilisation of the fund would have to conform to the SEBI norms.

The beneficial owners have to inform the details of the security certificates to be dematerialised and surrender the same to the participants, either directly or through the custodians of the securities. On receipt of this information, the participant forwards the details to the depository along with a confirmation of the agreement with the beneficial owner. The participant maintains records indicating the names of beneficial owners of securities surrendered, number of securities and details of security certificates received. The participants should within 7 days of the receipt of the certificate of security furnish to the issuer details of the security together with the certificate of security.

Within 15 days of the receipt of the certificate from the participant, the issuer should **(i)** confirm to the depository the listing of the securities on the stock exchange(s) where the securities issued earlier are listed, **(ii)** after due verification immediately mutilate and cancel the certificate,

(iii) substitute in its record the name of the depository as the registered owner and **(iv)** send a certificate to this effect to the depository and the stock exchange(s) where the security is listed. In the case of unlisted companies, the condition of listing on all the stock exchanges where earlier issued securities are listed would not be applicable. The depository would immediately enter in its records, the names of the beneficial owners as well as the participants and intimate the participants accordingly. The issuer should maintain a record of Certificates of securities which have been dematerialised.

The issuer or his agent should reconcile the records of dematerialised securities with all the securities issued by it on a daily basis; and where the Government is issuer of the depository, it should, on a daily basis, reconcile the records of the dematerialised securities. Every issuer should submit audit report on a quarterly basis to the concerned stock exchange by a charactered accountant/company secretary for reconciliation of **(i)** the total issued capital, **(ii)** listed capital, **(iii)** capital held by the depositories demat form, **(iv)** details of change in share capital during the quarter and **(v)** the in-principle approval from all the stock exchange(s) where it is listed in respect of such further issued capital. The audit report should also give the updated status of the register of members of the issuer confirming that the securities have been dematerialised within 21 days from the date of request. Where demat has not been effected within the stipulated period, the reasons for delay should be disclosed. The issuer should immediately bring to the notice of the depositories/stock exchange(s) any difference observed in its issued, listed and capital held by depositories in demat form.

Every issuer/its agent should **(i)** establish means of continuous electronic communication with the depository, and **(ii)** give information regarding dematerialised securities-book closures, record dates, dates for the payment of interest/dividend, for annual general/other meetings, redemption of debentures and the conversion of debentures/warrants-to the depository at the time/in the manner specified by the latter in its bye-laws/agreement.

Creating Pledge/Hypothecation A beneficial owner intending to create a pledge/hypothecation on a security should apply to the depository through the participant who would make a note in its records of the notice of pledge/hypothecation and forward the application to the depository. The depository would create and record the pledge/hypothecation within 15 days and intimate the participants of the pledgor (hypothecator) and the pledge (hypothecatee) who, in turn inform them of the entry of creation of pledge/hypothecation. If the pledge/hypothecation is not created, the depository would intimate the reasons to the respective participants. The cancellation of pledge/hypothecation by the depository on request from the pledgor/pledgee (hypothecator/hypothecatee) through participants would require the prior approval of the latter. Subject to the provisions of the pledge/hypothecation document, the pledgee/hypothecatee may invoke the pledge/hypothecation and the depository would register him as the beneficial owner and inform the respective participants accordingly who would in turn would make the necessary changes in their records and inform the concerned parties. A security in respect of which a notice/entry of pledge/ hypothecation is in force can be transferred by a participant only with the concurrence of the pledgee/hypothecatee.

Investment Advice A depository/participant or any of his employees can render directly/indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, only after disclosing his interest, including long/short position, in the security at the time of rendering the advice. The employee should also disclose the interest of his dependent family members and the employer.

Appointment of Compliance Officer Every depository/participant should appoint a compliance officer who would be responsible for monitoring the compliance with the SEBI Act/rules and regulations/notifications/guidelines/instructions and so on issued by the SEBI/Government and for redressal of investors' grievances. He should immediately and independently report to the SEBI any non-compliance observed by him.

A depository should ensure equal/unrestricted/transparent/fair access to all persons without any bias towards its associates/related entities.

Listing of Securities With the SEBI's approval, a depository may seek listing of its securities on a recognised stock exchange after completing three years of continuous operations immediately preceding the date of application. It should also be in compliance with the SEBI regulations particularly those relating to ownership and governance. However, a depository associate should not list securities on a stock exchange that is sponsor/associate of the depository.

Inspection The SEBI can undertake the inspection of books of accounts/records/documents and infrastructure/systems/ procedures or to investigate the affairs of a depository/participant/ beneficial owner/issuer or its agent for any of the following purposes:

- To ensure maintenance of books of accounts by them as specified by these regulations;
- To look into complaints from them/any other person;
- To ascertain compliance, by them, with the provisions of the SEBI Act, Depositories Act, bye-laws, agreements and these regulations;
- To ascertain the adequacy of the system, procedures and safeguards followed by them and
- To suo moto ensure the conduct of their affairs in a manner which are in the interest of the investors/securities market.

On the basis of the findings of the inspection/investigation report, the SEBI may call upon them to take such measures as it deems fit in the interest of the securities market and for due compliance with the provisions' of the SEBI/Depositories Act, regulations, bye-laws and agreements.

Action in Case of Default A depository/participant who **(i)** contravenes any of the provisions of the SEBI/Depositories Act, bye-laws, agreements and these regulations, **(ii)** fails to furnish information relating to activity as required under these regulations, **(iii)** does not furnish/furnish false/ misleading information, **(iv)** does not cooperate in any inspection/investigation/inquiry by the SEBI and **(v)** fails to comply with the SEBI directions and pay the annual fee would be dealt with in the manner specified by the **SEBI Intermediaries Regulation**.

If an issuer/agent **(a)** contravens provision(s) of the Depositories Act/bye-laws/agreements/ Depositories and Participants Regulations (DPRs)/directions, **(b)** fails to furnish information relating to its activities under the DPRs **(c)** does not furnish information called for by the SEBI relating to the securities held in a depository/furnishes false or misleading information in any material particular, **(d)** does not cooperate in any inspection/investigation/enquiry by the SEBI, **(e)** fails to comply with any SEBI direction(s) under the Depositories Act, the SEBI may, in addition to action under the SEBI Act, taken any action under the Depositories Act.

The depository should conduct inspection of the records of the issuers/agents to ensure that the records of the dematerialised securities are reconciled with all the securities issued by the issuer and submit report to the SEBI on failure in the reconciliation of records.

Miscellaneous ***Power to Call for Information*** SEBI may from time to time call for any information/documents/records from **(i)** the depository/its governing board or any shareholder/sponsor and **(ii)** depository participant.

Directions In the interest of public/trade/investors/securities market, the SEBI may issue directions as it deems fit including all/any of the following: **(i)** directing **(a)** a person holding equity shares/rights over equity shares in a depository in contravention of the applicable regulations to divest his holdings in the specified manner, **(b)** transfer of any proceeds/securities to the investor protection fund of the depository; **(ii)** debarring a depository/its shareholder, an associate/agent of shareholder, or any transferee of shares, or sponsors/directors/key personnel management of the depository from accessing the securities market and/or dealing in securities for a specified period.

SHORT SELLING AND SECURITIES LENDING AND BORROWING SCHEME, 2008

Short sellers provide liquidity to genuine investors. In a falling market, the purchases of short sellers, to cover their sales, lead to recovery in prices. In a rising market, short sales can arrest further rise. In order to provide a mechanism for borrowing of securities to enable settlement of securities short, the SEBI has put in place a full-fledged securities lending and borrowing (SLB) scheme (2008) for all market participants in the Indian securities market under the overall framework of its Securities Lending Scheme 1997. The main elements of the SEBI framework relating to the SLB scheme, namely, broad framework for short selling, broad framework for securities lending and borrowing and the securities lending scheme 1997 are discussed in this Section.

Broad Framework for Short Selling

The main elements of the framework for short selling are as follows.

1. "Short selling" should be defined as selling a stock which the seller does not own at the time of trade.
2. All classes of investors, namely, retail and institutional investors, should be permitted to short sell.
3. Naked short selling would not be permitted in the Indian securities market and accordingly, all investors would be required to mandatorily honour their obligation of delivering the securities at the time of settlement.
4. No institutional investor would be allowed to do day trading, that is, square-off their transactions intra-day. In other words, all transactions would be grossed for institutional investors at the custodians', level and the institution would be required to fulfil their obligation on a gross basis. The custodians, however, would continue to settle their deliveries on a net basis with the stock exchanges.
5. The stock exchanges should frame necessary uniform deterrent provisions and take appropriate action against the brokers for failure to deliver securities at the time of settlement which should act as a sufficient deterrent against failure to deliver.
6. A scheme for Securities Lending and Borrowing (SLB) should be put in place to provide the necessary impetus to short sell. The introduction of a full-fledged securities lending and borrowing scheme should be simultaneous with the introduction of short selling by institutional investors.

7. The securities traded in F&O segment should be eligible for short selling. The SEBI may review the list of stocks that are eligible for short selling transactions from time to time.
8. The institutional investors should disclose upfront at the time of placement of order whether the transaction is a short sale. However, retail investors would be permitted to make a similar disclosure by the end of the trading hours on the transaction day.
9. The brokers should be mandated to collect the details on scrip-wise short sell positions, collate the data and upload it to the stock exchanges before the commencement of trading on the following trading day. The stock exchanges should then consolidate such information and disseminate the same on their websites for the information of the public on a weekly basis. The frequency of such disclosures may be reviewed from time to time with the approval of the SEBI.

Broad Framework for Securities Lending and Borrowing

The main elements of the framework are as follows.

1. The stock exchange should put in place, a full-fledged securities lending and borrowing (SLB) scheme, within the overall framework of "Securities Lending Scheme, 1997" (**SLS)**, that is open for all market participants in the Indian securities market.
2. To begin with, the SLB should be operated through the Clearing Corporation/ House of stock exchanges having nation-wide terminals who will be registered as Approved Intermediaries (AIs) under the SLS, 1997.
3. The SLB should take place on an automated, screen based, order-matching platform which will be provided by the AIs. This platform should be independent of the other trading platforms.
4. To begin with, the securities traded in F&O segment should be eligible for lending and borrowing under the scheme.
5. All categories of investors including retail, institutional, and so on will be permitted to borrow and lend securities. The borrowers and lenders should access the platform for lending/borrowing set up by the AIs through the clearing members (CMs) (including banks and custodians) who are authorised by the AIs in this regard.
6. The AIs, CMs and the clients should enter into an agreement (which may have one or more parts) specifying the rights, responsibilities and obligations of the parties to the agreement. The agreement should include the basic conditions for lending and borrowing of securities as prescribed unde the SLS. In addition to that, AIs may also include suitable conditions in the agreement to have proper execution, risk management and settlement of lending and borrowing transactions with the clearing member and the client. Given the nature of the client base, while the major responsibility of ensuring compliance with "**Know Your Client**" (KYC) norms in respect of the clients rests with the CMs, the exact role of AIs/CMs *vis-à-vis* the clients in this regard need to be elaborated in the aforesaid agreement. In this regard, there would be one master agreement with two individual parts to the same. The first part of the agreement would be between the AIs and the CMs and the second part would be between the CMs and the clients. There would be adequate cross referencing between the two parts of the agreement so that all the concerned parties, namely, the AIs/CMs and the clients agree completely and are aware of the provisions governing the SLB transactions between them. However, there should be o direct agreement between the lender and the borrower. The CM will attach a certified copy of the first part of the

agreement signed with the AI in the second part of the agreement signed with each client. The model agreements in this regard would be devised by the stock exchanges.

7. The AIs should allot a unique ID to each client which should be mapped to the Permanent Account Number (PAN) of the respective clients. They should put in place appropriate systemic safeguards to ensure that a client is not able to obtain multiple client IDs.

8. The tenure of lending/borrowing should be fixed as standardised contracts. To start with, contracts with tenure of 30 trading days may be introduced. It may be 12 months now.

9. The SLB tenure of 30 days will result in the need for appropriate adjustment for corporate actions. These may be treated as follows:

  (a) The dividend amount should be worked out and recovered from the borrower on the book closure/record date and passed on to the lender.

  (b) In regard to stock split, the position of the borrower should be proportionately adjusted so that the lender receives the revised quantity of shares.

  (c) Other corporate actions such as bonus/merger/amalgamation/open offer and so on: The transactions should be foreclosed from the day prior to the *ex-date*. The lending fee should be recovered on *pro rata* basis from the lender and returned to the borrower.

10. The time for the SLB session would be the normal trade timings of 9:55 to 3:30 P.M.

11. The settlement cycle of SLB transactions should be on T+1 basis. The settlement of lending and borrowing transactions should be independent of normal market settlement.

12. The settlement of the lending and borrowing transactions should be done on a gross basis at the level of the clients, that is, no netting of transactions at any level will be permitted.

13. The AIs would frame suitable risk management systems to guarantee delivery of securities to borrower and return of securities to the lender. In the case of lender failing to deliver securities to the AI or borrower failing to return securities to the AI, the AI should conduct an auction for obtaining securities. In the event of exceptional circumstances resulting in non-availability of securities in auction, such transactions would be financially closed-out at appropriate rates, which may be more than the rates applicable for the normal close-out of transactions, so as to act as a sufficient deterrent against failure to deliver securities.

With regard to risk management, common risk management practices should be followed by the stock exchanges for SLB. They should ensure that the risk management framework strikes a balance between ensuring commercial viability of SLB transactions and adequate and proper risk management. They should satisfy themselves regarding the adequacy of the risk management system. Margins in SLB may be taken in the form of cash and cash equivalents.

14. Position limits at the level of market, CM and client should be decided from time to time by AIs in consultation with the SEBI. To begin with **(a)** the market-wide position limits for SLB transactions would be 10 per cent of the free-float capital of the company in terms of number of shares, **(b)** no clearing member should have open position of more than 10 per cent of the market-wide position limits or ₹50 crore (base value), whichever is lower, **(c)** for a FII mutual fund, the position limits should be the same as of a clearing member, **(d)** The client level position limits should be not more than 1 per cent of the market-wide position limits.

15. Any borrowing/lending and return of securities would not amount to purchase/disposal/transfer of the same for the purpose of compliance with the FDI/FII limits and the norms regarding acquisition of shares/disclosure requirements specified under the various regulations of the SEBI.
16. Adequate systems should be put in place by the stock exchanges/depositories to distinguish the SLB transactions from the normal market transactions in the demat system.
17. The AIs should provide suitable arbitration mechanism for settling the disputes arising out of the SLB transactions executed on the platform provided by them.
18. The AIs should disseminate in public domain, the details of SLB transactions executed on the platform provided by them and the outstanding positions on a weekly basis. The frequency of such disclosure may be reviewed from time to time with the approval of the SEBI.
19. The lenders/borrowers should have the facility for early recall/repayment of shares before completion of the contract. The lending fee for the balance period would be a market determined rate. In case of failure of the borrower to meet the margin obligations the AI should obtain securities and square off their position failing which there would be financial close-out. In case of early recall by the lender the **(i)** AI on a best effort basis should try to borrow for the balance period and pass on the security to him and collect the lending fee, **(ii)** original contract between the AI and the lender will exist till the execution of the contract with the new lender for the balance period and return of the securities to the original lender. In case of early repayment by the borrower, the margins should be released immediately. The AI should on a best effort basis try to onward lend the securities and the resulting income passed on to the concerned borrower. In case of the inability of the AI to find a new borrower for the balance period, the original borrower would have to forego the applicable lending fee.
20. **Roll-over facility** A lender/borrower who wishes to extend an existing lent/borrow position can roll-over such position, that is, a lender who is due to receive securities in the payout of an SLB session may extend the period of lending. Similarly, a borrower who has to return securities may extend the period of borrowing. The rollover would be conducted as part of the SLB session. However, netting of counter positions, that is, netting between the borrowed and lent position of a client would not be permitted. The roll-over would be available for 3 months, that is, the original contract plus two roll-over contracts.
21. **Liquid Index Exchange Traded Funds (ETFs)** The liquid ETFs (i.e. the ETF has traded on at least 80 per cent of the days and its impact cost is less than or equal to 1 per cent over the past six months) would be eligible for trading in the SLB segment. The position limits for SLB would be based on the assets under their management.

Securities Lending Scheme (SLS), 1997

The **securities lending** scheme enables lending of securities through an approved intermediary, registered with the SEBI, through whom the lender would deposit and the borrower would borrow the securities to a borrower, under an agreement for a specified period, with the condition that the borrower would return equivalent securities of the same type/class at the end of the period along with the corporate benefits accruing on the securities, including dividends (gross), rights, bonus, redemption benefits, interest or any other right/benefit accruing on the securities lent.

The lender(s) [i.e. any person(s) who deposits the securities registered in his name/in the name of any other person duly authorised on his behalf with the approved intermediary for lending unde the SLS] as well as borrower(s) [i.e. person(s) who borrow securities through an approved intermediary] have to enter into an agreement with the approved intermediary to lend/borrow securities respectively. There is no direct agreement between them for this. The agreement would provide that the beneficial interest in the securities deposited would continue to remain with the lender and the corporate benefits would also accrue him. He is entitled to deposit with the approved intermediary, for lending only, securities registered in his name/in the name of any other person duly authorised on his behalf. The lending of securities or the return of equivalent securities of the same type and class by the borrower does not constitute disposal of securities. On depositing the securities, a receipt would be issued by the intermediary. Unless otherwise provided in the agreement, the intermediary would guarantee the return of equivalent securities to the lender along with the corporate benefits accrued on them during the tenure of borrowing. In the event of failure of the borrower, the intermediary would be liable to make good the loss caused to the lender. The intermediary may return the deposited securities as a trustee on behalf of the lender.

The intermediary is entitled to lend the securities deposited to the borrower from time to time. It may retain them in its custody as a trustee on behalf of the lenders. The title of securities lent vests with the borrower and he would be entitled to deal with or dispose them off in any manner.

The borrower has an obligation to return the equivalent number of securities of the same type and class borrowed, to the approved intermediary, within the specified time, together with the corporate benefits that have accrued during the period of borrowing. He cannot discharge his liabilities through payment in cash or kind. The approved intermediary is entitled to receive from the borrower collateral security and fee for lending securities. The collaterals may be in the form of cash, bank guarantee, government securities, certificates of deposits or other securities.

The agreement between the lender/intermediary/borrower also provides for the following terms and conditions: period of lending/depositing of securities, charges/fee for depositing/lending and borrowing, collateral securities for borrowing, provision for the return/premature return of the securities deposited/lent and mechanism for the resolution of disputes through arbitration.

The intermediary should maintain a complete record of securities **(i)** deposited/lent **(ii)** received from the borrower/returned to the lender. In the event of failure, the borrower would become a defaulter and the intermediary would have the right to liquidate the collateral securities in order to purchase the equivalent securities, from the market, to be returned to the lender. It can also take any appropriate action against the defaulter to make good its loss, if any. Such defaults would be notified by the intermediary to the SEBI, concerned stock exchange(s) or authorities for the initiation of appropriate action against the defaulter.

Eligibility Criteria The criteria for registration with the SEBI as an approved intermediary are: a minimum net worth of the ₹50 crore; a clearing house/corporation with a net worth specified by the SEBI in consultation with stock exchange(s); adequate infrastructure facilities like office space, equipment and manpower experienced in dealing in securities, to effectively discharge its activities. The non-refundable application fee is ₹10,000. The registration would be valid for 3 years, renewable. The initial registration fee is ₹10 lakh and the renewal fee after 3 years would be ₹5 lakh. The annual fee would be ₹2 lakh.

Obligations/Responsibilities An approved intermediary for security lending has to comply with the undermentioned obligations/responsibilities. He should:

- Abide by the schemes and the guidelines issued by the SEBI from time to time.
- Comply with the requirements of eligibility criteria for the lender/borrower specified by the SEBI.
- Specify, **(i)** in the respective agreements, the fee payable to the lender/charged to the borrower; **(ii)** the amount and type of collateral acceptable for lending securities as well as the norms for valuation of securities; and **(iii)** the mechanism of sharing the income on collateral with the borrower.
- Issue, at the request of the lender, a receipt acknowledging the deposit of securities specifying the complete details of securities such as name, quantity, face value, certificate/folio number of the lender along with the date from when he became the registered holder of the security. On returning the securities to him, it should similarly issue a receipt containing the above details as proof of continuity of his holdings.
- Issue, at the request of the lender, a receipt acknowledging the deposit of securities specifying the complete details of securities such as name, quantity, face value, certificate/folio number of the lender along with the date from when he became the registered holder of the security. On returning the securities to him, it should similarly issue a receipt containing the above details as proof of continuity of his holdings.
- Maintain a complete record of securities **(i)** deposited by lender/lent to borrower, **(ii)** received from the borrower/returned to the lender. These records would be open for inspection by the SEBI or any person duly authorised by SEBI for this purpose.
- Maintain or make available to SEBI such information or documents/returns/reports as may be specified from time to time. Abide by the SEBI code of conduct specified below:

Code of Conduct for Approved Intermediaries An approved intermediary will be deemed to be guilty of misconduct or unprofessional conduct if it violates intentionally or otherwise any of the following provisions of the Code of Conduct: The approved intermediaries:

1. Agrees and undertakes to perform its duties with the highest standards of integrity and fairness in all its dealings,
2. Abide by the obligation as specified under the securities lending scheme and the terms of the agreement entered into by him with the lenders/borrowers,
3. Inform the client before taking up any assignment that it is obliged to comply with the code of conduct and it would deliver a copy of the same to its client, if the client is not aware of the same or does not have it,
4. Maintain true and correct record of the securities lending transactions undertaken by it under the scheme and in particular the records in respect of the securities **(a)** held by it on behalf of the lenders/ lent by it to the borrowers, **(b)** the time and tenure of such lending, **(c)** the tenure of equivalent security by the borrower after the tenure of lending to him, and **(d)** the return of equivalent security by him.
5. Ensure that the lending of security is not misused or disguised by the lender or borrower for the sale of security or for avoidance of capital gains tax.
6. **(i)** Render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment; **(ii)** Disclose to the clients its possible sources or potential areas of conflict of duties and interest and provide unbiased services.

7. Maintain confidentiality of information about a lender or borrower which it has come to possess as a consequence of dealings with it and should not divulge the same to other clients, the press or any other interested party.
8. Being fully aware of its obligations, endeavour to ensure that true and adequate information is provided to the SEBI, Income-tax Department, any other Government authority.
9. Abide by all the provisions of the SEBI Act, Rules, Regulations, Guidelines, Resolutions, Notifications, Directions, Circular, etc., as may be issued by the Government of India and SEBI from time to time as may be applicable to the approved intermediary.

The approved intermediary cannot be exempted from discharging any obligations placed on it by any law/regulation/guidelines.

Terms of Registration The registration of an intermediary would be for three years on the payment of fee specified by SEBI. It would have the right to suspend/cancel the registration in case of violation of terms of the scheme.

Taxation According to a clarification issued by the Central Board of Direct Taxes, transactions of lending shares/any other security under the securities lending scheme would not result in transfer for the purpose of involving the provisions relating to capital gains under Section 2 of the Income-tax Act.

CONCLUDING OBSERVATIONS

- The major elements of the stock market organisation in India are: stock broking, custodial services, depository system and short selling and securities lending and borrowing scheme.
- The components of stock broking are: brokers, sub-brokers, trading and clearing members and foreign brokers.
- A stockbroker is a member of a recognised stock exchange, who buys/sells/deals in securities. He must be registered with the SEBI to carry on his activities. He should abide by the code of conduct in terms of the general requirements, duty to investors and relationship with other stockbrokers. The SEBI can conduct an inspection/ investigation into the records of the brokers. Any broker who contravenes any of the provisions of the SEBI Act/rules/regulations would be liable to any or more of the following actions: monetary penalty, liability for action under the enquiry proceedings regulations, including suspension/cancellation of registration and prosecution. The capital adequacy requirements for brokers consist of a base minimum capital and an additional capital related to the volume of business.
- A sub-broker acts on behalf of a stockbroker, as an agent or otherwise, for assisting investors in buying/selling/dealing in securities through such brokers, but he is not a member of a stock exchange. However, he must be registered with the SEBI. The code of conduct applicable to him covers his duty to investors, his relationship with stock brokers and regulatory authorities. The general obligations and responsibilities and inspection and activities in default applicable to brokers are also applicable to sub-brokers.
- Custodial services mean safe-keeping of securities of a client and providing incidental services such as maintaining accounts of the securities; collecting the benefits/rights accruing to him in this respect; keeping him informed of the actions of the issuer of the securities having a bearing on the benefit accruing to him; and maintaining and reconciling a record of the above services. Registration of custodians with SEBI is mandatory. The custodian should abide by

the specified code of conduct. The activities relating to his business as a custodian should be segregated from his all other activities. A separate custody account for each client should be opened and the assets of one client should not be mixed with those of others. The custodians should have adequate internal control to prevent manipulation of records/documents and appropriate safekeeping measures to ensure that securities are protected from theft and natural hazards. They should follow the uniform norms and practices prescribed by SEBI, during their interaction with other market participants.

- A major reform of the Indian stock markets has been the introduction of the depository system and scripless trading mechanism. The essential element of scripless trading is the dematerialisation of share certificates through depositories. Conversion of physical share certificates into dematerialised holdings is called dematerialisation.
- The depository system in India operates within the framework of the Depositories Act and the SEBI Depositories and Participants Regulations. Any person can avail of depository services through a depository participant, by surrendering the certificate of security to the issuer company in the specified manner. The issuer would cancel the certificate and substitute in its records, the name of the depository as a registered owner in respect of that security. The depository would record the name of the person surrendering the certificate as the beneficial owner.
- All securities held by the depository would be dematerialised and would be in fungible form. A depository would be deemed to be the registered owner for the purpose of transfer of ownership of the security on behalf of a beneficial owner, though it would not have any voting rights in respect of the securities held. The beneficial owner would be entitled to all the rights/benefits and would be subjected to all liabilities.
- A beneficial owner can opt out of a depository. Rematerialisation is a process by which a client can get his electronic holding converted back into physical holdings-that is, he can get back the physical form of the share certificates.
- The depository system consists of depositories and depository participants (DPs). A depository is an organisation which holds the securities of shareholders (investors) in electronic form, transfers securities between accountholders, facilitates the transfer of ownership without handling securities and facilitates their safekeeping. The functions of depositories include, *inter-alia*, account opening, dematerialisation, rematerialisation, settlement and clearing and so on. Their sponsors can be public financial institutions, Indian and foreign banks, stock exchanges, financial services companies, companies/institutions providing custodial, clearing/settlement services in a securities market outside India.
- The DP is the key player in the system which acts as an agent of the depository and is, in fact, the customer interface of the depository. The DPs are the service providers for the investors.
- In order to provide a mechanism for borrowing of securities to enable settlement of securities, the SEBI has put in place a full-fledged SLB scheme (2008) fro all market participants under the overall framework of the Securities Lending Scheme, 1997.
- The main elements of the SLB are: Broad Framework for Securities Lending and Borrowing, SLS, 1997; and Broad Framework for Short Selling.
- Short selling is selling a stock which the seller does not own at the time of trade. All classes of investors are permitted to sell. Naked short selling is not allowed. No institutional investor can do day trading. The stock exchanges should frame uniform deterrent provisions and take appropriate action against brokers for failure to deliver securities at the time of settlement.
- A SLB scheme has been put in place to provide the necessary impetus to short sell. · The securities traded on the F&O Segment are eligible for short selling. The institutional investors should disclose upfront whether the transaction is a short sale.

- The main elements of the broad framework for SLB scheme are: **(1)** It would be operated through Clearing Corporation/House of the stock exchange; **(2)** It would take place an automatic screen-based order matching platform independent of all other platforms; **(3)** Securities trading in the F&O Segment are eligible for lending/borrowing; **(4)** All categories of investors are eligible; **(5)** The authorised intermediary, clearing members and clients should enter into an agreement(s) specifying their respective rights, responsibilities and obligations; **(6)** The intermediary should allot a unique ID to each client; **(7)** The tenure of contract should be 7 days; **(8)** The settlement cycle of SLB transaction should b T+1 basis and on a gross basis; **(9)** The intermediary should frames suitable risk management system to guarantee delivery/return of securities; **(10)** The market-wide position limit for SLB transaction should be 10 per cent of the free float capital of the company; **(11)** There should be no activity during the period of corporate action in the security and so on.
- The securities lending scheme of the SEBI enables lending of securities through an approved intermediary, to a borrower, for a specified period, with the condition that the borrower would return equivalent securities of the same type/class at the end of the period, along with the corporate benefits accruing on the securities, including dividends, rights, bonus, redemption benefits, interest or any other benefit/right accruing on the securities lent.
- There is no direct agreement between the lender(s) and the borrower(s). The intermediary should maintain a complete record of the securities deposited/lent, received from the borrower/returned to the lender. In the event of a default by the borrower, the intermediary would have the right to liquidate collateral securities in order to purchase the equivalent securities from the market, to be returned to the lender. It can also take appropriate action against the defaulter to make good its loss.
- Transactions of lending shares under the securities lending scheme would not result in a transfer for the purposes of capital gains.

CHAPTER 9

Money Markets

INTRODUCTION

The money market is a market for overnight to short-term funds, and for short-term money and financial assets that are close substitutes for money. "Short-term", in the Indian context, generally means a period upto one year; "close substitute for money" denotes any financial asset that can be quickly converted into money with minimum transaction cost and without loss in value. Stated in the perspective of the structure of the financial system/markets, money market refers to that segment of the system/markets that enables the raising of short-term funds for meeting the temporary shortages of cash and obligations, and the temporary deployment of excess funds for earning returns. The major participants in the market are the commercial banks, the other financial intermediaries, large corporates and the Reserve Bank of India (RBI). Being the residual resource of funds, RBI plays a pivotal role and occupies a strategic position in the Indian money market. By varying liquidity in the market through various instruments, it influences the availability and cost of credit. In fact, a developed money market contributes to an effective monetary policy. An effective money market requires the development of appropriate institutions, instruments and operating procedures that facilitate the widening and deepening of the market and the allocation of operating procedures with the minimum transactions cost and minimum delays. The broad objectives/functions of the money market are to provide:

(i) An equilibrating mechanism for evening out short-term surpluses and deficiencies;
(ii) A focal point of central bank (RBI) intervention for influencing liquidity in the economy and
(iii) A reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable price/cost.

Features

The money market has certain distinct operational features as compared to the capital market. First, while in the money market the operations (raising and deployment of funds) are for a short duration (normally upto one year), in the capital market they are for longer durations/periods, although at times the distinction/demarcation between the two segments of the market is not clearly marked out. As a corollary, the money market is the institutional source of working capital to the industry, the focus of the capital market being on financing fixed investments. Moreover, there are a large number of participants in the money market. In fact, the larger the number of participants, the greater the depth of the market. In addition, the money market is a wholesale market. The volume of funds/financial assets representing the money traded in the market is very large, which underscores the need for skilled professional operators. Also, unlike other markets (exchanges), trading in the money market is conducted on the telephone, followed by written confirmation from both the borrowers and the lenders. Further, generally, the transactions are on a **'same day settlement'** basis. Due to greater flexibility in the regulatory framework, there is a greater scope for innovative dealings. Finally, the money market consists of a number of interrelated sub-markets such as the call market, the commercial bill (bill) market, the treasury bill market, the commercial paper market, the certificates of deposit market and so on.

The main objective of this Chapter is to present a summarised view of the money market in India. **Its organisation is depicted in Exhibit 9.1.**

The focus is on its organisation/structure and not on quantitative growth. The focus is also on describing the current scenario in contrast to the historical evolution/past history. The RBI is the most important constituent of the money market organisation. The aims of its money market operations are three-fold: (i) To ensure that liquidity and short-term interest rates are maintained at levels consistent with the monetary policy objectives of maintaining price stability; (ii) To ensure an adequate flow of credit to the productive sectors of the economy; and (iii) To bring about order in the forex market. Section 1 dwells on the functions of the RBI with particular reference to its role as the regulator of the money and credit. The present organisation of the Indian money market in terms of its various segments/sub-markets is described in Section 2. Some concluding observations are given in the last Section.

RESERVE BANK OF INDIA (RBI)

The RBI, as the central bank of the country, is the nerve centre of the financial and monetary system and the main regulator of the banking system. As the apex institution, it has been guiding, monitoring, regulating, controlling and promoting the banking as well as the financial system. This Section briefly describes the main functions/role currently performed by the RBI.

Functions

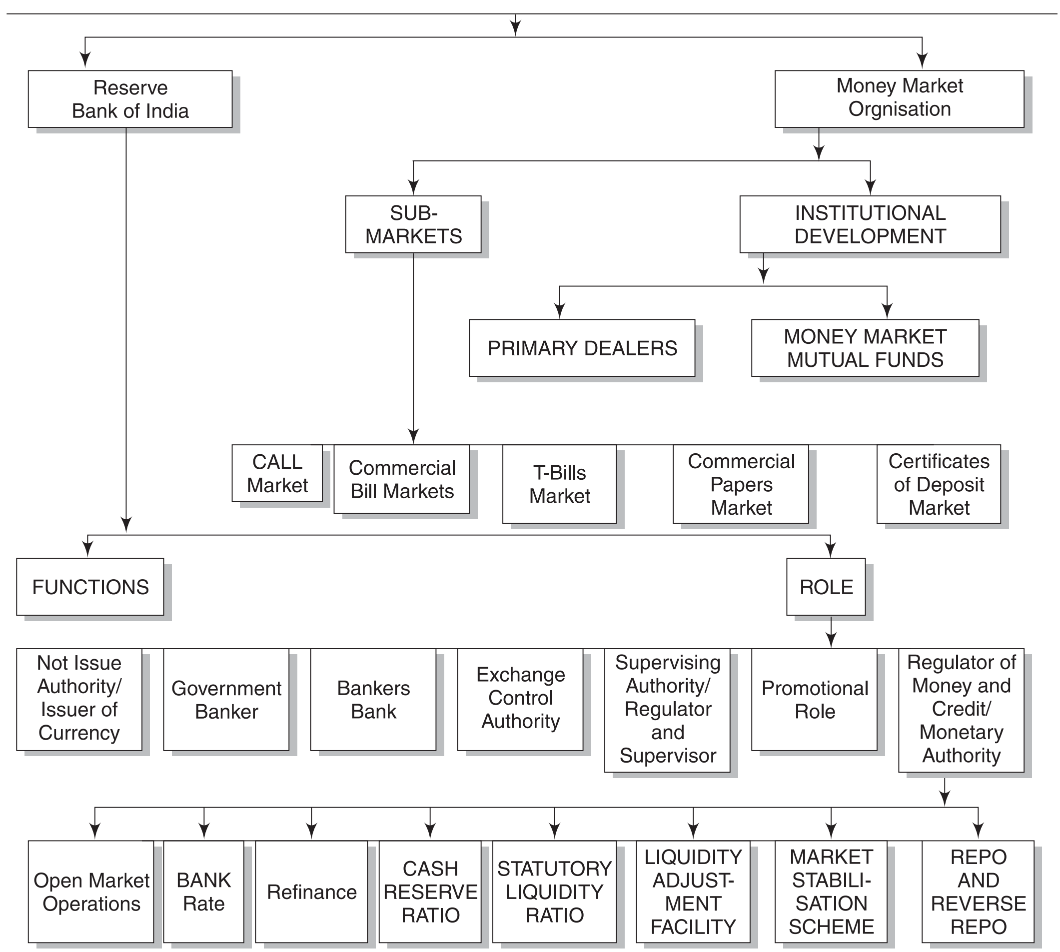
The RBI was constituted to regulate the issue of bank notes and to keep reserves to secure monetary stability and generally to operate the currency and credit system of the country. It has been gradually diversifying its business. The main functions of the RBI are:

(i) To maintain monetary stability so that the business and economic life can deliver welfare gains of a properly functioning mixed economy;

(ii) To maintain financial stability and ensure sound financial institutions so that monetary stability can be safely pursued and economic units can conduct their business with confidence;

(iii) To maintain stable payments systems so that financial transactions can be safely and efficiently executed;

Exhibit 9.1 Money Market Organisation in India



(iv) To promote the development of the financial infrastructure in terms of markets and systems, and to enable it to operate efficiently, that is, to play a leading role in developing a sound financial system so that it can discharge its regulatory function efficiently;

(v) To ensure that credit allocation by the financial system broadly reflects the national economic priorities and societal concerns; and

(vi) To regulate the overall volume of money and credit in the economy, with a view to ensuring a reasonable degree of price stability.

Roles of RBI

The roles that the RBI plays in the Indian banking and financial system relate to (i) Note issuing authority, (ii) Government banker, (iii) Bankers' bank, (iv) Supervising authority, (v) Exchange control authority, (vi) Promoter of the financial system and (vii) Regulator of money and credit.

Note Issuing Authority/Issuer of Currency The RBI has, since its inception, the sole right/authority/monopoly to issue currency notes other than one rupee notes/coins and coins of smaller denominations. In fact, the issue of currency notes is one of its basic functions. Although one rupee notes/coins and coins of smaller denominations are issued by the Central Government, they are put into circulation only through the RBI. The currency notes issued by the RBI are legal tender everywhere in India, without any limit. At present, the RBI issues notes in the denomination of ₹2, 5, 10, 20, 50, 100, 500 and 1,000. Currency management involves efforts to achieve self-sufficiency in the production of currency notes/coins with a judicious denomination mix, improvement in the efficiency of distribution networks and withdrawal and destruction of notes, technology upgradation and enhancement in the security features of currency notes. The functions of note issue and currency management is discharged by the RBI throughits regional issue offices/sub-offices and a wide network of currency chests maintained by the RBI/banks/Government treasuries spread across the country. The responsibility of the RBI is not only to put currency into/withdraw it from circulation, but also to exchange notes/coins of one denomination for those of other denominations as demanded by the public. All its affairs relating to currency management are conducted through its Issue Department.

The RBI can issue notes against the security of coins/bullion, foreign securities, rupee coins, Government of India securities and such bills of exchange/promissory notes as are eligible for purchase by it. The currency notes have a cent per cent backing/cover in these approved assets.

Government Banker The RBI is the banker to the Central and the State Governments. It provides in this capacity, to the Government(s), all banking services such as acceptance of deposits, withdrawal of funds by cheques, making payments as well as receiving /collecting payments on their behalf, transfer of funds, management of public debt and so on. It receives Government deposits free of interest and it is not entitled to any remuneration for the conduct of the ordinary banking business of the Government(s). The RBI also provides safe custody facilities; manages special funds such as the Consolidated Sinking Fund, Calamity Relief Fund; issues and manages Relief Bonds; and administers schemes for disbursal of the pension of Government employees and so on.

The issue, management and administration of the public debt of the Government(s) is a major function of the RBI for which it charges a commission. The objective of the debt management policy is to raise resources from the market at the minimum cost, while containing the refinance risk and maintaining consistency with the monetary policy objectives. To bridge temporary mismatches in the cashflows (i.e., temporary gaps between receipts and payments), the RBI provides Ways and Means Advances (WAMAs). The maximum maturity period of these advances is three months. The WAMAs to the State Governments are of three types: (i) normal/clean advances, that is, advances without any collateral security; (ii) secured advances, which are secured against the pledge of Central Government securities and (iii) special advances granted by the RBI at its discretion. In addition to WAMAs, the State Governments make heavy use of overdrafts from the RBI, in excess of the credit limits (WAMAs) granted by the RBI. Overdrafts are, in a way, unauthorised WAMAs drawn by the State Governments, on the RBI. In fact, the management of these overdrafts is one of the major responsibilities of the RBI these days. The interest charged by the RBI on the WAMAs is related to a graduated scale of interest based on its duration. Overdrafts upto 7 days are charged at the bank rate and an interest of 3 per cent above the bank rate is charged from the 8th day onwards.

Bankers' Bank As a bankers' bank, the RBI has a very special relationship with banks and the major part of its business is with these banks. It controls the volume of their reserves (SLRs and CRRs) and determines their deposits credit-creation ability. The banks hold all/part of their reserves with the RBI and in times of need, they borrow from it. The RBI is, in effect, the banker/lender of the last resort. It is the ultimate source of money and credit in India.

Supervising Authority/Regulator and Supervisor As a regulator and supervisor, RBI provides broad parameters within which the banking and financial system of India functions. It regulates and supervises the banking system in India according to the provisions of the RBI Act and the Banking Regulation Act. The non-banking financial companies (NBFCs) are regulated by the RBI under the provisions of Chapter III-B of the RBI Act. To promote a sound/adequate and effective banking system, the RBI is vested with wide-ranging powers to supervise and control banks. These, inter-alia, include: **(i)** to issue licenses for the establishment of new banks/bank branches, **(ii)** to prescribe minimum requirements relating to paid-up capital, reserves, transfer to reserve fund, cash reserves and other liquid assets, **(iii)** to inspect the working of banks in respect of their organisational set-up, branch expansion, deposit mobilisation, investment and credit portfolio management, credit appraisal, region-wise performances, profit planning, manpower planning and training and so on, **(iv)** to conduct ad hoc investigations from time to time, into complaints, irregularities and frauds in respect of banks, **(v)** to control methods of operations of banks so that they do not fritter away funds in improper investments and injudicious advances, **(vi)** to control appointment/reappointment/ termination of appointment of chairmen/chief executive officers of private sector banks and **(vii)** to approve/force amalgamations/reconstruction/liquidation of banks.

The function of bank supervision has been separated from the traditional central banking function of the RBI by the creation of a separate Department of Supervision (DoS). The Board of Financial Supervision (BFS) oversees the financial institutions and the non-banking financial companies (NBFCs). The DoS assists and implements the directions of the BFS.

Exchange Control (EC) Authority As the exchange control authority, the function of the RBI is to develop and regulate the foreign exchange market. Its role is to facilitate external trade and payment and provide or orderly development and maintenance of foreign exchange market within the framework of the Foreign Exchange Management Act (FEMA). The RBI is the custodian of the country's foreign exchange reserves. It is vested with the responsibility of managing the investment and utilisation of the reserves in the most advantageous manner. Its role as the stabiliser of the foreign exchange market, has become all the more important with the introduction of the floating exchange rate system and convertibility of the rupee on trade and current accounts. The RBI has the authority to enter into foreign exchange transactions, both on its own account as well as on behalf of the government. It deals in foreign exchange with the public through authorised dealers (ADs). It supervises, monitors and controls the foreign exchange market with a view to creating an active market with wide participation by the ADs and the exporters/importers so that the various currencies are actively traded, facilitating customers to obtain fine quotations, with rate variations being kept to the minimum. The objective of the RBI in respect of the foreign exchange forward market is to make it a useful tool for covering all exchange risks of the importers/exporters. Its regulations aim at ensuring that the forward market facilities are need-based and are not used for speculative purposes.

Promotional Functions The promotional/developmental functions of the RBI refer to its efforts to strengthen the financial system. It has played a highly commendable role in diversifying the institutional structure of the financial system in India. The financial institutions were either created by it or it advised and rendered help in setting them up. Included in the category of these financial institutions are: IDBI, IFCI, SFCs, SIDCs, SIICs, IIBI, Exim Bank, UTI, SIDBI, NABARD and so on. Moreover, by providing concessional financial support to the various financial institutions, the RBI enabled the financial system to deploy resources in conformity with the planning priorities. With the exception of the SIDBI and NABARD, concessional financing was phased out and the financial institutions geared up their resource mobilisation strategies according to the capital market-related arrangements. In the post-liberalisation phase, the RBI has completely disassociated itself from the financial institutions.

Regulator of Money and Credit/Monetary Authority The RBI, as the central bank of the country, formulates and conducts the monetary policy. Monetary policy refers to the use of the techniques of monetary control to achieve the broad objectives of **(a)** maintaining price stability and **(b)** ensuring adequate flow of credit to productive sectors so as to assist growth. A country's monetary policy creates conditions for growth by influencing the cost and availability of money and credit. It uses instruments directed towards regulating the money supply and the cost and availability of credit in the economy. The important techniques/tools/instruments of monetary control that are adopted by the RBI include: Open Market Operations (OMOs); Bank Rate; Refinance; Cash Reserve Ratio (CRR); Statutory Liquidity Ratio (SLR); Liquidity Adjustment Facility (LAF); and Repo Rates.

Open Market Operations (OMOs) The OMOs refer to the sale and purchase of securities of the Central and State Governments and Treasury Bills (T-bills). The multiple objectives of OMOs, inter-alia, are: **(i)** To control the amount of and changes in bank credit and money supply through controlling the reserve base of banks, **(ii)** To make the bank rate policy more effective, **(iii)** To maintain stability in the Government securities/T-bills market, **(iv)** To support the Government's borrowing programme and **(v)** To smoothen the seasonal flow of funds in the bank credit market. Through the OMOs, the RBI can affect the reserve position of banks, yields on Government securities/T-bills and the volume and cost of credit.

However, inspite of the wide powers to the RBI, the OMOs is not a widely-used technique of monetary control in India. There is no restriction on the quantity/maturity of the Government securities which the RBI can buy/sell/hold. The OMOs are conducted only in Central Government securities of all maturities. The Government securities directly bought by the RBI at the time of issue of loans are excluded from the OMOs. The RBI is continuously in the market, selling Government securities on tap and buying them mostly in 'switching operations', it does not ordinarily purchase them against cash. Switching operations involve the sale of long-term Government securities in exchange for short-term securities. In addition, the OMOs have been mostly used for debt management which has undermined their effectiveness as a tool of monetary policy. Nevertheless, the OMOs have indirectly helped in the regulation of the supply of bank credit in two ways: first, when they are conducted for switching operations, they lengthen the maturity structure of the Government securities which, in turn, has a favourable impact on the monetary policy; second, the net sales (sales minus purchase) of the Government securities has increased over the years which has helped in regulating the flow of bank credit to the private sector. As a result of the various measures taken in the recent years, including the introduction of market-related competitive coupon rates on Government securities to develop/activate the Government securities market, a broad-based and well-organised market in these securities is emerging. The OMOs are poised to emerge as a major tool of monetary policy.

Bank Rate The Bank Rate (B/R) is the standard rate at which the RBI buys/rediscounts bills of exchange/other eligible commercial paper(s). It is also the rate that the RBI charges on advances on specified collaterals to banks. An increase/decrease in the B/R would decrease/increase the volume of credit. An increase in the B/R would result in an increase in the lending rate of banks and vice versa. Thus, the B/R technique regulates the cost/availability of finance and, to that extent, the volume of funds available to banks and financial institutions. The B/R variation, like the OMOs, was not used as an effective tool of monetary management. The B/R was not changed frequently due to the RBI's reluctance to adversely affect the yield and the market for Government securities. It was revised only 3 times during 1975-76 on account of the compulsion to manage public/Government debt. In the post-1997 period, the B/R has been reactivated and it has emerged as a signaling rate to reflect the stance of the monetary policy. The interest rates on different types of accommodation from the RBI, including refinance, are now linked to the B/R. Banks use the signal of a B/R change to price their loans. The announcement impact of a B/R change has been reflected in the primary lending rates of banks.

Refinance The RBI uses this instrument to relieve liquidity shortages in the system, control monetary and credit conditions and direct credit to selective sectors. It has gradually reduced the access to the refinance facility and the refinance rate is now linked with the B/R. Currently, there are only two refinance schemes available to banks: export credit refinance and general refinance. The export credit facility is extended to banks against their outstanding export credit eligible for refinance. The general refinance is provided to tide over temporary liquidity shortages faced by banks. It has now been replaced by a collateralised lending facility within the overall framework of liquidity adjustment facility (LAF).

Cash Reserve Ratio Having regard to the needs of monetary stability, the RBI prescribes the CRR without any floor/ceiling rate as a percentage of demand/time liabilities of banks. **Demand liabilities** of banks include all liabilities payable on demand, namely, current/demand portion of savings deposits, margins hold against letter of credit/guarantees, balances in overdue fixed deposits, cash certificates and cumulative/recurring deposits, outstanding telegrahpic/mail transfers, demand drafts, unclaimed deposits, credit balances in the cash credit account and deposits held as security for advances payable on demand, money at call and short notice from outside the banking system. **Time liabilities** are payable otherwise than on demand and include fixed deposits, cash certificates, cumulative/recurring deposits, time liability portion of savings deposits, staff security deposits, margin held against letters of credit, gold deposits and so on.

In order to improve their cash management as a measure of simplification, there is a lag of one fortnight in the maintenance of the CRR. With a view to providing flexibility in choosing an optimum strategy of holding reserves depending on their inter-fortnight cash flows, banks have to maintain minimum CRR upto 70 per cent of the average daily required for a reporting fortnight on all days. The RBI does not pay any interest on the CRR balances.

Default in maintenance of CRR would be liable to penal interest: **(a)** Requirement on a daily basis, 3 per cent per annum above the bank rate on the amount of shortfall on that day and 5 per cent in case of continuing default; **(b)** Maintenance on average basis during a fortnight, penal action envisaged in Section 42(3) of the RBI Act. When panel rate of 5 per cent above the bank rate has become payable and the balance held during the next succeeding fortnight is below the prescribed minimum, director(s)/managers/secretary(s) of the bank who is knowingly/wilfully a party to the default would be punishable with a fine upto ₹500/further fine upto ₹500 for each subsequent fortnight during which the default continues. The RBI may also prohibit the bank from accepting any fresh deposits. The penality for failure to comply with this prohibition by director(s)/officer(s) who knowingly/wilfully are a party/otherwise contribute to such default would be the same as applicable to maintenance of the minimum balance.

Statutory Liquidity Ratio (SLR) While the CRR enables the RBI to impose primary reserve requirements, the SLR enables it to impose secondary and supplementary reserve requirements on the banking system. The objectives of the SLR are three-fold: **(i)** To restrict the expansion of bank credit, **(ii)** To augment a bank's investment in Government securities and **(iii)** To ensure solvency of banks. The SLR is the ratio of cash in hand (excluding CRR), balances in current ccount with banks and RBI, gold and unencumbered approved securities (i.e., Central and State Government securities, securities of local bodies and Government guaranteed securities) to the total demand and time liabilities of the banks. The SLR defaults result in restrictions on the access of refinance from the RBI and in higher costs of refinance. Failure to maintain the required SLR would also be liable to a penal interest of 3 per cent per annum above the bank rate and 5 per cent in case of continuing default in the next succeeding day(s). An increase in the SLR does not, however, restrain total expenditure in the economy; it would restrict only the private sector expenditure, but it would also help increase the Government/public sector expenditure. A decrease in the SLR would have the opposite effect. In a sense, therefore, SLR is not a technique of monetary control; it only distributes bank reserves in favour of the Government/public sector. The pre-1990 period was characterised by a very high level of SLR as a result of which, a prudential norm had virtually degenerated into a cheap source of public sector financing. The Narasimham Committee (1991) aptly described it as a reserve requirement tax. It now stands at (25 per cent)—its lowest level on their demand and time liabilities as on last Friday of the second preceding fortnight.

Liquidity Adjustment Facility (LAF) The LAF has emerged as one of the most important instruments of monetary policy in recent years. The RBI, as the lender of the last resort, was providing various general and sector-specific refinance facilities to the banks, for example, Export-Credit Refinance (ECR) and Collateralised Lending Facility (CLF). The CLF was available to banks against their collateral of excess holdings of Government dated securities and T-bills, over and obove the SLR requirements. In keeping with the recent policy objective of shifting from direct to indirect techniques of monetary control, it became necessary to do away with all sector-specific and discretionary refinance facilities and to move towards a general refinance facility. The Narasimham Committee II (1998) had, inter-alia, suggested that for orderly movements of interest rates in the inter-bank call market, the RBI support to the market should be through LAF, under which it would reset its repo and reverse repo rates which would in a sense, provide a reasonable corridor for market play. As a follow-up to these recommendations, the Interim Adjustment Liquidity Facility (ILAF) was introduced in April 1999, which was followed by the introduction of the final LAF June 2000. The apparent success of the LAF resulted in the phasing out of the CLF from October 2002.

Provisions of ILAF The ILAF had the following provisions: **(a)** With effect from April 21, 1999, the general finance facility was withdrawn and replaced by a collateralised lending facility (CLF) up to 0.25 per cent of the fortnightly average outstanding aggregate deposits in 1997-98, which would be available for two weeks at the B/R; **(b)** An additional collateralised lending facility (ACLF) for an equivalent amount of CLF would also be available at the B/R plus 2 per cent; **(c)** CLF and ACLF availed for periods beyond two weeks would be subject to a penal rate of 2 per cent for an additional period of two weeks; **(d)** The restriction on participation in money market was withdrawn; **(e)** Scheduled commercial banks became eligible for export credit refinance facility (ERF) at the B/R with effect from April 1, 1999; **(f)** Liquidity support against collateral of Government securities would be available to PDs (Primary Dealers) at the B/R for a period of 90 days; Additional liquidity support to PDs for a period not exceeding two weeks at a time would be available at the B/R plus 2 per cent; **(g)** The absorption of liquidity in the market would continue to be through fixed rate repos; and **(h)** The above facilities would be supplemented by OMOs by the RBI.

After the working of ILAF for about a year, a full fledged LAF came into being in June 2000. The LAF operates through repo auctions, that is, the sale of Government securities from the RBI portfolio for absorption of liquidity; and reserve repo auctions, that is, buying of Government securities for injection of liquidity on a daily basis, thereby creating a corridor for the call money rates and other short-term interest rates. The funds under LAF are expected to be used by banks for their day-to-day mismatches in liquidity. The maturity of repos is from one day to fourteen days. All scheduled banks and PDs are eligible to participate in the repo and reverse repo auctions. The minimum bid size for LAF is ₹5 crore and in multiples of ₹5 crore thereafter. All transferable Government of India dated securities/T-bills (except 14-day T-bills) can be traded in the repo and reverse repo markets. Call rate is a prime representative indicator of the availability of liquidity in the economy. The Discretionary Liquidity (DL) and call rate impact each other. The DL is the sum of the RBI balance sheet flows that arise out of its money market operations. It represents a change in the total liquidity in the system which occurs due to monetary policy action. It comprises of policy-induced flows from the RBI to banks and Primary Dealers (PDs). It is the sum of the following: **(i)** net repos and OMOs of the RBI, **(ii)** RBI credit to banks and (iii) RBI credit to PDs netted for cumulative changes in reserve requirements.

While interest rates in the repo market usually emerge out of bids (i.e., auctions are conducted on a 'uniform price' basis), the RBI occasionally conducts fixed interest rate (multiple price) auctions to send signals to the market. The LAF technique is based on the view that the RBI balance sheet can be partitioned into autonomous and discretionary components. The Autonomous Liquidity (AL) and DL bear an inverse relationship with the changes in the inter-bank call money rate. The AL is comprised of the RBI balance sheet flows that stem from regular control banking functions, such as currency authority and banker to Government and banks. It essentially comprises of liquidity that flows to banks without any monetary policy action. It represents the autonomous outflows from the RBI, netted for liabilities to sectors other than banks in the banking system. The AL is the sum of RBI's net incremental claims on the following: **(i)** the Government, adjusted for OMOs and repo operations, **(ii)** banks (other than credit to schedule banks), **(iii)** commercial sector (other than credit to PDs), and **(iv)** foreign assets net of liabilities (other than schedule bank deposits with RBI). In other words, the AL comprises of the incremental accommodation in the Ways and Means Advances (WMAs), net primary subscription to T-bills, dated securities and non-marketable securities; and rupee coins netted for the Government deposits with the RBI. The RBI's primary market subscriptions are included in the AL. In brief, AL is highly influenced by currency and is essentially a sum of flows determined by macroeconomic conditions (other than RBI's intervention in the money market).

The RBI can target call rate by modulating changes in AL and DL. The primary usefulness of LAF lies in its impact on short-term interest rates. During the regime of 'net liquidity ratio' and the 'slab rate system', it was the cost of liquidity which was controlled. The net liquidity (NL) is the sum of AL and DL. It is simply a change in bank reserves. The technique of CRR was used to control the quantum of liquidity. Now, the technique of LAF which operates primarily through buying and selling of repos to modulate discretionary liquidity, controls the quantum as well as the cost of liquidity.

Under LAF, the RBI, periodically, daily if necessariy, sets/resets its repos and reverse repo rate; it uses 3-day or 4-day repos to siphon of liquidity from the market. The repos are used for absorbing liquidity at a given rate (floor), and for infusing liquidity through reverse repos, at a given rate (ceiling). Liquidity is also made available to banks and PDs in the form of refinance at the B/R. There, thus, now exists an interest rate corridor in the inter-bank call money market with the repo rate acting as a floor rate, the B/R acting as a ceiling rate, and call rate acting as a middle rate. The repo rate is a three to four day rate, while the call rate is an overnight rate. It has been observed that usually, the call rate is higher than the repo rate. The B/R and repo rate are now emerging as the key indicators of movements in the interest rates in the money and credit markets. It has been found that call money rate and other money market rates respond to both high and low repo rates.

Merits of LAF The LAF is a new short-term liquidity management technique. It is a flexible instrument in the hands of the RBI to modulate, even out, adjust or manage short-term market liquidity fluctuations on a daily basis and to help create stable or orderly conditions in the overnight/call money market. It is meant to help monetary authorities to transmit short-term interest rate signals to other money markets, financial markets, and the long-end of the yield curve. The repo operations also provide liquidity and breadth to the underlying treasury securities markets. They help the banking system also by providing it with an outlet for short-term liquidity, and thereby to optimise the return on short-term surplus funds. **The LAF operations combined with OMOs and B/R changes, have become the major technique (operating procedure) of the monetary policy in India.**

Repos/Reverse Repos A repo/reverse repo/ready forward/repurchase (buy-back) is a transaction in which two parties agree to sell and repurchase the same security. The seller sells specified securities, with an agreement to repurchase the same at a mutually decided future date and price. Like wise, the buyer purchases the securities, with an agreement to resell the same to the seller on an agreed date and at a prederermined price. The same transaction is repo from the viewpoint of the seller of the securities and reverse **repo** from the viewpoint of the buyer of the securities. Whether a transaction is **repo** or **reverse repo** would depend on the counterparty (seller/buyer) which initiates it. Repo is also referred to as a ready forward transaction as it is a means of funding by selling a security held on a spot basis and repurchasing the same on a forward basis.

Repo is a collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. It is a temporary sale of debt, involving full transfer of ownership of the securities, that is, the assignment of voting and financial rights. The difference between the price at which the securities are bought and sold is the lender's profit/interest earned for lending money. The transaction combines elements of both a securities purchase/sale operation, as also a money market borrowing/lending operation. The terms of the contract is in terms of a **repo rate**, representing the money market borrowing/lending rate. **Repo rate** is the annual interest rate for the funds transferred by the lender to the buyer. It is generally lower than the B/R.

Repos/reverse repos are used to **(i)** meet a shortfall in the cash position, **(ii)** increase returns on funds held, **(iii)** borrow securities to meet regulatory (SLR) requirements, **(iv)** by the RBI adjust liquidity in the financial system under the LAF.

Repos, which are backed by securities and fully collateralised, are safer than pure call/notice/term money and inter-corporate deposits, which are non-collateralised. The counterparty risks in repos are minimum. As market-based instruments, repos can be used as an indirect instrument of monetary control, for absorbing/injecting short-term liquidity. They help maintain an equilibrium between demand for, and supply of, short-term funds. The repos market serves as an equilibrium between the money market and the securities market and provides liquidity and depth to both. Monetary authorities can transmit policy signals through repos to the money market which has a significant influence on the Government securities market and foreign exchange market.

Repos are usually entered into with a maturity of 1-14 days. The collateral security in the form of SGL is transferred from the seller (borrower) to the buyer (lender). Generally, repo transactions take place in market lots of ₹5 crore. Repo transactions have very low credit risk due to the SGL mechanism and the existence of a collateral in the form of the underlying security. The interest rate risk is also minimal because the period of lending is very short, that is, 1-14 days. Similarly, the liquidity risk is very little because the lender has surplus funds. Moreover, settlement risk is small as all transactions are settled through the Public Debt Office and the SGL System of the RBI. Thus, repo transactions are very safe.

There are two legs involved in a repo transaction. In the first leg, the borrower sells the security to the lender and the transaction is generally concluded at the market value of the security to avoid the credit risk of the counterparty. The calculation of the first leg is the same as in an outright sale transaction, that is,

Total consideration = Deal rate × Face value + Accrued interest.

In the second leg, the interest paid for borrowing, that is, the repo rate, is adjusted with the interest earned on the securities during the holding period, to arrive at the reversal price.

Reversal price = Deal rate × Face value + (Interest for holding period – Interest paid at repo rate)/Face value.

The calculation for the accrued interest is the same as that for outright purchase on the reversal date:

Total consideration = Reversal price × Face value + Accrued interest.

To illustrate, Bank X entered into a repo for 14 days with Bank Y for ₹10 crore. The security chosen is 13.6% GS – 2010. The repo rate is 5 per cent. The agreed purchase price is ₹10.1.12. The last coupon was paid 30 days ago.

Calculation for First Leg:

Sale price	₹1,01,12,00,000
Accrued interest (30 days)	₹1,13,333
Net cash outflows	₹1,01,13,13,333

Calculation for Second Leg:

Repo interest income (₹101,13,13,333 × 0.05 × 14/365)	19,39,500
Cash inflow (₹101,13,13,333 + ₹19,39,500)	1,01,32,52,838
Less Accrued interest (44 days)	1,63,945
Purchase price	1,01,30,99,893
Rate = ₹101.38	

Types of Repo Auctions There are two types of repo auctions: **(i)** Discretionary price repo auctions and **(ii)** Fixed rate repo/uniform price auctions. Under the discretionary price repo auction, bidders submit multiple price-quantity sealed bids; auction results are announced the same day and successful bidders who are awarded bids at/or below the cut-off repo rate, make their payments the next day. This type of repo auctions were in vogue in India till October 1997. The fixed rate/uniform price repo auction was introduced and has been in vogue since November 1997. Under this type of repo auction, the repo rates are pre-announced and the bidders are required to submit bids indicating the volume of repos. The results are announced on the day of the submission of bids.

Types of Repos Two types of repos are currently in operation in India: Inter-bank repos and RBI repos.

Inter-Bank Repos Such repos are now permitted only under regulated conditions. Repos were misused by banks/brokers during the 1992 securities scam. They were banned subsequently. With the lifting of the ban in 1995, repos were permitted for restricted, eligible participants and instruments. Initially, repo deals were allowed in T-bills and five dated securities on the NSE. With gradual liberalisation over the years, all Central Government dated securities, State Government securities and T-bills of all maturities have been made eligible for repo. Banks and PDs can undertake repo deals (ready forward transactions) if they are routed through the SGL accounts maintained by the RBI. Repos are allowed to develop a secondary market in PSU bonds, FIs bonds, corporate bonds and private debt securities if they are held in demat form and the deals are done through recognised stock exchange(s). There are no restrictions regarding a minimum period for inter-bank repo deals. Non-bank participants (i.e., FIs and other specified parties) are allowed to participate only in the reverse repo, that is, they can only lend money to other eligible participants. The non-bank entities holding SGL accounts with the RBI can enter into reverse repo transactions with banks/PDs, in all Government securities. With the phasing out of the non-bank entities from the call/notice money market and the setting up of the Clearing Corporation, the inter-bank repo market has emerge as a significant component of the money market. The mutual funds are the major providers of funds, while the foreign/private sector banks and the PDs are the major borrowers in the repo market.

RBI Repos The RBI undertakes repo/reverse repo operations with banks and PDs as part of its OMOs, to absorb/inject liquidity. With the introduction of the LAF, the RBI has been injecting liquidity into the system through repos on a daily basis. The repo auctions are conducted on all working days except Saturdays and are restricted to banks and PDs. This is in addition to the liquidity support given by the RBI to the PDs through refinance/reverse repo facility at a fixed price. Auctions under LAF were earlier conducted on a uniform price basis, that is, there was a single repo rate for all successful bidders. Multiple price auction was introduced subsequently. The weighted average cut-off yield in case of a multiple price auction is released to the public. This, along with the cut-off price, provides a band for call money to operate.

The RBI conducts repo auctions to provide banks with an outlet for managing short-term liquidity; even out short-term liquidity fluctuations in the money market; and optimise returns on short-term surplus liquid funds. The RBI has switched over from discriminatory price auction repos to the daily fixed rate repos auction system. Fixed rate repos signal money market rates, bring about orderly conditions in the forex market and impart stability to short-term interest rates by setting a floor for call money rates. The RBI participates actively in the call money market with LAF repos operations conducted throughout the year to modulate the surplus liquidity in the market. It also conducts reverse repo operations under the LAF to prevent sudden spurts in the call rates. Both repos and reverse repo operations play an effective role in imparting stability to the market.

The repo rate has become akin to a signalling rate, together with the B/R. The repo rate serves the purpose of a floor and the B/R, that of a cap for the money market to operate within an interest rate corridor. With the introduction of variable repo rates and daily repo auctions, a market-determined benchmark is expected to emerge for the call (overnight) rate. As a result of the conversion of the call/notice money market into a pure inter-bank call/notice money market, the repo market comprising of active repo traders across a wide spectrum of maturity, will help in directing funds of the non-bank entities/FIIs from the call market to the mid- and long-term money market. The repo rate, along with the B/R and CRR, has emerged as an important tool of liquidity and monetary management.

To sum up, the RBI's regulation of money and credit now comprises of **(i)** the reactivation of OMOs and introduction of repos, **(ii)** the introduction of LAF and its emergence as one of the significant operating instruments, **(iii)** the reactivation of B/R and the use of repo rates, **(iv)** the continuation of the use of the CRR. The B/R changes, combined with changes in the CRR and the LAF repo rates have emerged as active and important tools of liquidity and monetary management. The LAF has developed as an effective tool for absorbing/injecting liquidity on a day to day basis in a flexible manner and for providing a corridor for the call money and other money markets.

Market Stabilisation Scheme To manage the forex rate, the RBI intervenes in the forex market by buying dollars flowing into the economy. This leads to release of large rupee supply in the system resulting in a flood of rupee liquidity. In order to dry off a part of this rise in supply, the RBI sells bonds to banks. During 2003-04, there was a sharp fall in the level of Government market borrowing programme and the RBI's stock of Government securities fell dramatically to all-time low. There was persistent flow of foreign exchange which was absorbed through the LAF and the OMOs conducted by the RBI. However, the depletion in the stock of Government securities hampered their operation. To remedy the situation, the RBI initiated the issuance of dated Government securities with less than two years maturity and T-bills under the Market Stabilisation Scheme (MSS) with effect from April 2004. The main purpose of the MSS was to absorb surplus liquidity of a more enduring nature and reduce the burden of stabilisation on the LAF window. These securities (i.e. stabilisation bonds) have a 2-year tenor and their proceeds are kept in a separate account of the RBI which is utilised solely for redeeming the principal amount of the market stabilisation bonds. The interest payment is the liability of the Government. There is a ceiling on the outstanding amount based on mutual assessment of Government/RBI of the liquidity in the system. The RBI issues an indicative schedule for the issuance of the securities under the MSS to provide transparency and stability in the market. The MSS enables the RBI to improve liquidity management in the system, maintain stability in the forex market and conduct monetary policy in accordance with the LAF/OMOs. It also **(i)** helps the transition from direct instruments to indirect instruments, stabilisation of short-term money market rates, **(ii)** enable affecting demand for funds and modulate their supply on a daily basis to met day-to-day mismatches.

MONEY MARKET ORGANISATION

The organisation of the Indian economy money market till the mid-eighties suffered from serious deficiencies/lacuna. In the first place, it had a narrow base. Apart from the RBI, the only participants were banks, LIC and UTI. Even amongst the restricted participants, there was considerable lop-sidedness in their operations because, firstly, the SBI, LIC and UTI were the three prominent lenders, but there were a large number of borrowers (banks) and, secondly, there were virtually no participants who could make the market active by alternating between lending and borrowing. The second deficiency of the pre-1987 organisation was the paucity of financial instruments of short-term maturity. The only instruments in which dealings took place were money at call and short notice, inter-bank deposits/loans and bills discounting and 91-day T-bills. The third deficiency was that interest rates were controlled either by the RBI directly or by a voluntary agreement between the participants through the Indian Bank Association (IBA). However, during periods of tight liquidity they were breached.

In the light of these deficiencies of the money market in India, the Chakravarty and Vaghul Committees outlined a scheme for its development. The main elements of the Indian money market now are a follow-up of their recommendations. This Section discusses the present organisation of the money market in terms of the main instruments/markets and the intermediaries. A discussion of their operations over the years is beyond the scope of the book. The instruments traded in the money market and the sub-markets are: Call/notice market; Treasury bills (T-bills) market; Commercial bills market; Commercial papers (CPs) market; and Certificate of Deposits (CDs) market. The money market intermediaries are Primary Dealers (PDs) and Money Market Mutual Funds (MMMFs).

Call/Notice Money Market and Short-term Deposits/Term Money Market

This component of the money market in India deals with the (borrowed and lent) overnight/one-day (call) money and notice money for period(s) upto 14 days. It primarily serves the purpose of balancing the short-term liquidity position of banks. The call/notice money market is a market for short-term funds repayable on demand and with maturity period varying between one day to a fortnight. When money is borrowed/lent for a day, it is known as call (overnight) money. When money is borrowed/lent for more than a day and upto 14 days, it is known as notice money. Deals in funds for 15 days to 1 year are called term money. No collateral security is required to cover these transactions. It is basically an over-the-counter (OTC) market without the intermediation of brokers. Call money is required by banks to meet their CRR requirements. They borrow money from other banks and non-bank entities to cover any shortage of cash on a **'reporting Friday'**. As per the RBI stipulations relating to the maintenance of CRR by banks, to enable banks to choose an optimum strategy of holding CRR depending upon their intra-period cash flows, banks are allowed to maintain the CRR on the basis of the last Friday of the second preceding fortnight. The daily minimum requirement is 50 per cent of the fortnightly required for the first 7 days of the reporting fortnight and 65 per cent for the remaining 7 days including the reporting Friday. The reduction in the minimum CRR requirement is for smooth adjustment of liquidity and better cash management to avoid sudden increase in overnight call rates.

Participants Till 1971, the call market was strictly speaking an inter-bank market. The participants were a few large lenders and a large number of borrowers. The UTI and LIC were permitted in 1971 to operate as lenders only to enable them to utilise their sizeable float money gainfully and at the same time augment the supply of short-term funds in the market. The list of participants as lenders in the market was enlarged in the early nineties to widen the market and bring about integration of its various segments. The enlarged list included GIC, IDBI, NABARD, PDs including DFHI and STCI, mutual funds and corporates. The PDs participated in the market as both borrowers as well as lenders. Non-bank entities with bulk lendable resources were allowed access by the RBI only through PDs. The minimum size of operation for routing transactions through the PDs was gradually reduced over the years from ₹20 crore to ₹3 crore.

Following the recommendations of the Naraimshima Committee II (NC II) (1998), significant changes in the participants in this segment of the money market have been gradually introduced by the RBI. The NC II had recommended that non-bank participants other than PDs should be excluded and a pure inter-bank call market including PDs should be developed. The non-bank participants should, however, continue to have free access to other money market instruments including T-bills. Moreover, there should be clearly defined prudential limits for banks' reliance on the call market. Simultaneously, measures should be taken to widen the repo market and improve non-bank participation in a variety of other instruments. The RBI's support to the money market should be through the LAF operated by way of repo/ready forward transactions providing a reasonable corridor to market players.

The RBI has implemented these recommendations in a phased manner. A four-phase exit of non-bank participants from the call market commenced in May 2001. The call market is now a pure inter-bank market. Participants in the market currently include banks (excluding RRBs) cooperative banks (other than land development banks) and primary dealers both as borrowers and lenders. As per the RBI prudential norms/limits relating to reliance (lending and borrowing) of banks on call market, lending of a bank, on a daily average basis, should not exceed 25 per cent of its capital funds (i.e. Tier-1 and Tier-2 capital). However, a bank can lend upto 50 per cent on any day during the fortnight. The borrowing of a bank on a daily average basis on a reporting fortnight should not exceed 100 per cent of capital funds, the ceiling on borrowing being 125 per cent. Prudential limits on exposure (lending and borrowing) to call money also apply to PDs. The Ceiling on lending and borrowing on a daily average basis in a reporting fortnight respectively are 25 and 225 per cent of net owned funds (NOFs). The NOF is calculated as the **(a)** aggregate paid-up capital and free reserves less **(i)** accumulated balance of loss **(ii)** deferred revenue expenditure and **(iii)** other intangible assets; **(b)** further reduced by **(1)** investments in shares of **(i)** subsidiaries **(ii)** companies in the same group, **(iii)** all other NBFCs, **(2)** book value of debentures/bonds/outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with **(i)** subsidiaries, **(ii)** group companies to the extent exceeding 10 per cent of **(a)** above. For cooperative banks, there is no prudential limit on lending but their borrowing on a daily basis should not exceed 2 per cent of their aggregate deposits at the end of March of the previous financial year. Fortnight would be on a reporting Friday basis and mean the period from Saturday to the second following Friday, both days inclusive. With the approval of their Boards of Directors, the participants may arrive at the prudential limits which should be conveyed to the Clearing Corporation of India Ltd (CCIL) for setting of limits on the NDS-call system. Other non-banking institutions are not permitted to participate in the market.

The interest rate paid on call loans is known as the call rate. Eligible participants are free to decide on the call rate. The calculation of payable interest would be based on the methodology suggested by the Fixed Income Money Market and Derivatives Association of India (FIMMDA).

The dealings in market can be done between 9 AM and 5 PM or as specified by the RBI. The participants may adopt the documentation suggested by the FIMMDA. The transactions can be executed either on the Negotiated Dealing System (NDS)-Call, that is a screen based, negotiated quote-driven electronic trading system managed by the CCIL or over-the-counter (OTC) through bilateral communication. The OTC deals should be reported within 15 minutes on the NDS-Call reporting platform upto 5 PM. Any misreporting or repeated reporting of OTC deals should be immediately brought to the notice of the RBI. The RBI may call for information in respect of money market transactions of the eligible participants.

Commercial Bills Market

Commercial bill is a short-term, negotiable and self-liquidating instrument with low risk. It is a written instrument containing an unconditional order signed by the maker, directing to pay a certain amount of money only to a particular person or to the bearer of the instrument. Bills of exchange are drawn by the seller (drawer) on the buyer (drawee) for the value of the goods delivered by him. Such bills are called trade bills. Commercial banks can be inland or foreign. Inland bills are drawn/payable in India or darwn upon any person resident in India. Foreign bills are (i) drawn/payable outside India, (ii) drawn on a party/payable in India or drawn in India/payable outside India. A related classification is export and import bills. While export bills are drawn by exporters in any country outside India, import bills are drawn on importers in India by overseas exporters. When trade bills are accepted by commercial banks, they are called commercial bills. If the seller gives some time for payment, the bill is payable at a future date (usance bill). During the currency of the bill, if the seller is in need of funds, he may approach his bank for discounting the bill (discounted bill). One of the methods used by banks for providing credit to customers is by discounting commercial bills at a negotiated discount rate. The bank receives the maturity proceeds (face value) of discounted bills from the drawee. Meanwhile, if the bank is in need of funds, it can rediscount the bills already discounted in the Commercial Bill Discount Market.

Bill rediscounting is an important segment of the money market and the bill, as an instrument, provides short-term liquidity to the banks in need of funds. The commercial bill market in India is based on the suggestions of the Narasimham Study Group in 1970. Based on its recommendations, the Bill Markets Scheme (1970) replaced the 1952 Scheme. In the initial stages of the development of the bill rediscounting market, the RBI provided significant support, but over the years it gradually withdrew its support as financial institutions such as banks, LIC, UTI, GIC and its subsidiaries, ICICI, IRBI and ECGC were permitted to rediscount bills of exchange presented by banks. However, these institutions were not permitted to raise funds by a further round of rediscounting. The rate of discount was governed by directive from the RBI till 1989. The cost of funds raised by banks through the bills rediscounting scheme was lower than the effective cost of inter-bank deposits or loans of over 60 days, as the latter was subjected to reserve requirements. As a result, bill rediscounting emerged as a satisfactory source of funds for banks that sought funds through the money market. Yet, despite the various measures taken by the RBI to develop bill finance, the instrument did not become popular.

During the post-1991 period, to augment the facilities for rediscounting and make resources available for the purpose, the RBI progressively enlarged the number of eligible institutions for rediscounting of bills to include, besides scheduled commercial banks, all-India financial institutions like the, UTI, IDBI, LIC, GIC and its subsidiaries. ICICI, IRBI (HBI), IFCI, ECGC, NABARD, NHB, Exim Bank, SCICIC, HDFC mutual funds and state and urban cooperative banks.

In addition, the discount/rediscount rates were modified to encourage the borrowers to switch over to the bill rediscounting market. The prescribed ceiling in the rediscount rate was freed in so far as the banks/financial institutions rediscounted the bills with the DFHI. In other words, the DFHI was permitted to fix its own bid/offer discount rates for the bills. The bill rediscounting rates were totally freed from May 1, 1989.

Another step in the direction of activating the bill market was the abolition of stamp duty. The endorsement/delivery of the bills at the time of rediscounting was also done away with. To facilitate further rediscounting of bills, banks were permitted to draw derivative usance primissory notes for a suitable amount with a maturity period up to 90 days, on the strength of the underlying bonafide commercial/trade bills discounted by them. The stamp duty on these bills was remitted by the Government as the underlying bills were stamped in the normal course. Since the physical lodgement of bills was done away with, multiple rediscounting was facilitated and greater liquidity was imparted to bills.

The RBI also promoted a drawee bill scheme to secure prompt payment to small scale units.

The development of bill finance/culture not only facilitates an efficient payment system but also ensures the liquidity of the assets/funds of the banks. This segment of the money market in India, however, is not developed to the extent desirable or as compared to its counterparts in other money markets. The factors hindering the development of bill finance/culture are:

(i) Reluctance on the part of the users to move towards bill culture owning to the element of strict financial discipline.
(ii) Lack of an active secondary market.
(iii) Administrative problems relating to the physical scrutiny of invoices, physical presentation of bills for payment, endorsements/re-endorsement at the time of rediscounting.
(iv) Absence of specialised credit information agencies.
(v) System of cash credit which is more convenient and cheaper than bill financing as the procedure for discounting/rediscounting are complex and time-Consuming.
(vi) Misuse of the bill market in the early 1990's by banks and finance companies.
(vii) Small size of the foreign trade.
(viii) Absence of specialised discounting institutions.

Treasury Bills (T-bills) Market

A T-bill is basically an instrument of short-term borrowing by the Government of India. It is a particular kind of finance bill (i.e. a bill which does not arise from any genuine transaction in goods) or a promissory note issued by the RBI on behalf of the Government. The T-bills are used to raise short-term funds to bridge seasonal/temporary gaps between receipts (revenue and capital) and expenditure of the Government of India. The main features of T-bills are: **(i)** They are negotiable securities; **(ii)** They are issued at discount and are repaid at par on maturity. The difference (discount) between the price at which they are sold and their redemption value is the effective return on T-bills; **(iii)** High liquidity on account of short tenure (i.e. 91-day and 364-days) and inter-bank repos, **(iv)** Absence of default risk due to Government guarantee and RBI's willingness to always purchase/discount them, negligible capital depreciation; **(v)** Assured yield; **(vi)** Low transaction cost; **(vii)** Eligibility for inclusion in SLR; and **(viii)** Purchases/sales effected through the SGL (Subsidiary General Ledger) Account with the RBI.

The development of T-bill market is at the heart of the growth of the money market. The T-bills play a vital role in the cash management of the Government. Being a risk-free instrument, their yields at various maturities serve as a benchmark and help in pricing different floating rates instruments in the market. The T-bill market is RBI's preferred tool for intervention to influence liquidity and short-term interest rates. Its development is a pre-requisite for effective OMOs.

Evolution Ad hoc T-bills were introduced in 1955 to replenish Government's cash balances with the RBI. They were just an accounting measure in the RBI's books and, in effect, resulted in automatic monetisation of Government's budget deficit. A monetised deficit is the increase in the net RBI credit to the Government. In the seventies and eighties, a large proportion of ad hoc T-bills were converted into long-term dated/undated Government securities. This conversion was referred to as **funding.** Their expansion put a constraint on the conduct of monetary policy by the RBI. To give enough independence to the RBI to effectively manage monetary policy and instil fiscal discipline in the Government finances, the ad hoc T-bills were replaced with the Ways and Means Advances (WMAs) in 1997. The WMA is an arrangement to cover temporary mismatch of the government revenue and expenditure. It is not a source of financing the Government deficit. It is an overdraft facility of the Government with the RBI.

91-Day T-bills The RBI issued 91-day T-bills on the basis of weekly auctions. The **auction system** was replaced by on **tap basis** since 1965 at a discount rate (bill rate) related to change in the bank rate till 1974. After 1974, the discount rate remain unchanged. The extremely low yield on the T-bills was totally out of alignment with the other interest rates in the system. Moreover, the RBI freely rediscounted these bills as a consequence of which the market for the T-bills remained more or less artificial and banks made use of them essentially for parking funds for short periods, generally 1-2 days. Also, there were violent fluctuations in the volume of outstanding T-bills. The RBI, therefore, introduced two measures: first, recycling of T-bills under which the rediscounted T-bills could be resold to banks; second, an additional early rediscounting facility was imposed in case banks rediscounted the T-bills within 14 days of purchase. Though the weekly fluctuations declined, the T-bill market could not become an integral part of the money market and the bulk continued to be held by the RBI. The interest rate also did not compare favourably with other short-term rates.

A scheme for the issue of 91-day T-bills was introduced in 1992-93 on the basis of auction system with a predetermined/notified amount. The cut-off yields were significantly higher than the fixed discount rate on tap bills. The major holders of auctioned 91-days T-bills are the RBI, State governments and banks. The 91-day T-bills are sold/auctioned on competitive/non-competitive bids. The state governments, state-run pension funds and eligible provident funds participate in the auction on a non-competitive basis. In a non-competitive bid, the participants are not allowed to bid and they have to put in their applications and are allotted T-bills at the weighted average price determined in competitive bidding. They are not allowed any rediscounting facility from the RBI. The non-competitive bids aim at attracting retail investors in the T-bills market. The participants in the competitive bids are banks, mutual funds, financial institutions, PDs, foreign banks, corporates, FIIs and so on.

182-Day T-bills The introduction of the 182-day T-bill market in 1986 was significant development from the point of view of the money market. The introduction of the 182-day T-bill was the Government's contribution to the development of the short-term money market. The 91-day T-bill had failed to smoothen the short-term liquidity requirements, mainly because of its poor yield resulting from pegging the discount rate at 1974 level. The 182-day T-bills represented a financial instrument with intermediate maturities between the dated securities of the Government on the one hand and the existing 91-day T-bills, on the other. Apart from being a useful fiscal instrument, it was also a handy instrument for money management in banks as much as it could be effectively deployed for meeting the SLR and CRR requirements. It had a higher yield combined with liquidity and safety. In recognition of their potential as an effective instrument of the money market, certain changes were introduced after 1987. The periodicity of auctions was changed from a monthly to a fortnightly basis to provide prospective investors with an array of maturities that could facilitate the development of a secondary market. The cut-off yield at the auctions had spurted over the years to make it an attractive instrument and with a view to providing easy liquidity to these bills, refinance facility was introduced by the RBI in April 1987. Since its inception, the DFHI had been actively participating in the primary auctions of these bills and had also been trading in the secondary market by quoting two-way prices - daily bid (buying) and offer (selling) rates - with fine spreads. Besides the sale and purchase of these bills on a outright basis under the repo facility, it also gave buy-back and sell-back commitments for periods up to 14 days, to banks, financial institutions and the public sector undertakings, at negotiated interest rates. The repo facility provided banks the flexibility for maintenance of CRR and SLR. The DFHI had been provided with refinance facility by the RBI to the extent of 90 per cent of the face value of its holdings of the 182-day T-bills. By varying the quantum and rate of interest of refinance to the DFHI, the RBI was able to transmit signals to the short-term money market.

The DFHI had stimulated considerable activity in the secondary market for these bills. Investors found transactions with the DFHI more attractive than approaching the RBI for refinance. When the call money market was tight, banks had an advantage in raising funds at a lower cost against the collateral of these bills through the DFHI and when conditions were easy in the call money market, banks could enter into buy-back arrangement in these bills with the DFHI for comparatively better returns.

Though treasury bills were not issued in scrip form, their purchases and sales are effected through the Subsidiary General Ledger (SGL) account maintained by the RBI for the investors. For investors who did not have a the facility of the SGl account, the T-bills sold to them were held by DFHI on their behalf. On the maturity date, the DFHI paid the maturity proceeds to investors of such bills on their behalf. It quoted its bid daily and offered annual discount rates, which varied from time to time, depending upon the conditions in the money market.

The list of the eligible participants had also been enlarged. Originally, the participants were banks, the RBI, and financial institutions like the LIC, GIC, UTI, NABARD, IDBI, IFCI and ICICI. Later on, corporates and 'other entities' also became eligible in the T-bills market. Due to their good yield and liquidity, they were an attractive instrument for short-term surpluses. The issue of such bills was discontinued after the introduction of 364-day T-bills in April 1992. However, the auction of 182-day T-bills on a fortnightly basis was reintroduced in 1998 by the RBI. Foreign Institutional Investors (FIIs) were permitted to purchase/sell T-bills within their overall debt ceiling, with effect from May 1998, to provide an opportunity for temporary absorption of liquid funds pending investment in long-term securities. **The issue of such bills was discontinued with effect from 2001-2002.**

364-Day T-bills These T-bills were introduced by the Government in April 1992 to stabilise the money market. They are sold on the basis of a fortnightly auction, but the amount, however, is not specified in advance. Since the RBI does not extend rediscounting facility to such bills, they have been instrumental in reducing the net RBI credit to the Government. The 364-day T-bills became extremely popular due to their higher yield coupled with liquidity and safety and are being used as a benchmark by the IDBI and other financial institutions for determining the rate of interest on floating bonds/notes. They have also widened the money market and provided an innovative outlet for surplus funds. The periodicity of holding 364-day T-bills auctions was made on a monthly basis since October 1998, as against the earlier arrangement of fortnightly auctions. A multiple/discriminatory price auction is conducted where successful bidders have to pay prices (yield) they have actually bid. The investors response to these T-bills depends, inter-alia, on the uncertainties in the Government securities market, variations in the SLR and the yield.

14-Days Intermediate T-bills After the abolition of the 91-days T-bills on tap, an alternative 14-day instrument/bill had been introduced effective from 1996-97. The investors were limited to the State Governments, foreign central banks and specified bodies. These were non-transferable and were issued only in book entry forms to be redeemed at par. The discount rate was set afresh at the beginning of each quarter. The effective yield was set equal to the rate of interest payable by the Central Government on Ways and Means Advances (WMAs). **They have been discontinued now owing to lack of public response**.

28-Days T-bills These bills were announced/introduced in 1998. But **they have been discontinued now**.

To sum up, T-bills are zero coupon bonds issued by the RBI, maturing in less than a year. They are issued in the form of a promissory notes. The RBI presently issues T-bills only in two maturities, namely, 91 days and 364 days. These bonds do not bear any coupon and are, hence, issued at a discount and redeemed at par. They are issued on a yield basis and not on a price basis. The T-bills are issued by the RBI through the auction method. It declares the auction calendar at the starting of the financial year, mentioning the amount of issue, the day of the auction and the day of payment.

The 91-day T-bills are auctioned every Wednesday. The multiple price based auction technique is used. The 364-days T-bills are auctioned on second and fourth Wednesday of the month using the uniform price based auction.

T-bills are quoted in yield terms. The yield of T-bill is calculated as per the following formula:

$$Y = \frac{(100 - P) \times 365 \times 100}{P \times D}$$

where

Y = Discounted yield

P = Price

D = Days to maturity

To illustrate, PNB Gilts Ltd wishes to buy 91-days T-bills maturing on December 6, 2005 on October 12, 2005. The rate quoted by SBI Gilts is ₹99.1489 (₹100 face value). The YTM = (₹100 – ₹99.1489) × 365 × 100/(99.1489 × 55) = 5.70 per cent.

T-bills have a primary as well as a secondary market. In the primary market, RBI auctions T-bills. The dealers bids through the Negotiated Dealing System (NDS). In secondary market, the already issued T-bills are traded in by banks, financial institutions and mutual funds. The quotes for T-bills in the secondary market are on a yield basis. Two-way yields are quoted, indicating the buying as well as the selling yields. The bid yield is higher than the ask yield, indicating an inverse relationship with prices. The deals are either conducted directly through the Negotiated Dealing Screen or through a broker. All T-bills deals are reported through the Negotiated Dealing Screen (NDS). Bids are to be submitted on NDS by 2.30 p.m. on Wednesday. If Wednesday happens to be a holiday, bids are to be submitted on Tuesday.

Bids are submitted in terms of price per ₹100. For example, a bid for 91-day T-bills auction could be for ₹97.50. The auction committee of the RBI decides the cut-off price and results are announced on the same day. Bids above the cut-off price receive full allotment; bids at cut-off price may receive full or partial allotment and bids below the cut-off price are rejected.

Types of Auctions There are two types of auctions: **(i)** multiple-price auction and **(ii)** uniform-price auction.

Multiple Price Auction The RBI invites bids by price, that is, the bidders have to quote the price (per ₹100 face value) at which they desire to purchase. It then decides the cut-off price at which the issue would be exhausted. Bids above the cut-off price are allotted securities. In other words, each winning bidder pays the price it bids.

The advantage of this method is that the RBI obtains the maximum price each participant is willing to pay. It can encourage competitive bidding because each bidder is aware that it will have to pay the price it bids, not just the minimum accepted price. The disadvantage is that bidders bid more cautiously (that is, offer lower prices) in these auctions. This is so because it may happen that bidders who paid higher prices could face large capital losses if the trading in these securieis starts below the marginal price at the auction. This is known as the "winner's curse". The winner's curse can be a problem in those markets where price volatility is high. In order to eliminate the problem, the RBI introduced uniform price auction in case of 91-days T-bills.

Uniform-price Auction In this method, the RBI invites bids in descending order and accepts those that fully absorb the issue amount. Each winning bidder pays the same (uniform) price decided by the RBI. In other wrods, all winning bidders are awarded the auctioned amount at the same price.

The advantage of the uniform price auction are that they tend to minimise uncertainty and encourage broader participation. On the other hand, it may be possible that uniform price auctions could reduce the need to prepare for the auction as allotment at a uniform price reduces the incentive to bid. Moreover, there are dangers of iresponsible bidding or of collusion in a uniform price auction.

There is a fixed calendar for auction of bills. The RBI, through a press communication, two or three days prior to the auction, invites bids indicating the auction date and the amount/type of auction and so on. The T-bill auction is operationalised on the Public Debt Office Negotiated Dealing System (PDO-NDS). It is processed on-line in a straight-through-process (STP) on the system.

Commercial Papers (CPs) Market

Following the recommendations of the Vaghul Committee in March 1989, the RBI permitted the issue of CPs within the frameork of its guidelines, which were modified from time to time to enhance their suitability as money market instruments.

The CP is a short-term unsecured negoitable instrument consisting of usance primary notes with a fixed maturity, thus, indicating the short-term obligation of an issuer. It is generally issued by companies as a means of raising short-term debt and, by a process of securitisation, intermediation of the bank is eliminated. The PDs and all-India financial insitutions can also issue CPs. It is issued on a discount to face value basis but it can also be issued in interest-bearing form. The issuer promises the buyer a fixed amount at a future date but pledges no assets. His liquidity and earning power are the only guarantee. In other words, the CP is not tied to any specific self liquidating trade transaction in contrast to the commercial bills that arise out of specific trade/commercial transaction. A CP can be issued by a company directly to the investor or through bank/merchant banks (dealers). When the companies directly deal with the investors, rather than use a securiies dealer as an intermediary, the CP is called a direct paper. Such companies/borrowers announce the current rates of CPs of various maturities. Investors can then select those maturities that closely aproximate their holding period and acquire the security/paper directly from the issuer. When CPs are issued by security dealer/dealers on behalf of their corporate customers, they are called dealer papers. They buy at a price less the commission and sell at the highest possible level. It is generally backed by a revolving underwriting facility from banks to esnure continuous availability of funds on each roll-over of the CP. Moreover, unlike commercial bills, maturities within the range can be tailored to specific requirements.

Advantages A CP, as a short-term financial instrument, has several advantages both to the issuer and the investor. It is a simple instrument as it hardly involevs any documentation between the issuer and the investor. It is additionally flexible in terms of maturities of the underlying promissory note, which can be tailored to match the cash flow of the issuer. Further, a well rated company can diversify its sources of finance from banks to the short-term money market at a cheaper cost. This is particulalry relevant in a system, such as in India, in which reserve requirements on banks are in vogue in the form of SLR and CRR, which raise the effective cost of bank lending. Also, the CP provides investors with returns higher than what they obtain from the banking system. In addition, companies that are able to raise funds through CPs become better kown in the financal world and are thereby placed in a more favourable position for raising long-term capital. Thus, there is an in-built incentive for companies to remain financially strong. Unlike bank credit which is secured by a first charge on the current assets, CP is unsecured. There are no limitations on the end-use of funds raised through CPs, and as negotiable/transferable instruments, they are highly liquid. Finally, in the Indian context, the creation of a commercial paper market has resulted in a part of the intercorporate funds flowing into this market, which is under the control of the monetary authorities.

Framework of Indian CP Market Commercial paper (CP) is a unsecured money market instrument issued in the form of a promissory note. As a privately placed instrument, CP was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide additional instrument to investors. Subsequently, primary/satellite dealers and all-India financial institutions (FIs) were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. The issue of CP is governed by the directions/guidelines issued by the RBI from time to time. These guidelines provide the broad framework of the CPs market in India. The main elements of the present framework of the Indian CP market, prescribed by the RBI, are outlined below.

Eligibility for Issue of CP Companies, primary dealers (PDs) and financial institutions (FIs) that have been permitted to raise short-term resources under the umbrella limit fixed by the RBI are eligible to issue CP. A company would be eligible to issue CP provided: **(a)** the tangible net worth of the company, as per the latest audited balance sheet, is not less than ₹4 crore; **(b)** company has been sanctioned working capital limit by bank(s) or FIs; and **(c)** the borrowal account of the company is classified as a standard asset by the financing bank(s)/institution(s). **Working capital** limit means the aggregate limits including those by way of purchase/discount of bills sanctioned by banks/FIs for meeting the working capital requirements.

Rating Requirements All eligible participants/issuers should obtain the credit rating for issuance of the CP from any one of the SEBI-registered credit rating agencies. The minimum credit rating should be **A-3** as per the standardised rating symbols/definitions provided by the SEBI. The issuers should ensure at the time of issuance of the CP that the rating obtained is current and has not fallen due for review.

Tenor A CP can be issued for maturities between a minimum of 7 days and a maximum up to one year from the date of issue. The maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.

Issue of CP: Credit Enhancement Limits A CP can be issued as a "stand alone" product. It would not be obligatory for banks/FIs to provide stand-by facility. Banks/FIs may, based on their commercial judgement, subject to the prudential norms applicable to them, with the specific approval of their respective Board of Directors, choose to provide stand-by assistance/credit, backstop facility by way of credit enhancement for a CP issue. Non-bank entities (including corporates) may provide unconditional/irrevocable guarantee for credit enhancement for CP issue provided: **(i)** the issuer fulfils the eligibility criteria for issuance of CP, **(ii)** the guarantor has a credit rating at least one notch higher than the issuer by an approved agency, and **(iii)** the offer document properly discloses the networth of the guarantor company, the names of companies to which the guarantor has issued similar guarantees, the extent of guarantee offered and the condition under which the guarantee would be invoked. The aggregate amount of a CP from an issuer should be within the limit as approved by its Board of Directors or the quantum indicated by the credit rating agency for the specified rating, whichever is lower. Banks and FIs will, however, have the flexibility to fix working capital limits duly taking into account the resource pattern of companies' financing including CPs. An FI can issue a CP within the overall umbrella limit fixed by the RBI.

The total amount of CP proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription. The CP may be issued on a single date or in parts on different dates provided that in the latter case, each CP should have the same maturity date. Every issue of CP, including renewal, should be treated as a fresh issue.

Investment in CP Individuals, banks, other corporate bodies registered or incorporated in India and unincorporated bodies, NRIs and FIIs would be eligible to invest in CP. However, FPIs would be eligible to invest subject to **(i)** conditions set by the SEBI, and **(ii)** compliance with the provisions of the FEMA/Foreign Exchange Deposit Regulations and Foreign Exchange Management (Transfer/Issue of Security by a Person Resident Outside) Regulations.

Mode of Issuance The CP can be issued either in the form of a promissory note or in a dematerialised form through any depository approved by and registered with the SEBI. However, RBI-regulated entities are required to make fresh investments and hold CPs only in dematerialised form. The CPs should be issued in denominations of ₹5 lakh and multiples. The amount invested by a single investor should not be less than ₹5 lakh (face value). It will be issued at a discount to face value as may be determined by the issuer. No issuer should have the issue of a CP underwritten or co-accepted. Options (call/put) are not permitted on CPs.

Investment/Redemption The investor in CP (primary subscriber) should pay the discounted value of the CP to the account of the issuer through the IPA. When CP is held in demat form, the holder of the CP will have to get it redeemed and receive payment from the IPA.

Procedure for Issuance Every issuer must appoint an IPA for issuance of a CP. He should disclose to the potential investors its financial position as per the standard market practice. After the exchange of deal confirmation between the investor and the issuer, the issuer should arrange for crediting the CP to the investor's account with a depository through the IPA. The investors should be given a copy of the IPA certificate to the effect that the issuer has a valid agreement with the IPA and documents are in order.

Trading and Settlement All OTC trades in CP should be reported within 15 minutes of the trade to the Financial Markets Trade Reporting and Confirmation Platform (F-TRAC) of Clearcorp Dealing System (India) Ltd (CDSL). The requirement of exchange of physical confirmation of trades matched on F-TRAC is waived subject to the participants **(i)** entering into one-time bilateral agreement for eliminating the exchange of confirmation or multilateral agreement drafted by the FIMMDA, **(ii)** adhering to the applicable laws such as stamp duty and **(iii)** ensuring adherence to a sound risk management framework and complying with all the regulatory/legal requirements/ practices in this regard. They should be settled through the clearing house of the NSE/BSE. The settlement cycle for OTC trades in CPs should be T+0/T+1.

Buyback of CP Issuers may with the approval of their Board of Directors, buy-back CPs from the investors before maturity through the secondary market at prevailing market price. The buy-back cannot be before a minimum period of seven days from the issue date and the issuer should intimate the IPA of the buy-back undertaken.

Duties/Obligations The duties/obligations of the issuer, the issuing and the paying agent (IPA) and credit rating agency (CRA) are set out below:

(a) Issuer They should ensure that the guidelines and procedures laid down for the CP issuance are strictly adhered to.

(b) Issuing and Paying Agent (IPA) The IPA should ensure that the issuer has the minimum credit rating as stipulated by the RBI and the amount mobilised through issuance of CP is within the quantum indicated by the CRA for the specified rating or as approved by its Board of Directors, whichever is lower. It has to verify all the documents submitted by the issuer, namely, copy of the Board resolution, signatures of authorised executants (when CP in physical form) and issue a certificate that the documents are in order. It should also certify that it has a valid agreement with the issuer. The certified copies of original documents verified by the IPA should be held in its custody. All banks acting as IPAs should report the details of issuance of CPs on the Online Returns Filing System (ORFS) module of the RBI within two days from the date of issuance. They should immediately report, on occurrence, full particulars of default in repayment of CP in the prescribed format to the RBI. They should similarly report all instances of buy-back undertaken by the issuers.

(c) Credit Rating Agency (CRA) The code of conduct prescribed by the SEBI for CRAs for undertaking rating of capital market instruments would be applicable to them for rating a CP. Further, the CRA would have the discretion to determine the validity period of the rating depending upon its perception about the strength of the issuer. Accordingly, the CRA should at the time of rating, clearly indicate the date when the rating is due for review. They would have to closely monitor the rating assigned to the issuers vis-à-vis their track record at regular intervals and make their revision in the ratings public through their publications and website.

Documentation Procedure Standardised procedures/documentation for CPs are prescribed by the Fixed Income Money Market and Derivatives Association of India (FIMMDA) in consonance with international best practices. Issuers/IPAs should follow the guidelines issued by the FIMMDA with the RBI's approval.

Non-applicability of Certain Other Directions Nothing contained in the RBI NBFCs Directions, would apply to any NBFC insofar as it relates to the acceptance of deposits by issuance of CP, in accordance with these guidelines.

Effective Cost/Interest Yield As CPs are issued at discount and redeemed at their face value, their effective pre-tax interest yield

$$= \left(\frac{\text{Face value} - \text{Net amount realised}}{\text{Net amount realised}}\right) \times \left(\frac{360}{\text{Maturity period}}\right)$$

where net amount realised = face value – discount – issuing and paying agent (IPA) charges, that is, stamp duty, rating charges, dealing bank fee and fee for stand by facility.

Assuming face value of a CP to be ₹5,00,000, maturity period to be 90 days, net amount realised = ₹4,80,000, discount and other charges associated with the issue of CP = 1.5 per cent, the pre-tax

$$\text{effective cost of CP} = \left(\frac{₹5{,}00{,}000 - (₹4{,}80{,}000 - ₹7{,}500)}{(₹4{,}80{,}00 - ₹7{,}500)}\right) \times \left(\frac{360}{90}\right) = 23.3 \text{ per cent}$$

The participants in the market are corporatre bodies, banks, mutual funds, the UTI, LIC, GIC and so on, which have surplus funds and are on a lookout for opportunities for short-term investments. The PDs also operate both in the primary and secondary markets for CPs by quoting its bid and offering prices.

Although the CP market has become fairly popular now, a secondary market is yet to develop and when fully developed, it would impart strength and vitality to the money market. Investors, with temporary surplus, would be able to get attractive yields for their short-term funds and borrowers would be able to raise resources at market-related rates. The development of a secondary market with the active participation of the PDs will improve the liquidity of CPs.

Certificate of Deposits (CDs) Market

A CD is a document of title to a time deposit and can be distinguished from a conventional time deposit in respect of its free negotiability and, hence, marketability. In other words, CDs are a marketable receipt of funds deposited in a bank for a fixed period at a specified rate of interest. They are bearer documents/instruments and are readily negotiable. They are attractive both to the bankers and the investors in the sense that the former is not required to encash the deposit prematurely, while the latter can sell the CDs in the secondary market before its maturity and thereby the instrument has liquidity/ready marketability.

The feasibility of introducing CDs was examined in 1982 by the Tambe Working Group but it did not recommend it, firstly, because of the absence of a secondary market, an administered interest rate structure on bank deposits and, secondly, the danger of CDs giving rise to fictitious transactions. The Vaghul Committee was also of the opinion that developing the CDs as a money market instrument would not be meaningful unless short-term interest rates were aligned with other rates in the system and the DFHI was set up.

Based on the recommendations of the Vaghul Committee, the RBI formulated a scheme in June 1989 for the issue of CDs by scheduled banks (excluding RRBs). The RBI guidelines provide the framework for its operations. In order to broadbase the primary market, and also to develop an active secondary market, modifications have been introduced from time to time in the limit for issue of CDs, minimum size, denomination and so on.

RBI Guidelines A CD is a negotiable money market instrument, issued in a demat form or as a usance promissory note against funds deposited at a bank/other eligible financial institutions (FIs) for a specified time period.

Eligibility The CDs can be issued by (i) commercial banks [excluding the RRBs/Local Area Banks (LABs)] and (ii) select all-India FIs permitted by the RBI to raise resources by way of term money/deposits, certificate of deposits, CPs and inter-corporate deposits within the umbrella limit fixed by it.

Aggregate Amount Banks have freedom to issue CDs depending on their funding requirements. An FI may issue CDs within the overall umbrella limit fixed by the RBI, time to time.

Minimum Size of Issue and Denominations The minimum amount of a CD should be ₹1 lakh, that is, the minimum deposit that could be accepted from a single subscriber should not be less than ₹1 lakh and in multiples of ₹1 lakh.

Investors The CDs can be issued to individuals/corporations/companies/(including banks/PDs) trusts/funds/associations and so on. The NRIs may also subscribe to CDs on a non-repatriable basis only. They cannot be endorsed to another NRI in the secondary market.

Maturity The maturity period of a CD issued by a bank should be between 7 days (minimum) and one year (maximum). The FIs can issue CDs with maturity of 1-3 years.

Discount/Coupon Rate The CDs may be issued at a discount on face value. They can also be issued on floating rate basis provided the methodology of the compiling the floating rate is objective, transparent and market-based. The issuer is free to determine the discount/coupon rate. The interest rate on the floating rate CDs should be set periodically according to the predetermined formula that indicates the spread over a transparent benchmark. The investors should be clearly informed of the same.

Reserve Requirements Banks have to maintain the appropriate SLR and CRR on the issue price of the CDs.

Transferability The physical CDs can be freely transferred by endorsement and delivery. The demated CDs can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for the CDs.

Trade in CDs The trading procedure applicable to the CPs **(discussed earlier)** is also applicable to the CDs.

Settlement All OTC traders in CDs must be cleared and settled through the authorised clearing houses of the stock exchanges, that is, NSCCL/ICCL/CCL.

Loans/Buy-backs Loans against CDs and buy-back of CDs by the issuers before maturity are not permitted.

Format The CDs should be issued only in demat form. Issuance of CDs in physical form, if any, on the insistence of the investors should be separately reported to the RBI. The issuance of CD would attract stamp duty. There would be no grace period for repayment.

Security Since physical CDs are freely transferable by endorsement and delivery, they should be printed on good quality security paper and necessary precautions should be taken to guard against tampering with the document. They should be signed by two/more authorised signatories.

Payment of Certificate Since CDs are transferable, the physical certificate may be presented for payment to the last holder. Since the question of liability on account of any defect in the chain of endorsements may arise, banks should be cautious and make payments only by a crossed cheque. The holders of the dematted CD should approach their respective Depository Participants (DPs) and give transfer/delivery instructions to transfer the demat security represented by informational securities identification number (ISIN) to the CD Redemption Account maintained by the issuer. The holder should also communicate to the issuer by a letter/fax a copy of the delivery instruction given to the DP and intimate the place at which the payment is requested to facilitate prompt payment. Upon receipt of the demat credit of CDs in the CD Redemption Account, the issuer on maturity date would arrange to pay to the holder/transferor by way of bankers cheque/high value cheque.

Duplicate Certificate Duplicate certificates can be issued in case of loss of physical certificates only in physical form after compliance with the following: **(i)** a notice in at least one local newspaper of loss of CD certificate, **(ii)** lapse of 15 days from the date of notice and **(iii)** execution of an indemnity bond by the investor tot he satisfaction of the issuer of the CD. The duplicate certificates should be only in physical form and fresh stamping would not be required.

Primary Dealers

In accordance with the announcement of the monetary policy, on May 14, 1994 to introduce a system of Primary Dealers (PDs), the RBI has framed the guidelines for their enlistment as detailed below.

Objectives of PDs The objectives of the PDs are:

(i) To strengthen the infrastructure in the Government securities market, including the money market, in order to make it vibrant, liquid and broad based;

(ii) To ensure the development of underwriting and market capabilities for Government securities outside the RBI so that the latter will gradually shed these functions;

(iii) To improve the secondary market trading system, which would contribute to price discovery, enhance liquidity and turnover and encourage voluntary holding of Government securities amongst a wider investor base; and

(iv) To make PDs an effective conduit for conducting open market operations (OMOs).

Eligibility Conditions The following classes of institutions are eligible to apply for primary dealership:

(i) Subsidiaries of scheduled commercial bank(s) and all-India financial institution(s) dedicated predominantly to the securities business and in particular to the Government securities market.

(ii) Companies incorporated under the Companies Act, 1956 and engaged predominantly in the securities business and in particular to the Government securities market.

(iii) Subsidiaries/joint ventures set up by entities incorporated abroad under the approval of the Foreign Investment Promotion Board (FIPB).

The applicant should have owned funds (NOFs) of a minimum of ₹50 crore, consisting of paid-up equity capital, free reserves, balance in share premium account and capital reserves representing a surplus arising out of sale proceeds of assets but not reserves created by the revaluation of assets, less accumulated loss balance, deferred revenue expenditure and other intangible assets. The decision to enlist PDs would be taken by the RBI based on its perception of market needs, suitability of the applicant and the likely value addition to the system.

PDs' Role and Obligations The PDs are expected to play an active role in the Government securities market, both in its primary and secondary segments. A PD is required to have a standing arrangement with the RBI, based on the execution of an undertaking and an authorisation letter issued by the RBI covering, interi-alia, the following aspects:

(i) A PD has to commit to aggregatively bid for Government of India dated securities on an annual basis of not less than a specified amount and auction T-bills for specified percentage of each auction. The agreed minimum amount/percentage of bids has to be separately indicated for dated securities as well as T-bills.

(ii) A PD is required to achieve a minimum success ratio of 40 per cent for dated securities and T-bills.

(iii) The PDs are collectively offered to undewrite upto 100 per cent of the notified amount in respect of all issues where the amounts are notified. A PD can offer to underwrite an amount not exceeding five times of its net owned funds. The amount so arrived at should not exceed 30 per cent of the notified amount of the issue. If two/more issues are floated at the same time, the 30 per cent limit applies to the amounts of both the issues taken together.

In the case of devolvement, allotment of securities is made at the competitive cut-off price/yield decided at the auction or at par in 'the case of predetermined coupon flotation. Obligations under items (i) to (iii) above are confined only to Central Government dated securities and obligations under item (i) to (ii) to T-bills.

(iv) The T-bills issues are not underwritten. Instead, PDs are required to commit to submit minimum bids at each auction. Their commitment to participate in T-bills subscription works out as follows: **(a)** a each PD individually commits, at the beginning of the year, to submit a minimum bid as a fixed percentage of the notified auction, **(b)** the minimum percentage of bids for each PD is determined by the RBI through negotiations so that the entire issue is collectively apportioned among all PDs and **(c)** in determining the minimum bidding commitment, the RBI takes into account the offer made by the PD, its net owned funds and track record. The percentage of minimum bidding commitment determined by the RBI remains unchanged for the entire financial year or till furnishing of undertaking on bidding commitment for the next financial year, whichever is later.

(v) A PD offers a firm two-way quote either through the Negotiated Dealing System (NDS) or the over-the-counter telephone market or through a recognised stock exchange in

India an deals in the secondary market for Government securities and takes principal positions.

(vi) A PD has to maintain the prescribed minimum capital standards at all points of time.

(vii) A PD should achieve a sizeable portfolio in Government securities before the end of the first year of operation after authorisation.

(viii) The annual turnover of a PD in a financial year cannot be less than five times of the average month-end stocks in Government dated securities and 10 times of the average month-end stocks in T-bills. Of the total, the turnover in respect of outright transactions cannot be less than three times in respect of Government dated securities and six times for T-bills. The turnover is calculated as under:

Total purchase and sales during the year divided by average of month-end stocks during the year. Purchases are inclusive of primary market purchases and sales are inclusive of redemption on maturities. The target should be achieved by the end of the first year of operations, after authorisation by the RBI.

(ix) A PD has to maintain physical infrastructure in terms of office, computing equipment, communication facilities like telex, fax, telephone etc. and skilled manpower for efficient participation in primary issues, trading in the secondary market and to provide advice and education to investors.

(x) A PD should have an efficient control system for the fair conduct of business, settlement of trades and maintenance of accounts. The Guidelines on Securities Transaction to be followed by DPs, issued from time to time, should be strictly adhered to.

(xi) A PD must provide access to the RBI to all records, books, information and documents as may be required.

(xii) A PD is subject to all prudential and regulatory guidelines of the RBI.

(xiii) A PD must submit periodic returns as prescribed by the RBI.

(xiv) A PD's investment in G-Secs and T-bills on a daily basis should at least be equal to its net call borrowing plus net RBI borrowings plus net owned funds of ₹50 crore.

Facilities from RBI to PDs The RBI extends thse following facilities to PDs to enable them to effectively fulfil their obligations:

(i) Access to current account facility and Subsidiary General Ledger (SGL) Account facility (for Government securities).

(ii) Permission to borrow and lend in the money market, including call money market, and to obtain all money market instruments.

(iii) Access to liquidity support through Repos operations with the RBI in Central Government dated securities and Auction Treasury Bills upto the limit fixed by the RBI. The scheme is separately notified every year. The limit is fixed at 16.67 per cent and 10 per cent respectively of commitments made by a PD for tendering aggregavative bids on an annual basis in Government of India dated securities and T-bills. Special discretionary access may be considered when market conditions warrant it.

(iv) Access to Liquidity Adjustment Facility (LAF) of the RBI.

(v) Favoured access to open market operations by the RBI.

Money Market Mutual Funds

The sophistication and versatility of the money market is reflected in the diversity of money market instruments to suit the varied needs of market participants. The money market instruments outlined earlier in the chapter deals with wholesale transactions involving large amount and are suitable for large corporate and institutional investors. To enable small investors to participate in the money market, a money market mutual fund (MMMF) works as a conduit through which they can earn the market related yield. In April 1991, the RBI outlined a broad framework for setting up these institutions. As a follow-up, in September 1991, a Task Force was appointed to work out the operating guidelines for the setting up of MMMFs. Following the recommendations of the Task Force, in April 1992, the RBI announced detailed guidelines in this regard. Despite the lapse of three years since the guidelines were issued, MMMFs continued to be consciously absent in the money market in India. View a view to imparting greater liquidity and depth to the money market and in order to make the scheme more flexible and attractive to banks and financial institutions, certain modifications to the existing scheme were introduced in December 1995.

In its credit policy, announced on October 29, 1999, the RBI stipulated that from the angle of consistent policy, with regard to investor protection, MMMFs would be brought under the umbrella of the SEBI regulations like other mutual funds. Once the SEBI regulatory framework for MMMFs was in place, the RBI would withdraw its guidelines. However, banks/FIs desirous of setting up MMMFs would have to take necessary clearance from the RBI before approaching the SEBI for registration. The SEBI Mutual Fund Regulations (discussed in a subsequent chapter) are since 2000 applicable to money market mutual funds also.

However, the growth in MMMFs has been less than expected. The size of the MMMF schemes floated by three sponsors is rather small. The MMMFs would hopefully grow when the Indian money market would grow in volume and acquire depth.

CONCLUDING OBSERVATIONS

- Money market is a market for overnight to short-term funds (i.e., upto 1 year) and for short-term money and financial assets that are close substitutes for money, that is, financial assets that can be quickly converted into cash (money) with minimum transaction cost and without loss in value.
- These broad objectives/functions of the money market are three-fold: (i) It acts as an equilibrating mechanism for evening out short-term surpluses and deficiencies of funds, (ii) It is the focal point of RBI intervention for influencing liquidity in the economy and (iii) It provides reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable cost or to temporarily deploy their excess funds for earning returns.
- The operational features of the money market, in contrast to the capital market are: short duration (upto 1 year); institutional source of working capital financing; large number of participants; wholesale market (large volume of funds); same day settlement of transactions; scope for innovative dealings; a large number of inter-related sub-markets and so on.
- The RBI is the nerve-centre of the money market and the main regulator of the banking system. The functions/roles of the RBI comprise of: note issuing authority (issue of currency), Government banker, bankers' bank, supervisory authority, promoter of the financial system and regulator of money and credit (monetary authority).

- One basic function of the RBI is to issue currency notes that are legal tender every where in India without any limit. Currency management by the RBI involves efforts to achieve self-sufficiency in the production of currency notes/coins, with a judicious denomination mix, improvement in the efficiency of distribution networks, withdrawal and destruction of notes, technology upgradation and enhancement in the security features of currency notes. The currency notes have 100 per cent backing of eligible assets.
- As the Government banker, apart from banking services relating to receipts/payments on behalf of the Government, the issue, management and administration of Government public debt is a major function of the RBI. The objective of its debt management policy is to raise resources at the minimum cost, while maintaining consistency with the monetary policy objectives. To bridge temporary mismatches in the cashflows, it provides WAMAs for a period upto 3 months.
- As the bankers' bank, the RBI has a special relationship with banks. It controls the volume of SLR and CRR and determines their credit-creation ability. It is, in effect, the banker of the last resort.
- As a regulator and supervisor, the RBI prescribes the broad parameters within which the banking and financial system functions. It regulates and supervises the banking system, under the provisions of the Banking Regulation Act. The NBFCs are regulated under the provisions of Chapter III-B of the RBI Act.
- The RBI develops and regulates the foreign exchange market within the framework of the FEMA.
- As the central bank of the country, the RBI formulates and conducts the monetary policy. Monetary policy refers to the use of the techniques of monetary control to achieve the broad objectives of maintaining price stability and ensuring an adequate flow of credit to productive sectors so as to assist growth. The instruments of monetary control used by the RBI are: OMOs, Bank rate, Refinance, CRR, SLR, LAF and Repo Rates.
- The OMOs involve sale and purchase of Government securities and T-bills. Through the OMOs, the RBI can affect the reserve position of banks, yields on Government securities/T-bills and volume/cost of credit. They are poised to emerge as a major tool of monetary policy in India.
- The B/R is the standard rate **(i)** at which the RBI buys/rediscounts bills of exchange/other eligible commercial papers and **(ii)** that RBI charges on advances on specified collaterals to banks. The B/R technique regulates the cost/availability of finance to banks/FIs.
- The CRR refers to the cash which banks have to maintain with the RBI as a percentage of their demand and time liabilities to ensure safety and liquidity of bank deposits. As an instrument of policy, the CRR has been used by the RBI very actively.
- The SLR enables the RBI to impose a secondary and supplementary reserve requirement. Strictly speaking, SLR is not a technique of monetary control; it only distributes bank resources in favour of the Government/public sector.
- The LAF has emerged as one of the most important instruments of monetary policy in recent years. The LAF operates through repo auctions for absorption of liquidity and reverse repo auctions for injection of liquidity on a daily basis, thereby creating a corridor for the call rates and other short-term interest rates. The funds under LAF are expected to be used by banks for their day to day mismatchces in liquidity.
- A repo/reverse repo/ready forward/repurchase (buy-back) is a transaction in which two parties agree to sell and repurchase the same security. The seller sells specified securities, with an agreement to repurchase the same at a mutually decided future date and price. Likewise, the buyer purchases the security with an agreement to resell the same to the seller, on an agreed date and at a predetermined price. The same transaction is 'repo' from the viewpoint of the

seller and 'reverse repo' from the angle of the buyer. Repo is also known as ready forward as it is a means of funding by selling a security held on a spot basis and repurchasing the same on a forward basis. The terms of the contract are in terms of a repo rate, representing the money market borrowing/lending rate. It is generally lower than the B/R. Repos have a maturity of 1-14 days. They are very safe transactions.

- Two types of repos are currently in operation in India: bank repos and RBI repos.
- The inter-bank repos are permitted under regulated conditions. Banks and PDs can undertake repo deeds in all Government securities and T-bills of all maturities, through the SGL Account maintained by the RBI. Repos are also allowed to develop a secondary market in PSU bonds, FI bonds, corporate bonds and private debt securities if held in demat form and if deals are done through stock exchange(s). However, non-bank participants can deal only in reverse repos, that is, they can only lend money to the eligible participants. Such entities holding SGL accounts, can enter into reverse repos with banks/PDs, in all Government securities.
- The RBI undertakes repos/reverse repo operations with banks/PDs to absorb/inject liquidity under the LAF. It uses the daily fixed rate repo auction system. It participates actively in the call market, with LAF repos conducted throughout the year to modulate the surplus liquidity in the market. It also conducts reverse repo operations under the LAF to prevent sudden spurts in the call rates. The repo rate has emerged as the signalling rate, together with the B/R. The repo rate serves the purpose of a floor rate and the B/R serves as a cap for the money market to operate within an interest rate corridor.
- The organisation of the money market in India till the mid-eighties, suffered from three deficiencies: an arrow base in terms of limited participants, paucity of instruments and controlled interest rates.
- The present organisation comprises of a number of instruments (interrelated sub-markets) and intermediaries. The sub-markets are: call/notice market, T-bills market, commercial bills market, CPs market and CDs market. The money market intermediaries are PDs and MMMFs.
- The call/notice money market deals with overnight/one-day (call) money and notice money for upto 14 days. Call money is required by banks to meet their CRR requirements on a reporting Friday. Till 1971, the call market was strictly an inter-bank market. Non-bank entities were permitted to operate through the DFHI/PDs only as lenders, to utilise their sizeable float money gainfully as also to augment the supply of short-term funds in the market consequent upon the steep hike in the CRR. Following the recommendations of the NC II, a four-phase exit of non-bank participants commenced in 2001. The call market is a pure inter-bank market now, including PDs. There are also prudential limits on lending and borrowing by banks (PDs) in the call market. The lending limit on a fortnightly average basis is 25 per cent of owned funds. The borrowing limits are the higher of 100 per cent of owned funds or 2 per cent of the aggregate deposits of a bank and 100 per cent of net owned funds of a PD. To further deepen the call market, the participants have access to two derivative products, namely, IRS and FRAs. The non-bank entities have now access to the repo market as an alternative to the call market. The access to CPs/CDs has also been made more attractive for the same reason.
- The interest rate paid on call loans is known as the call rate. Till 1973, the call rates were determined by market forces (i.e., demand and supply factors). The IBA regulated them during 1974-88. They were freed from administrative control in1989. The call rates are affected by a number of factors such as easy/tight liquidity conditions, reserve requirements, volatile forex market conditions and so on. The RBI moderates liquidity and volatility in the call market through LAF, repo and reverse repo and changes in CRR.

- A commercial bill is a short-term negotiable and self-liquidating instrument. It is a written instrument containing an unconditional order signed by the maker (seller of goods), directing the buyer to pay a certain amount of money only to a particular person or to the bearer of the instrument. The bills can be discounted in the Bill Discount Market. In the initial stages of the development of the bill discounting market, the RBI provided significant support, but it gradually withdrew its support and allowed FIs to rediscount such bills.
- Bill rediscounting, as a money market instrument, has not become popular in India inspite of several measures, including abolition of stamp duty, taken by the RBI to develop bill finance. The main factors hindering the development of the bill finance/culture are: system of cash credit, small size of foreign trade, absence of specialised discounting institutions, lack of an active secondary market and so on.
- A T-bill is an instrument of short-term borrowing by the Government of India to bridge seasonal/temporary gaps between receipts and expenditures. It is issued by the RBI on behalf of the Government. The features of T-bills are: negotiability, issued at discount and redemption at par on maturity, high liquidity, low transaction cost, absence of default risk, eligibility for inclusion in the SLR and transaction through SGL Account. Being a risk-free instrument, the yields on T-bills at various maturities serve as a benchmark and help in pricing different floating rate instruments in the market. The T-bill market is the RBI's preferred tool for intervention, to influence short-term interest rates.
- T-bills are zero coupon bonds issued by the RBI on behalf of the Government, in the form of a promissory note. It presently issues T-bills in two maturities: 91 days and 364 days. They are issued through auction. The RBI declares the auction calendar at the starting of the financial year, mentioning the amount of issue, the day of auction and the day of payment.
- The 91-days T-bills are auctioned every Wednesday. The multiple price based auction technique is used. Under this method (also known as French Auction), all bids equal to/above the cut-off price are accepted. However, the bidder has to obtain the T-bills at the price quoted by him. The 364-days T-bills are auctioned on the second and fourth Wednesdays of the month, using the uniform price based auction (also known as Dutch Auction). Under this system, all the bids equal to/above the cut-off prices are accepted at the cut-off level. The bidder obtains the T-bills at the cut-off (uniform) price and not at the price quoted by him.
- A CP is a short-term, unsecured, negotiated instrument consisting of a usance promissory note with a fixed maturity. It is not tied to any specific self-liquidating trade transaction. Depending on whether it is issued by the company concerned directly or through a dealer, the CP is called a *direct paper* or a *dealer paper* respectively. As a short-term instrument, a CP offers several advantages to the issuers as well as the investors, such as simplicity, flexible maturities, lower cost, higher credit standing, no restriction on end-use of funds, high liquidity, higher return and so on.
- The framework of the Indian CP market has to conform to the RBI guidelines. The main elements of the framework relate to the **(i)** eligible issuers in terms of minimum tangible networth, sanction of working capital limits by banks/FIs and classification of borrowal account as standard asset, **(ii)** instrument in terms of minimum rating, denomination and stand-alone character, **(iii)** renewal of a CP, **(iv)** eligible investors and **(v)** form of issue and so on.
- A CD is a negotiable money market instrument, issued in a demat form or as a usance promissory note for funds deposited at a bank/other eligible FIs for a specified time period. In other words, a CD is a marketable receipt of funds deposited in a bank/FII, for a fixed period, at a specified rate of interest. It is attractive both to the bank/FII and the investors as the former

does not have to encash the deposit prematurely, while the latter can sell it in the secondary market before its maturity.

- The framework of the issue of CDs in India is prescribed by the RBI. The main elements of the RBI guidelines relate to eligibility of issuers, aggregate amount of issue, minimum issue size and denomination, eligible subscribers, maturity, discount/coupon rate, reserve requirements, transferability, loans/buy back and so on.
- The money market intermediaries are primary dealers (PDs) and money market mutual funds.
- The objectives of PDs are: strengthening the infrastructure in the Government securities market including the money market, improving the secondary market trading system and making an effective conduit for conducting OMOs. Subsidiaries of banks/TIIs, companies engaged primarily in the securities business and subsidiaries/JVs by entities incorporated abroad, approved by the FIPB, with a minimum of NOFs of ₹50 crore can be registered with the RBI as PDs. To enable them to effectively fulfil their obligations, the RBI extends facilities such as access to SGL account; permission to borrow and lend in the money market including the call market and to obtain all money market instruments; access to LAF; favoured access to OMOs; and access to liquidity support through repos and reverse repose.
- An MMMF is a conduit through which small investors can participate in the money market to earn the market-related yield. They are, however, a marginal player in the Indian money market.

Part 3

Financial Intermediaries

Financial intermediaries/institutions, as a link between the savers and investors, are a critically significant constituent of the financial system. In fact, the more diversified and broadbased is the institutional structure of the financial system, the more active and vibrant are the financial markets. Part three comprehensively examines the main financial intermediaries in the Indian financial system and comprises seven chapters. The discussions cover structure, organisation, policies and practices and the driving forces behind these developments. The quantitative dimensions of the operations of the financial intermediaries is beyond the scope of our discussions.

The banking system, as a vital economic institution, is deeply influenced by the socio-political and economic environment/changes. The focus of bank management in the post-90 period has shifted to their internal financial management in sharp contrast to the statutory compliances earlier. Chapter 10 examines the prudential norms relating to the (i) credit/advances portfolio of banks, (ii) investment portfolio of banks. The management of non-performing assets and Basel II capital adequacy framework are covered in Chapter 11 and 12 respectively. The risk management of bank funds in the context of the emerging prudential banking is comprehensively discussed in Chapter 13.

The non-banking financial companies which provide a variety of financial services greatly contribute to the development of an articulate and matured financial system. Their operational framework is elaborated in Chapter 14.

A significant institutional development in the Indian capital market has been the emergence of a diversified structure of mutual funds. Chapter 15 focuses on the framework of their regulation and operation.

The dismantling of the monopoly of two monolothic public sector insurance organisations, namely, LIC and GIC and its subsidiaries, and the consequent entry of private players represents a landmark in the evolution of the Indian financial system in the post-2000 period. A detailed account of the emerging insurance organisation in the country is given in Chapter 16.

CHAPTER 10

Prudential and Exposure Norms Relating to Credit/Advance and Investment Portfolios of Banks

INTRODUCTION

The focus of management of banks in the post-1990 period has shifted from regulatory compliance to internal financial management. The four important dimensions of the management of banks are: **(i)** Prudential Norms Relating to the Credit/Advances and Investment Portfolio of Banks and their Exposure Norms, **(ii)** Management of Non-Performing Asses, **(iii)** Capital Adequacy: Basel II Framework, and **(iv)** Risk Management in Banks. **The prudential norms relating to the credit/advances and investment portfolios of banks and their exposure norms discussed in this Chapter are portrayed in Exhibit 10.1**. While Section 1 analyses prudential accounting norms relating to the credit/advances portfolio, the prudential norms relating to the investment portfolio are examined in Section 2. Section 3 discusses their exposure norms. The last Section contains some concluding observations.

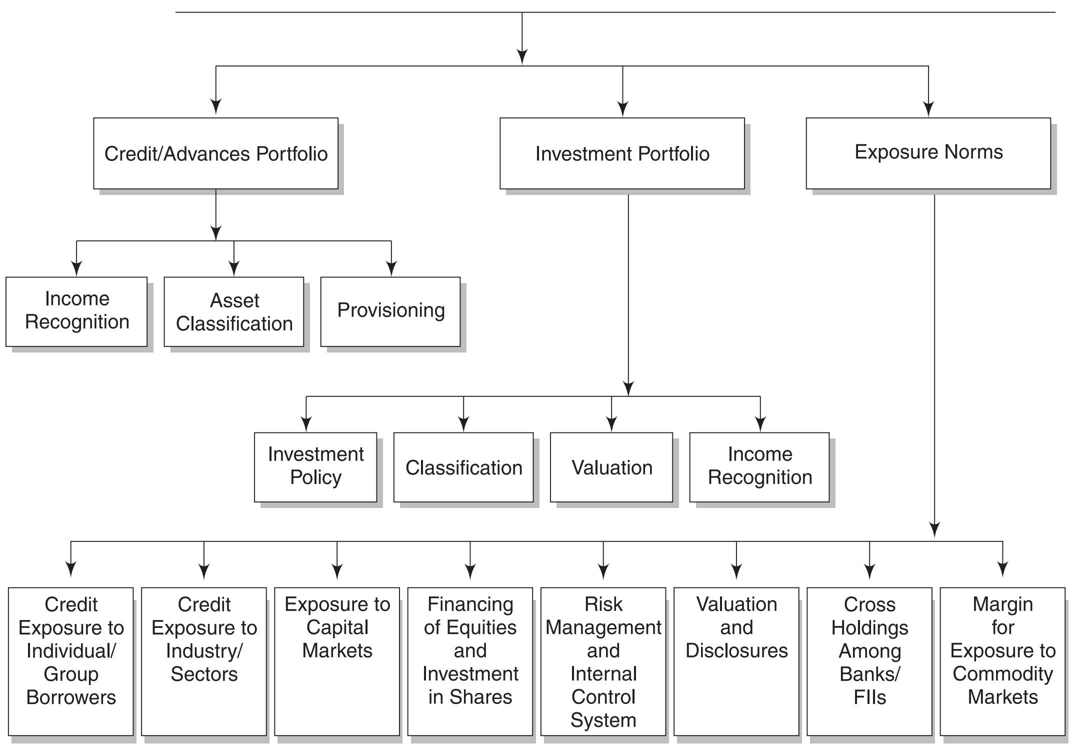
PRUDENTIAL NORMS RELATING TO CREDIT/ADVANCES PORTFOLIO

In line with the international practices and as per the recommendations by the (Narsimham) Committee on the Financial Systems, the RBI has introduced prudential norms for **(i)** income recognition, **(ii)** asset classification, and **(iii)** provisioning for the advances portfolio of the banks in a phased manner, so as to move towards greater consistency and transparency in their published accounts.

Income Recognition

The policy of income recognition has to be objective and based on the record of recovery. The banks should, therefore, not charge and take to income account interest on any NPA. An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. NPA is defined as a credit facility/advance whose: **(1)** interest and/or instalment of

Exhibit 10.1 Prudential Norms Relating to Credit/Advances and Investment Portfolios of Banks and Exposure Norms



principal remain overdue (i.e. an amount due has not been paid on the due date fixed by the bank) for more than 90 days (one quarter) in respect of a term loan, **(ii)** account remains 'out of order' for more than 90 days in respect of an overdraft (OD)/cash credit (CC), **(iii)** bill remains overdue for more than 90 days in case of bills purchased/discounted, **(iv)** interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half-years in case of advances granted for agricultural purposes, and **(v)** amount to be viewed remains overdue for more than 90 days in respect of other accounts. An account would be out of order if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of the balance sheet or if credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

However, interest on advances against term deposits, NSCs (National Saving Certificates), IVPs (Indira Vikas Patras), KVPs (Kisan Vikas Patras) and life policies may be taken to income account on the due date provided adequate margin is available in the accounts. Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.

If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Reversal of Income If any advance, including bills purchased and discounted and Government guaranteed accounts, becomes NPA at the close of any year, interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for if the same is not realised. In respect of NPAs, fees, commission, and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Leased Assets The finance charge component of finance income [as defined in Accounting Standard (AS)-19: Leases issued by the Institute of Chartered Accountants of India (ICAI)] on the leased asset which has accrued and was credited to income account before the asset became NPA and remaining unrealised should be reversed or provided in the current accounting period.

Appropriation of Recovery in NPAs The interest realised on the NPAs may be taken into account provided the credits in the accounts towards interest are not out of fresh/additional credit facilities sanctioned to the borrower concerned. In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in the NPAs (i.e. towards principal or interest due), banks should exercise the right of appropriation of recoveries in a uniform and consistent manner.

Interest Application The banks can use their own discretion in debiting interest to an NPA account taking the same to interst suspense account or maintaining only a record of such interest in proforma accounts.

Reporting of NPAs A report in the prescribed format on the NPAs as on March 31 each year after completion of audit should be furnished by the banks. The NPAs should relate to their global portfolio, including the advances at the foreign branches. While reporting the NPA figures to RBI, the amount held in Interest Suspense Account should be shown as a deduction from the gross NPAs as well as gross advances while arriving at the net NPAs. The banks which do not maintain Interest Suspense Account for parking interest due on non-performing advances accounts, may furnish the amount of interest receivable on the NPAs as a foot note to the report. Whenever the NPAs are reported to the RBI, the amount of technical write-off, if any, should be reduced from the outstanding gross advances and gross NPAs to eliminate any distortion in the quantum of NPAs being reported.

Asset Classification

The classification of assets of banks has to be based on an objective criteria to ensure a uniform and consistent application of norms. The NPAs should be classified further into three categories based on the period for which the asset has remained non-performing and the realisability of the dues: **(a)** sub-standard assets, **(b)** doubtful assets, and **(c)** loss assets

Sub-standard Assets A sub-standard asset is one which is classified as NPA for a period not exceeding 12 months. In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure full recovery of bank dues. In other words, such an asset has well-defined credit weakness that jeopardise the liquidation of debt and is characterised by the distinct possibility that the bank would sustain some loss, if deficiencies are not corrected.

Doubtful Assets A doubtful asset is one which has remained NPA for a period exceeding 12 months. A loan classified as doubtful has all the weaknesses inherent in sub-standard assets, with the added characteristic that the weakness make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss Assets A loss asset is one where loss has been identified by the bank or its internal or external auditors, or by the RBI inspection, though the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

Guidelines for Classification of Assets Broadly speaking, classification of assets into the above four categories should be done taking into account the degree of well-defined credit weaknesses and the extent of dependence on collateral security for realisation of dues. The banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of the NPAs, especially in respect of high value accounts. They may fix a minimum cut-off point to decide what would constitute a high value account depending upon their respective business levels. The cut-off point should be valid for the entire accounting year. The responsibility and validation levels for ensuring proper asset classification may be fixed by the banks. The system should ensure that any doubts in assets classification due to any reason are settled through the specified internal channels within one month from the date on which the account would have been classified as NPA as per the extant guidelines. These guidelines for asset classification relate to: **(1)** accounts with temporary difficulties, **(2)** accounts regularised near balance sheet dates, **(3)** assets classification borrower-wise, **(4)** advances under consortium arrangements, **(5)** accounts with no erosion in value of security, **(6)** loans with moratorium, **(7)** Government guaranteed advances, **(8)** restructuring/rescheduling of loans, **(9)** corporate debt restructuring, **(10)** projects under implementation, **(11)** availability of security, **(12)** take-out finance, **(13)** post-shipment suppliers credit, **(14)** export financing, and **(15)** advances under rehabilitation approved by BFIR/TLIs.

Accounts with Temporary Deficiencies The classification of an asset as NPA should be based on the record of recovery. A bank should not classify an advance account as NPA merely due to some temporary deficiencies such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, and so on. In the matter of classification of accounts with such deficiencies, banks may follow the following guidelines:

- **(a)** The banks should ensure that the drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. The drawing power is required to be arrived at based on the current stock statement. However, considering the difficulties of larger borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular. A working capital borrowal account would become NPA if such irregular drawings are permitted in the account for a continuous period of 180 days even though the unit may be working or the borrower's financial position is satisfactory.
- **(b)** The regular and *ad hoc* limits need to be reviewed/regularised not later than three months from the due date/date of *ad hoc* sanction. In case of constraints such as non-availability

of financial statements and other data from the borrowers, the concerned bank branch should furnish evidence to show that the renewal/review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable. Hence, an account where the regular/*ad hoc* credit limits have not been reviewed/renewed within 180 days from the due date/date of *ad hoc* sanction should be treated as NPA.

Upgradation of Loan Accounts Classified as NPAs If arrears of interest and principal are paid by the borrower in case of loans accounts classified as NPAs, the account should be classified as standard.

Accounts Regularised Near About the Balance Sheet Date The asset classification of borrowal accounts, where a solitary or a few credits are recorded before the balance sheet date, should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA. In other genuine cases, the banks must furnish satisfactory evidence to the statutory auditors/inspecting officers about the manner of regularisation of the account to eliminate doubts on their performing status.

Asset Classification to be Borrower-wise and not Facility-wise All facilities granted by a bank to a borrower would have to be treated as NPA and not the particular facility or part thereof which has become irregular. If the debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account should also be treated as part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification, and provisioning.

Advances Under Consortium Arrangements The asset classification of accounts under consortium should be based on the record of recovery of the individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank, and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of other member banks, and therefore, treated as NPA. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Accounts Where There is Erosion in the Value of Security An NPA need not go through various stages of classification in case of serious credit impairment and such assets should be straightaway classified as doubtful or loss assets as appropriate. The erosion in the value of security can be reckoned as significant, when its realisable value is less than 50 per cent of the value assessed by the bank, or accepted by the RBI at the time of the last inspection. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets. If the realisable value of the security, as assessed by the bank/approved valuers/RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written-off or fully provided for by the bank.

Loans with Moratorium for Payment of Interest In case of bank finance given for projects where moratorium is available, payment of interest becomes 'due' only after the moratorium or gestation period. Therefore, such amounts of interest do not become overdue, and hence, NPA with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected. In case of housing loans or similar advances granted to staff members of banks where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates.

Agricultural Advances Where interest and/or instalment of principal remains unpaid after it has become past due for at least two harvest seasons but not exceeding two half-years, the advance should be treated as NPA. In case of **(i)** conversion of short-term production loan into a term loan or **(ii)** reschedulement of the payment period when natural calamaties impair the repaying capacity of borrowers, the term loan as well as fresh short-term loan need not be classified as NPA. If after the revised terms and conditions the interest/instalment of principal remains unpaid for two harvest seasons but not exceeding two half-years, the loan should be treated as NPA.

Government Guaranteed Advances The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. However, this exemption from classification of Government guaranteed advances as NPA is not for the purpose of recognition of income. The advances sanctioned against state government guarantees should be classified as NPA in the normal course, if the guarantee is invoked and remains in default for more than 90 days.

Restructuring/Rescheduling of Loans In the context of restructuring the accounts, the following stages, at which the restructuring/rescheduling/renegotiation of the terms of loan agreement could take place, should be identified: **(a)** before commencement of commercial production, **(b)** after commencement of commercial production but before the asset has been classified as sub-standard, and **(c)** after commencement of commercial production and after the asset has been classified as sub-standard. In each of the foregoing three stages, the rescheduling of principal and/or of interest could take place, with or without sacrifice, as part of the restructuring package evolved.

Treatment of Restructured Standard Account A rescheduling of the instalments of principal alone, at any of the aforesaid first two stages would not cause a standard asset to be classified in the sub-standard category provided the loan/credit facility is fully secured. A rescheduling of interest element at any of the foregoing first two stages would not cause an asset to be downgraded to sub-standard category subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written-off or provision is made to the extent of sacrifice involved. For this purpose, the future interest dues as per the original loan agreement in respect of an account should be discounted to the present value at a rate appropriate to the risk category of the borrower (i.e., current PLR + appropriate credit risk premium for the borrower-category), and compared with the present value of the dues expected to be received under the restructuring package, discounted on the same basis. In case there is a sacrifice involved in the amount of interest in present value terms, the amount of sacrifice should either be written-off or provision made to the extent of the sacrifice involved.

Treatment of Restructured Sub-standard Accounts A rescheduling of the instalments of principal alone would render a sub-standard asset eligible to be continued in the sub-standard category for the specified period, provided the loan/credit facility is fully secured. A rescheduling of interest element would render a sub-standard asset eligible to be continued to be classified in sub-standard category for the specified period subject to the condition that the amount of sacrifice, if any, in terms of interest, measured in present value terms, is either written-off or provision is made to the extent of the sacrifice involved. For this purpose, the future interest due as per the original loan agreement in respect of an account should be discounted to the present value at a rate appropriate to the risk category of the borrower (i.e., current PLR + appropriate credit risk premium for the borrower-category) and compared with the present value of the dues expected to be received under the restructuring package, discounted on the same basis. In case there is a sacrifice involved in the amount of interest in present value terms, the amount should either be written-off or provision made to the extent of the sacrifice involved. Even in cases where the sacrifice is by way of write-off of the past interest dues, the asset should continue to be treated as sub-standard.

Upgradation of Restructured Accounts The sub-standard accounts which have been subjected to restructuring, where in respect of principal instalment or interest amount, by whatever modality, would be eligible for upgradation to the standard category only after the specified period, that is, a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due, subject to satisfactory performance during the period. The amount of provision made earlier, net of the amount provided for the sacrifice in the interest amount in present value terms as aforesaid, could also be reversed after the one year period. During this one year period, the sub-standard asset would not deteriorate in its classification if satisfactory performance of the account is demonstrated during the period. In case, however, the satisfactory performance during the one year period is not evident, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

Provisioning Norms In conformity with the prudential norms, provisions should be made on the NPAs on the basis of classification of assets into the prescribed categories as detailed above. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against sub-standard assets, doubtful assets and loss assets as detailed below.

Loss Assets The entire asset should be written-off. If the assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

Doubtful Assets **(i)** 100 per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis. **(ii)** In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful:

Period for which the advance has been considered as doubtful	*Provisioning requirement (%)*
Up to one year	20
One to three years	30
More than three years	100

Valuation of Security for Provisioning Purposes With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of ₹5 crore and above, stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board of Directors would be mandatory in order to enhance the reliability on stock valuation. The collaterals such as immovable properties charged in favour of the bank should be got valued once in three years by valuers appointed as per the guidelines approved by the Board of Directors.

Sub-standard Assets A general provision of 10 per cent on total outstanding should be made without making any allowance for DICGC/ECGC (Deposit Insurance and Credit Guarantee Corporation/Export Credit and Gruarantee Corporation) guarantee cover and securities available. The 'unsecured exposures' identified as sub-standard would attract additional provision of 10 per cent (i.e. 20 per cent on the outstanding balance). Unsecured exposure means the exposure where the realisable value of the security (i.e. tangible security property discharged to the bank excluding intangible securities such as guarantees, comfort letters and so on) as assessed by the bank/approved valuers/RBI's inspecting officers is more than 10 per cent, *ab initio*, of the outstanding exposure. 'Exposure' includes all funded and non-funded exposures including underwriting and similar commitments.

Standard Assets The banks should make a general provision of a minimum of 1 per cent on standard assets on *global loan portfolio basis*. The provisions on standard assets should not be reckoned for arriving at the net NPAs. Such provisions need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions - Others' in Schedule 5 of the balance sheet.

Floating Provisions Some of the banks make a 'floating provision' over and above the specific provisions made in respect of accounts identified as NPAs. The floating provisions, wherever available, could be set-off against provisions required to be made as per above stated provisioning guidelines. Considering that higher loan loss provisioning adds to the overall financial strength of the banks and the stability of the financial sector, banks should voluntarily set apart provisions much above the minimum prudential levels as a desirable practice.

Provisions on Leased Assets: Sub-standard Assets 10 per cent of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge as defined as AS-19: Leases issued by the ICAI. Unsecured lease exposures identified as sub-standard would attract, like the sub-standard assets, additional provision of 10 per cent (i.e. a total of 20 per cent).

Doubtful Assets 100 per cent of the extent to which the finance is not secured by the realisable value of the leased asset. The realisable value should be estimated on a realistic basis. In addition, the following provision should be made on the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge of the secured portion, depending upon the period for which asset has been doubtful:

Period	*Percentage of provision*
Up to one year	20
One to three years	30
More than three years	100

Loss Assets The entire asset should be written-off. If for any reason, an asset is allowed to remain in books, 100 per cent of the net book value should be provided for.

Provisions Under Special Circumstances: *Government Guaranteed Advances* In respect of advances sanctioned against state government guarantee, if the guarantee is invoked and remains in default for more than one quarter (90 days), the banks should make normal provisions.

Advances Granted Under Rehabilitation Packages Approved by BIFR/Term Lending Institutions (TLIs) The provision should continue to be made in respect of dues to bank on the existing credit facilities as per their classification as sub-standard or doubtful assets. Regarding the additional facilities sanctioned as per the package finalised by the BIFR and/or the TLIs, provision on additional facilities sanctioned need not be made for a one year period from the date of disbursement.

In respect of additional credit facilities granted to the SSI (small scale industrial) units which are identified as sick and where rehabilitation packages/nursing programmes have been drawn by the banks themselves or under consortium arrangements, no provisions need to be made for a period of one year. The advances against term deposits, NSCs eligible for surrender, IVPs, KVPs, and life policies are exempted from the provisioning requirements.

Treatment of Interests Suspense Account The amounts held in the interest suspense account should not be reckoned as part of provisions. They should be deducted from the relative advances and thereafter, provisioning as per the norms, should be made on the balances after such deduction.

Advances Covered by ECGC/DICGC Guarantee In case of advances guaranteed by DICGC/ECGC, provision should be made only for the balance in excess of the amount guaranteed by them. Further, while arriving at the provision required to be made for doubtful assets, the realisable value of the securities should first be deducted from the outstanding balance in respect of the amount guaranteed by them and then provision made as illustrated below:

Outstanding balance	₹ 4 lakh
DICGC cover	50 per cent
Period for which the advance has remained doubtful	More than 3 years remained doubtful (as on March 31, 2004)
Value of security held (excludes worth of)	₹ 1.50 lakh
Provision required to be made:	
Outstanding balance	₹ 4 lakh
Less: value of security held	1.50 lakh
Unrealised balance	2.50 lakh
Less: DICGC cover (50% of unrealisable balance)	1.25 lakh
Net unsecured balance	1.25 lakh
Provision for unsecured portion of advance	1.25 lakh (@ 100 per cent of unsecured portion)
Provision for secured portion of advance	0.90 lakh (@ 60 per cent of secured portion)
Total provision required to be made	2.15 lakh (as on March 31, 2005)

Advance Covered by CGTSI (Credit Guaranteed Fund Trust for Small Industries) Guarantee In case the advance covered by CGTSI guarantee becomes non-performing, no provision need to be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances. Two illustrative examples are given below:

Example I

Asset classification status	*Doubtful - More than 3 years*	
CGTSI cover	75% of the amount outstanding or 75% of the unsecured amount or ₹18.75 lakh, whichever is the least	
Realisable value of security	₹1.50 lakh	
Balance outstanding	₹10 lakh	
Less: Realisable value of security	₹1.50 lakh	
Unsecured amount	₹8.50 lakh	
Less: CGTSI cover (75%)	₹6.38 lakh	**Provision required (as on**
Net unsecured and uncovered portion	₹2.12 lakh	**March 31, 2005)**
Secured portion	₹1.50 lakh	₹0.90 lakh (@ 60%)
Unsecured & uncovered portion	₹2.12 lakh	2.12 lakh (100%)
Total provision required		3.02 lakh

Example II

Asset classification status	*Doubtful - More than 3 years* (*as on March 31, 2005*)	
CGTSI cover	75% of the amount outstanding or 75% of the unsecured amount or ₹18.75 lakh, whichever is the least	
Realisable value of security	₹ 10 lakh	
Balance outstanding	40 lakh	
Less: Realisable value of security	10 lakh	
Unsecured amount	30 lakh	
Less: CGTSI cover (75%)	18.75 lakh	
Net unsecured and uncovered portion:	11.25 lakh	*Provision required:* (as on
Secured portion	10 lakh	March 31, 2005)
		₹10 lakh (@ 100%)
Unsecured and uncovered portion	11.25 lakh	
		₹11.25 lakh (100%)
Total provision required		21.25 lakh

Take-out Finance The lending institution should make provisions against a 'take-out finance' turning into NPA pending its take-over by the taking-over institution. As and when asset is taken-over by the taking-over institution, the corresponding provisions could be reversed.

Reserve for Exchange Rate Fluctuations Account (REFRA) When exchange rate movements of Indian rupee turn adverse, the outstanding amount of foreign currency dominated loans (where actual disbursement was made in Indian rupee) which becomes past due, goes up correspondingly, with its attendant implications of provisioning requirements. Such assets should not be normally revalued. In case such assets need to be revalued as per requirements of accounting practices or for any other requirement, the following procedure may be adopted:

- The loss on revaluation of assets has to be booked in the profit and loss account.
- Besides the provisioning requirement as per asset classification, banks should treat the full amount of the revaluation gain relating to the corresponding assets, if any, on account of foreign exchange fluctuation as provision against the particular assets.

Provision for Country Risk Banks should make provisions on the net funded country exposures in respect of a country where its net funded exposure is 1 per cent or more of its total assets on a graded scale ranging between 0.25 to 100 per cent according to the risk categories mentioned below. To begin with (w.e.f. March 2003), they should make provisions as per the following schedule:

Risk category	*ECGC classification*	*Provisioning (%)*
Insignificant	A1	0.25
Low	A2	0.25
Moderate	B1	5
High	B2	20
Very high	C1	25
Restricted	C2	100
Off-credit	D	100

The provisioning for country risk should be in addition to the provisions applicable to the asset classification status of the asset. For "loss assets" and "doubtful assets", provision including for country risk should not exceed 100 per cent of the outstanding.

A lower provisioning (say 25 per cent of the requirement) may be made in respect of short-term exposures (i.e. with contractual maturity of less than 180 days).

Provisioning Norms for Sale of Financial Assets to Securitisation/Reconstruction Companies (SRCs) If the sale of the assets to the SRCs is at a price below the net book value (NBV) [i.e. book value minus provisions held), the shortfall should be debited to the profit and loss account of the year. The excess of the sale price over the NBV should be utilised to meet the shortfall/loss on sale of other financial assets to the SRCs. Banks should build up provisions significantly above the minimum regulatory requirements for their NPAs particularly for those proposed to be sold to SRCs to meet such shortfalls.

Writing-off of NPAs In terms of Section 43-D of the Income-Tax Act, 1961, income by way of interest in relation to such categories of bad and doubtful debts as may be prescribed having regard to the guidelines issued by the RBI in relation to such debts, should be chargeable to tax in the previous year in which it is credited to the bank's profit and loss account or received, whichever is earlier. This stipulation is not applicable to provisioning required to be made as indicated above. In other words, amounts set aside for making provision for NPAs as above are not eligible for tax deductions. Therefore, the banks should either make full provision as per the guidelines or write-off such advances and claim such tax benefits as are applicable, by evolving appropriate methodology in consultation with their auditors/tax consultants. The recoveries made in such accounts should be offered for tax purposes as per the rules.

Write-off at Head Office Level Banks may write-off advances at head office level, even though the relative advances are still outstanding in the branch books. However, it is necessary that provision is made as per the classification accorded to the respective accounts. In other words, if an advance is a loss asset, 100 per cent provision would have to be made.

PRUDENTIAL NORMS FOR CLASSIFICATION, VALUATION AND OPERATION OF INVESTMENT PORTFOLIO BY BANKS

With the introduction of prudential norms on capital adequacy, income recognition, asset classification and provisioning requirements, the financial position of banks in India has improved in the last few years. Simultaneously, trading in securities market has improved in terms of turnover and the range of maturities dealt with. In view of these developments, and taking into consideration the evolving international practices, the RBI has issued guidelines on classification, valuation and operation of investment portfolio by banks from time to time. The main elements of the current guidelines in terms of **(i)** investment policy, **(ii)** classification, **(iii)** valuation, and **(iv)** income recognition stipulations are discussed in this Section.

Investment Policy

(A) Banks should frame internal investments policy guidelines and obtain the approval of its Board of Directors. The investment policy may be suitably framed/amended to include PD (Primary Dealer) activities also. Within the overall framework of the investment policy, the PD business undertaken by the bank should be limited to dealing, underwriting and market–making in Government securities. Investments in corporate/PSUs/FIs bonds, commercial papers, certificate of deposits, debt mutual funds and other fixed income securities will not be deemed to be part of PD business. The investment policy guidelines should be implemented to ensure that operations in securities are conducted in accordance with sound and acceptable business practices. While framing the investment policy, the following should be kept in view:

- **(a)** Banks may sell a government security already contracted for purchase, provided: **(i)** the purchase contract is confirmed prior to the sale, **(ii)** the purchase contract is guaranteed by Clearing Corporation of India Ltd (CCIL) or the security is contracted for purchase from the RBI and, **(iii)** the sale transaction will settle either in the same settlement cycle as the preceding purchase contract, or in a subsequent settlement cycle so that the delivery obligation under the sale contract is met by the securities acquired under the purchase contract (for example, when a security is purchased on T+0 basis, it can be sold on either T+0 or T+1 basis on the day of the purchase; if however it is purchased on T+1 basis, it can be sold on T+1 basis on the day of purchase or on T+0 or T+1 basis on the next day). For purchase of securities from the RBI through open market operations (OMO), no sale transactions should be contracted prior to receiving the confirmation of the deal/advice of allotment. In addition to the above, the banks [other than regional rural banks (RRBs) and local area banks (LABs)] and primary dealers are permitted to short sell Government securities in accordance with the requirements specified in **Appendix 10-A on the website. The website address is: http://www.mhhe.com/khanifs10e.** Further, the NDS-OM (Negotiated Dealing System Order Matching) members can transact on 'When Issued' basis in central Government dated securities, subject to the guidelines specified in **Appendix 10-B on the website. (The website address is: http://www.mhhe.com/khanifs10e.)**
- **(b)** Banks successful in the auction of primary issue of government securities, may enter into contracts for sale of the allotted securities in accordance with the terms and conditions as

per **Appendix 10-C on the website. The website address is: http://www.mhhe.com/khanifs10e.**

(c) The settlement of all outright secondary market transactions in government securities will be done on a standardised T+1 basis.

(d) All the transactions put through by a bank, either on outright basis or ready forward basis and whether through the mechanism of Subsidiary General Ledger (SGL) Account or Bank Receipt (BR), should be reflected on the same day in its investment account and, accordingly, for SLR purpose wherever applicable.

(e) The brokerage on the deal payable to the broker, if any, should be clearly indicated on the notes/ memoranda put up to the top management seeking approval for putting through the transaction and a separate account of brokerage paid, broker-wise, should be maintained.

(f) For issue of BRs, the banks should adopt the format prescribed by the Indian Banks' Association (IBA) and strictly follow the guidelines prescribed by them in this regard. The banks, subject to the above, could issue BRs covering their own sale transactions only and should not issue BRs on behalf of their constituents, including brokers.

(g) The banks should be circumspect while acting as agents of their broker clients for carrying out transactions in securities on behalf of brokers.

(h) Any instance of return of SGL form from the Public Debt Office for want of sufficient balance in the account should be immediately brought to the RBI notice with the details of the transactions.

(i) Banks desirous of investing in equity shares/ debentures should observe the following: **(1)** Build up adequate expertise in equity research by establishing a dedicated equity research department, as warranted by their scale of operations, **(2)** Formulate a transparent policy and procedure for investment in shares, etc., with the approval of the Board of Directors, and **(3)** The decision in regard to direct investment in shares, convertible bonds and debentures should be taken by the investment committee set up by the bank's Board. The Investment Committee should be held accountable for the investments made by the bank.

(B) With the approval of their respective Boards of Directors, banks should **(a)** clearly lay down the broad investment objectives to be followed while undertaking transactions in securities on their own investment account and on behalf of clients, **(b)** clearly define the authority to put through deals, procedure to be followed for obtaining the sanction of the appropriate authority, procedure to be followed while putting through deals, various prudential exposure limits and the reporting system. While laying down such investment policy guidelines, banks should strictly observe the following detailed instructions in terms of **(a)** ready forward (buy back) deals, **(b)** transaction through subsidiary general ledger account, **(c)** use of bank receipts, **(d)** retailing of government securities, **(e)** internal control system, **(f)** dealings through brokers, **(g)** audit, review and reporting, and **(h)** Non-SLR investments.

The aforesaid instructions will be applicable *mutatis mutandis*, to the subsidiaries and mutual funds established by banks, except where they are contrary to or inconsistent with, specific regulations of the SEBI and RBI of India governing their operations.

Ready Forward Contracts in Government Securities The terms and conditions subject to which ready forward contracts (including reverse ready forward contracts) may be entered into, are as under:

(a) Ready forward contracts may be undertaken only in **(i)** dated securities and T-bills issued by Government of India and **(ii)** dated securities issued by State Governments.

(b) Ready forward contracts in the above mentioned securities may be entered into by: **(i)** persons or entities maintaining a Subsidiary General Ledger (SGL) account with the RBI, and **(ii)** the following categories of entities who do not maintain SGL accounts with the RBI but maintain gilt accounts (i.e gilt account holders) with a bank or any other entity (i.e. the custodian) permitted by the RBI to maintain Constituent Subsidiary General Ledger (CSGL) account with its Public Debt Office: Any **(a)** scheduled bank, **(b)** primary dealer, **(c)** non-banking financial company, **(d)** mutual fund, **(e)** housing finance company, **(f)** insurance company, **(g)** non-scheduled urban co-operative bank, and **(h)** listed company, having a gilt account with a scheduled commercial bank, subject to the following conditions:
- The minimum period for reverse repo (lending of funds) by listed companies is seven days. However, they can borrow funds through repo for shorter periods including overnight;
- Where the listed company is a 'buyer' of securities in the first leg of the repo contract (i.e. lender of funds), the custodian through which the repo transaction is settled should block these securities in the gilt account and ensure that these securities are not further sold or re-repoed during the repo period but are held for delivery under the second leg; and
- The counterparty to the listed companies for repo / reverse repo transactions should be either a bank or a primary dealer maintaining SGL Account.

(c) All persons or entities specified above can enter into ready forward transactions among themselves subject to the following restrictions: **(i)** An SGL account holder may not enter into a ready forward contract with its own constituent. That is, ready forward contracts should not be undertaken between a custodian and its gilt account holder; **(ii)** Any two gilt account holders maintaining their gilt accounts with the same custodian (i.e., the CSGL account holder) may not enter into ready forward contracts with each other, and **(iii)** Cooperative banks may not enter into ready forward contracts with the non-banking financial companies. This restriction would not apply to repo transactions between urban co-operative banks and authorised primary dealers in Government securities.

(d) All ready forward contracts should be reported on the Negotiated Dealing System (NDS). In respect of ready forward contracts involving gilt account holders, the custodian (i.e., the CSGL account holder) with whom the gilt accounts are maintained will be responsible for reporting the deals on the NDS on behalf of the constituents (i.e. the gilt account holders).

(e) All ready forward contracts should be settled through the SGL Account/CSGL Account maintained with the RBI, with the Clearing Corporation of India Ltd. (CCIL) acting as the central counter party for all such ready forward transactions.

(f) The custodians should put in place an effective system of internal control and concurrent audit to ensure that: **(i)** ready forward transactions are undertaken only against the clear balance of securities in the gilt account, **(ii)** all such transactions are promptly reported on the NDS, and **(iii)** other terms and conditions referred to above have been complied with.

(g) The RBI regulated entities can undertake ready forward transactions only in securities held in excess of the prescribed statutory liquidity ratio (SLR) requirements.

(h) No sale transaction should be put through, in the first leg of a ready forward transaction by CSGL constituent entities, without actually holding the securities in the portfolio.

(i) Securities purchased under the ready forward contracts should not be sold during the period of the contract except by entities permitted to undertake short selling.

(j) Double ready forward deals in any security are strictly prohibited

(k) The guidelines for uniform accounting for repo/reverse repo transactions are furnished below.

Uniform Accounting for Repo/Reverse Repo Transactions In order to ensure uniform accounting treatment for accounting repo /reverse repo transactions and to impart an element of transparency, uniform accounting principles, have been laid down for repo/reverse repo transactions undertaken by all the regulated entities. However, for the present, these norms would not apply to repo/reverse repo transactions under the liquidity adjustment facility (LAF) with the RBI. The market participants may undertake repos from any of the three categories of investments, namely, Held for Trading, Available For Sale and Held to Maturity. The securities sold under repo (the entity selling referred to as "seller") are excluded from the investment account of the seller of securities and the securities bought under reverse repo (the entity buying referred to as "buyer") are included in the investment account of the buyer of securities. Further, the buyer can reckon the approved securities acquired under reverse repo transaction for the purpose of statutory liquidity ratio (SLR) during the period of the repo. At present, repo transactions are permitted in Central Government securities including T-Bills and dated State Government securities. Since the buyer of the securities will not hold it till maturity, the securities purchased under reverse repo by banks should not be classified under Held to Maturity category. The first leg of the repo should be contracted at prevailing market rates. Further, the accrued interest received/paid in a repo/reverse repo transaction and the clean price (i.e. total cash consideration less accrued interest) should be accounted for separately and distinctly. The other accounting principles to be followed while accounting for repos / reverse repos will be as under:

Coupon In case the interest payment date of the security offered under repo falls within the repo period, the coupons received by the buyer of the security should be passed on to the seller on the date of receipt as the cash consideration payable by the seller in the second leg does not include any intervening cash flows. While the buyer will book the coupon during the period of the repo, the seller will not accrue the coupon during the period of the repo. In the case of discounted instruments like T-Bills, since there is no coupon, the seller will continue to accrue the discount at the original discount rate during the period of the repo. The buyer will not, therefore, accrue the discount during the period of the repo.

Repo Interest Income/Expenditure After the second leg of the repo/reverse repo transaction is over, **(a)** the difference in the clean price of the security between the first leg and the second leg should be reckoned as repo interest income/expenditure in the books of the buyer / seller respectively; **(b)** the difference between the accrued interest paid between the two legs of the transaction should be shown as repo interest income/expenditure account, as the case may be; and **(c)** the balance outstanding in the repo interest income/expenditure account should be transferred to the profit and loss account as an income or an expenditure.

As regards repo/reverse repo transactions outstanding on the balance sheet date, only the accrued income/expenditure till the balance sheet date should be taken to the profit and loss account. Any repo income/expenditure for the subsequent period in respect of the outstanding transactions should be reckoned for the next accounting period.

Marking to Market The buyer will mark to market the securities acquired under reverse repo transactions as per the investment classification of the security. To illustrate, for banks, in case the securities acquired under reverse repo transactions have been classified under Available for Sale category, the mark to market valuation for such securities should be done at least once a quarter. For entities who do not follow any investment classification norms, the valuation for securities acquired under reverse repo transactions may be in accordance with the valuation norms followed by them in respect of securities of similar nature.

In respect of the repo transactions outstanding as on the balance sheet date: **(a)** the buyer will mark to market the securities on the balance sheet date and will account for the same as laid down in the extant valuation guidelines issued by the respective regulatory departments of RBI, **(b)** the seller will provide for the price difference in the profit and loss account and show this difference under "other assets" in the balance sheet if the sale price of the security offered under repo is lower than the book value, **(c)** the seller will ignore the price difference for the purpose of profit and loss account but show the difference under "other liabilities" in the balance sheet, if the sale price of the security offered under repo is higher than the book value; and **(d)** similarly the accrued interest paid/received in the repo/reverse repo transactions outstanding on balance sheet dates should be shown as "other assets" or "other liabilities" in the balance sheet.

Book Value on Re-purchase The seller shall debit the repo account with the original book value (as existing in the books on the date of the first leg) on buying back the securities in the second leg.

Disclosure The disclosures to be made by banks in the "notes on accounts' to the balance sheet should be in the specified format.

Accounting Methodology The accounting methodology to be followed are given below and illustrations are furnished in **Appendix 10-D on the website: The website address is: http://www.mhhe.com/khanifs10e**. While market participants, having different accounting systems, may use accounting heads different from those used in the illustration, there should not be any deviation from the accounting principles enunciated above. Further, to obviate disputes arising out of repo transactions, the participants may consider entering into bilateral master repo agreement as per the documentation finalised by FIMMDA.

The recommended accounting methodology for uniform accounting of repo/reverse repo transactions is as under:

- **(a)** The following accounts may be opened: **(i)** Repo Account, **(ii)** Repo Price Adjustment Account, **(iii)** Repo Interest Adjustment Account, **(iv)** Repo Interest Expenditure Account, **(v)** Repo Interest Income Account, **(vi)** Reverse Repo Account, **(vii)** Reverse Repo Price Adjustment Account, and **(viii)** Reverse Repo Interest Adjustment Account.
- **(b)** The securities sold/purchased under repo should be accounted for as an outright sale/purchase.
- **(c)** The securities should enter and exit the books at the same book value. For operational ease, the weighted average cost method whereby the investment is carried in the books at their weighted average cost may be adopted.
- **(d)** In a repo transaction, the securities should be sold in the first leg at market related prices and re-purchased in the second leg at the derived price. The sale and repurchase should be accounted in the repo account.
- **(e)** The balances in the repo account should be netted from the bank's investment account for balance sheet purposes.

(f) The difference between the market price and the book value in the first leg of the repo should be booked in repo price adjustment account. Similarly the difference between the derived price and the book value in the second leg of the repo should be booked in the repo price adjustment account.

(g) In a reverse repo transaction, the securities should be purchased in the first leg at prevailing market prices and sold in the second leg at the derived price. The purchase and sale should be accounted for in the reverse repo account.

(h) The balances in the reverse repo account should be part of the investment account for balance sheet purposes and can be reckoned for SLR purposes if the securities acquired under reverse repo transactions are approved securities.

(i) The security purchased in a reverse repo will enter the books at the market price (excluding broken period interest). The difference between the derived price and the book value in the second leg of the reverse repo should be booked in the reverse repo price adjustment account.

(j) In case the interest payment date of the security offered under repo falls within the repo period, the coupons received by the buyer of the security should be passed on to the seller on the date of receipt as the cash consideration payable by the seller in the second leg does not include any intervening cash flows.

(k) The difference between the amounts booked in the first and second legs in the repo/reverse repo price adjustment account should be transferred to the repo interest expenditure account or repo interest income account, as the case may be.

(l) The broken period interest accrued in the first and second legs will be booked in repo interest adjustment account or reverse repo interest adjustment account, as the case may be. Consequently the difference between the amounts booked in this account in the first and second legs should be transferred to the repo interest expenditure account or repo interest income account, as the case may be.

(m) At the end of the accounting period the, for outstanding repos, the balances in the repo/reverse repo price adjustment account and repo/reverse repo interest adjustment account should be reflected either under item VI - 'Others' under Schedule 11 - 'Other Assets' or under item IV 'Others (including Provisions)' under Schedule 5 - 'Other Liabilities and Provisions' in the Balance Sheet, as the case may be.

(n) Since the debit balances in the repo price adjustment account at the end of the accounting period represent losses not provided for in respect of securities offered in outstanding repo transactions, it will be necessary to make a provision therefor in the profit and loss Account.

(o) To reflect the accrual of interest in respect of the outstanding repo/reverse repo transactions at the end of the accounting period, appropriate entries should be passed in the Profit and Loss account to reflect repo interest income/expenditure in the books of the buyer/seller respectively and the same should be debited/credited as an income/expenditure accrued but not due. Such entries passed should be reversed on the first working day of the next accounting period.

(p) In respect of repos in interest bearing (coupon) instruments, the buyer would accrue interest during the period of repo. In respect of repos in discount instruments like T-Bills, the seller would accrue discount during the period of repo based on the original yield at the time of acquisition.

(q) At the end of the accounting period, the debit balances (excluding balances for repos which are still outstanding) in the repo interest adjustment account and reverse repo interest adjustment account should be transferred to the repo interest expenditure account and the credit balances (excluding balances for repos which are still outstanding) in the repo interest adjustment account and reverse repo interest adjustment account should be transferred to the repo interest income account.

(r) Similarly, at the end of accounting period, the debit balances (excluding balances for repos which are still outstanding) in the Repo/Reverse Repo Price Adjustment Account should be transferred to the Repo Interest Expenditure Account and the credit balances (excluding balances for repos which are still outstanding) in the Repo/Reverse Repo Price Adjustment Account should be transferred to the Repo Interest Income Account.

Transactions Through SGL Account The following instructions should be followed by banks for purchase/sale of securities through SGL A/c under the Delivery Versus Payment (DVP) System wherein the transfer of securities takes place simultaneously with the transfer of funds.

All transactions in Government securities for which SGL facility is available should be put through SGL A/cs only. Under no circumstances, a SGL transfer form issued by a bank in favour of another bank should bounce for want of sufficient balance of securities in the SGL A/c of seller or for want of sufficient balance of funds in the current a/c of the buyer. The SGL transfer form received by purchasing banks should be deposited in their SGL A/cs. Immediately, that is, the date of lodgement of the SGL Form with RBI should be within one working day after the date of signing of the transfer form. While in cases of OTC trades, the settlement has to be only on '**spot**' delivery basis as per Section 2**(i)** of the Securities Contract (Regulation) Act, in cases of deals on the recognised stock exchanges, settlement should be within the delivery period as per their rules, bye laws and regulations. No sale should be effected by way of return of SGL form held by the bank. The SGL transfer forms should be signed by two authorised officials of the bank whose signatures should be recorded with the RBI and other banks. The SGL transfer forms should be in the standard format prescribed by the RBI and printed on semi-security paper of uniform size. They should be serially numbered and there should be a control system in place to account for each SGL form. If a SGL transfer form bounces for want of sufficient balance in the SGL A/c, the (selling) bank which has issued the form will be liable to the following penal action against it:

The amount of the SGL form (cost of purchase paid by the purchaser of the security) would be debited immediately to the current account of the selling bank with the RBI. In the event of an overdraft arising in the current account following such a debit, penal interest would be charged by the RBI on the amount of the overdraft at a rate of 3 percentage points above the Discount and Finance House of India's (DFHI) call money lending rate on the day in question. However, if the DFHI's closing call money rate is lower than the prime lending rate of banks, as stipulated in the RBI interest rate directive in force, the applicable penal rate to be charged will be 3 percentage points above the prime lending rate of the bank concerned. If the bouncing of the SGL form occurs thrice, the bank will be debarred from trading with the use of the SGL facility for a period of 6 months from the occurrence of the third bouncing. If, after restoration of the facility, any SGL form of the concerned bank bounces again, the bank will be permanently debarred from the use of the SGL facility of the RBI. The bouncing on account of insufficient balance in the current account of the buying bank would be reckoned (against the buying bank concerned) for the purpose of debarment from the use of SGL facility on par with the bouncing on account of insufficient balance in SGL a/c. of the selling bank (against selling bank). Instances of bouncing in both the accounts (i.e SGL a/c and current a/c) will be reckoned together against the SGL account holder concerned for the purpose of debarment (i.e three in a half-year for temporary suspension and any bouncing after restoration of SGL facility, for permanent debarment.)

Use of Bank Receipt (BR) No BR should be issued under any circumstances in respect of transactions in Government securities for which SGL facility is available. Even in the case of other securities, BR may be issued for ready transactions only, under the following circumstances: **(i)** The scrips are yet to be issued by the issuer and the bank is holding the allotment advice; **(ii)** The security is physically held at a different centre and the bank is in a position to physically transfer the security and give delivery thereof within a short period; and **(iii)** The security has been lodged for transfer/interest payment and the bank is holding necessary records of such lodgements and will be in a position to give physical delivery of the security within a short period.

No BR should be issued on the basis of a BR (of another bank) held by the bank and no transaction should take place on the basis of a mere exchange of BRs held by the bank. The BRs could be issued covering transactions relating to banks' own investments accounts only, and no BR should be issued by banks covering transactions relating to either the accounts of portfolio management scheme (PMS) clients or other constituents' accounts, including brokers. No BR should remain outstanding for more than 15 days. A BR should be redeemed only by actual delivery of scrips and not by cancellation of the transaction/set off against another transaction. If a BR is not redeemed by delivery of scrips within the validity period of 15 days, it should be deemed as dishonoured and the bank which has issued the BR should refer the case to the RBI, explaining the reasons under which the scrips could not be delivered within the stipulated period and the proposed manner of settlement of the transaction. The BRs should be issued on semi-security paper, in the standard format (prescribed by IBA), serially numbered and signed by two authorised officials of the bank, whose signatures are recorded with other banks. As in the case of SGL forms, there should be a control system in place to account for each BR form. Separate registers of BRs issued and BRs received should be maintained and arrangements should be put in place to ensure that these are systematically followed up and liquidated within the stipulated time limit. The banks should also have a proper system for the custody of unused BR Forms and their utilisation. The existence and operations of these controls at the concerned offices/ departments of the bank should be reviewed, among others, by the statutory auditors and a certificate to this effect may be forwarded every year to the RBI. Any violation of the instructions relating to BRs would invite penal action, which could include raising of reserve requirements, withdrawals of refinance facility from the RBI and denial of access to money markets. The RBI may also levy such other penalty as it may deem fit in accordance with the provisions of the Banking Regulation Act.

Retailing of Government Securities The banks may undertake retailing of Government securities with non-bank clients subject to the following conditions: Such retailing should be **(i)** on outright basis and there is no restriction on the period between sale and purchase and **(ii)** on the basis of ongoing market rates/yield curve emerging out of secondary market transactions.

Internal Control System The banks should observe the following guidelines for internal control system in respect of investment transactions: There should be a clear functional separation of **(i)** trading, **(ii)** settlement, monitoring and control and **(iii)** accounting. Similarly, there should be a functional separation of trading and back office functions relating to banks' own investment accounts, portfolio management scheme (PMS) clients' accounts and other constituents (including brokers') accounts. The portfolio management service may be provided to clients, subject to strictly following the guidelines in this regard (discussed subsequently in this Section). Further, PMS clients accounts should be subjected to a separate audit by external auditors. For every transaction entered into, the trading desk should prepare a deal slip which should contain data relating to nature of the deal, name of the counter-party, whether it is a direct deal or through a broker, and if through a broker, name of the broker, details of security, amount, price, contract date and time. The deal slips should be serially numbered and controlled separately to ensure that each deal slip has been properly accounted for. Once the deal is concluded, the dealer should immediately pass on the deal slip to the back office for recording and processing. For each deal there must be a system of issue of confirmation to the counterparty. The timely receipt of requisite written confirmation from the counterparty, which must include all essential details of the contract, should be monitored by the back office. With respect to transactions matched on the NDS-OM module, since CCIL is the central counterparty to all deals, exposure of any counterparty for a trade is only to CCIL and not to the entity with whom a deal matches. Besides, details of all deals on NDS-OM are available to the counterparties as and when required by way of reports on NDS-OM itself. In view of the above, the need for counterparty confirmation of deals matched on NDS-OM does not arise. However, all government securities transactions, other than those matched on NDS-OM, will continue to be physically confirmed by the back offices of the counterparties. Once a deal has been concluded, there should not be any substitution of the counter party bank by another bank by the broker, through whom the deal has been entered into; likewise, the security sold/purchased in the deal should not be substituted by another security. On the basis of vouchers passed by the back office (which should be done after verification of actual contract notes received from the broker/counterparty and confirmation of the deal by the counterparty), the Accounts Section should independently write the books of account. In the case of transaction relating to PMS clients' accounts (including brokers), all the relative records should give a clear indication that the transaction belongs to PMS clients/other constituents and does not belong to bank's own investment account and the bank is acting only in its fiduciary/ agency capacity. The Records of SGL transfer forms issued/received, should be maintained.

Balances as per bank's books should be reconciled at quarterly intervals with the balances in the books of the Public Debt Offices of the RBI. If the number of transactions so warrant, the reconciliation should be undertaken more frequently, say on a monthly basis. This reconciliation should be periodically checked by the internal audit department.

Any bouncing of SGL transfer forms issued by selling banks in favour of the buying bank, should immediately be brought to the notice of the RBI by the buying bank.

A record of BRs issued/ received should be maintained.

A system for verification of the authenticity of the BRs and SGL transfer forms received from the other banks and confirmation of authorised signatories should be put in place.

Banks should put in place a reporting system to report to the top management, on a weekly basis, the details of transactions in securities, details of bouncing of SGL transfer forms issued by other banks and BRs outstanding for more than one month and a review of investment transactions undertaken during the period.

Banks should not draw cheques on their account with the Reserve Bank for third party transactions, including inter-bank transactions. For such transactions, bankers' cheques/ pay orders should be issued.

In case of investment in shares, the surveillance and monitoring of investment should be done by the Audit Committee of the Board, which shall review in each of its meetings, the total exposure of the bank to capital market both fund based and non-fund based, in different forms as stated above and ensure that the guidelines issued by RBI are complied with and adequate risk management and internal control systems are in place;

The audit committee should keep the Board of Directors informed about the overall exposure to capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems;

In order to avoid any possible conflict of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the Investment Committee or in the decisions in regard to making investments in shares, etc., or advances against shares.

The internal audit department should audit the transactions in securities on an on going basis, monitor the compliance with the laid down management policies and prescribed procedures and report the deficiencies directly to the management of the bank.

The banks' managements should ensure that there are adequate internal control and audit procedures for ensuring proper compliance of the instructions in regard to the conduct of the investment portfolio. The banks should institute a regular system of monitoring compliance with the prudential and other guidelines issued by the RBI. The banks should get compliance in key areas certified by their statutory auditors and furnish such audit certificate to the RBI.

Engagement of Brokers For engagement of brokers to deal in investment transactions, the banks should observe the following guidelines:

Transactions between one bank and another bank should not be put through the brokers' accounts. The brokerage on the deal payable to the broker, if any (if the deal was put through with the help of a broker), should be clearly indicated on the notes/memorandum put up to the top management seeking approval for putting through the transaction and separate account of brokerage paid, broker-wise, should be maintained. If a deal is put through with the help of a broker, the role of the broker should be restricted to that of bringing the two parties to the deal together. While negotiating the deal, the broker is not obliged to disclose the identity of the counterparty to the deal. On conclusion of the deal, he should disclose the counterparty and his contract note should clearly indicate the name of the counterparty. It should also be ensured by the bank that the broker note contains the exact time of the deal. Their back offices may ensure that the deal time on the broker note and the deal ticket is the same. The bank should also ensure that their concurrent auditors audit this aspect. On the basis of the contract note disclosing the name of the counterparty, settlement of deals between banks, namely, both fund settlement and delivery of security should be directly between the banks and the broker should have no role to play in the process. With the approval of their top managements, banks should prepare a panel of approved brokers which should be reviewed annually or more often if so warranted. Clear-cut criteria should be laid down for empanelment of brokers, including verification of their creditworthiness, market reputation, etc. A record of broker-wise details of deals put through and brokerage paid, should be maintained. A disproportionate part of the business should not be transacted through only one or a few brokers. Banks should fix aggregate contract limits for each of the approved brokers. A limit of 5 per cent of total transactions (both purchase and sales) entered into by a bank during a year should be treated as the aggregate upper contract limit for each of the approved brokers. This limit should cover both the business initiated by a bank and the business offered/ brought to the bank by a broker. Banks should ensure that the transactions entered into through individual brokers during a year normally did not exceed this limit. However, if for any reason it becomes necessary to exceed the aggregate limit for any broker, the specific reasons therefor should be recorded, in writing, by the authority empowered to put through the deals. Further, the board should be informed of this, post facto. However, the norm of 5 per cent would not be applicable to banks' dealings through Primary Dealers. The concurrent auditors who audit the treasury operations should scrutinise the business done through brokers also and include it in their monthly report to the Chief Executive Officer of the bank. Besides, the business put through any individual broker or brokers in excess of the limit, with the reasons therefor, should be covered in the half-yearly review to the Board of Directors/ Local Advisory Board. These instructions also apply to subsidiaries and mutual funds of the banks.

Inter-bank securities transactions should be undertaken directly between banks and no bank should engage the services of any broker in such transactions.

Audit, Review and Reporting of Investment Transactions The banks should follow the following instructions in regard to audit, review and reporting of investment transactions. They should undertake a half-yearly review (as of 30 September and 31 March) of their investment portfolio, which should, apart from other operational aspects of investment portfolio, clearly indicate amendments made to the investment policy and certify adherence to laid down internal investment policy and procedures and the RBI guidelines, and put up the same before their respective Boards within a month, that is, by end-April and end-October. A copy of the review report put up to the Bank's Board, should be forwarded to the RBI by 15 November and 15 May respectively. In view of the possibility of abuse, treasury transactions should be separately subjected to concurrent audit by internal auditors and the results of their audit should be placed before the CMD of the bank once every month. Banks need not forward copies of the above mentioned concurrent audit reports to the RBI. However, the major irregularities observed in these reports and the position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

Non- SLR Investments Banks have made significant investment in privately placed unrated bonds and, in certain cases, in bonds issued by corporates who are not their borrowers. While assessing such investment proposals on private placement basis, in the absence of standardised and mandated disclosures, including credit rating, banks may not be in a position to conduct proper due diligence to take an investment decision. Thus, there could be deficiencies in the appraisal of privately placed issues.

Disclosure Requirements in Offer Documents The risk arising from inadequate disclosure in offer documents should be recognised and banks should prescribe minimum disclosure standards as a policy with Board approval. **Appendix 10-C on the website contains the minimum disclosure requirements as well as conditions regarding documentation and creation of charge for private placement issues which may serve as a "best practice model" for bank. The website address is: http://www.mhhe.com/khanifs10e.**

Internal Assessment With a view to ensuring that the investments by banks in issues through private placement, both of the borrower customers and non-borrower customers, do not give rise to systemic concerns, it is necessary that banks should ensure that their investment policies duly approved by the Board of Directors are formulated after taking into account the following aspects:

- The Boards of Directors of banks should lay down policy and prudential limits on investments in bonds and debentures including cap and on private placement basis, sub limits for PSU bonds, corporate bonds, guaranteed bonds, issuer ceiling, and so on;
- Investment proposals should be subjected to the same degree of credit risk analysis as any loan proposal. Banks should make their own internal credit analysis and rating even in respect of rated issues and should not entirely rely on the ratings of external agencies. The appraisal should be more stringent in respect of investments in instruments issued by non-borrower customers;
- Strengthen their internal rating systems which should also include building up of a system of regular (quarterly or half-yearly) tracking of the financial position of the issuer with a view to ensuring continuous monitoring of the rating migration of the issuers/issues;
- As a matter of prudence, banks should stipulate entry level minimum ratings/ quality standards and industrywise, maturity-wise, duration-wise, issuer-wise etc. limits to mitigate the adverse impacts of concentration and the risk of illiquidity; and
- The banks should put in place proper risk management systems for capturing and analysing the risk in respect of these investments and taking remedial measures in time.

Some banks/FIs have not exercised due precaution by reference to the list of defaulters circulated/published by RBI while investing in bonds, debentures, and so on, of companies. Banks should exercise due caution while taking any investment decision to subscribe to bonds, debentures, shares and so on, and refer to the '**Defaulters List**' circulated/published by the RBI to ensure that investments are not made in companies/entities who are defaulters to banks/FIs. Some of the companies may be undergoing adverse financial position turning their accounts to substandard category due to recession in their industry segment, like textiles. Banks should not refuse proposals for such investments in companies whose director's name(s) find place in the defaulter companies list at periodical intervals and particularly in respect of those loan accounts, which have been restructured under the RBI guidelines, provided the proposal is viable and satisfies all parameters for such credit extension.

Prudential Guidelines on Investment in Non-SLR Securities These guidelines cover banks' investments in non-SLR securities issued by corporates, banks, FIs and State and Central Government sponsored institutions, SPVs and so on, including, capital gains bonds, bonds eligible for priority sector status. The guidelines apply to investments both in the primary market as well as the secondary market.

- Banks should not invest in Non-SLR securities of original maturity of less than one-year, other than commercial papers and certificates of deposits.
- They should undertake usual due diligence in respect of investments in non-SLR securities. The RBI regulations preclude banks from extending credit facilities for certain purposes. Banks should ensure that such activities are not financed by way of funds raised through the non- SLR securities.
- Banks must not invest in unrated non-SLR securities.
- While making fresh investments in non-SLR debt securities, banks should ensure that such investment are made only in listed debt securities of companies which comply with the requirements of the SEBI in regard to full disclosures as well as credit rating.

- Bank's investment in **unlisted** non-SLR securities should not exceed 10 per cent of its total investment in non-SLR securities as on March 31, of the previous year. The unlisted non-SLR securities in which banks may invest up to the limits specified above, should comply with the disclosure requirements as prescribed by the SEBI for listed companies.
- Bank's investment in unlisted non-SLR securities may exceed the limit of 10 per cent, by an additional 10 per cent, provided the investment is on account of investment in securitisation papers issued for infrastructure projects, and bonds/debentures issued by securitisation and reconstruction companies (SRCs).
- Investment in the following will not be reckoned as 'unlisted non-SLR securities' for computing compliance with these prudential limits: **(i)** Security receipts issued by the SRCs; **(ii)** Investment in asset backed securities (ABS) and mortgage backed securities (MBS) which are rated at or above the minimum investment grade. However, there should be close monitoring of exposures to ABS on a bank specific basis based on monthly reports to be submitted to the RBI.
- The investments in RIDF/SIDBI deposits may not be reckoned as part of the numerator for computing compliance with the prudential limit of 10 per cent of its total non-SLR securities as on March 31, of the previous year.
- Only investment in units of such mutual fund schemes which have an exposure to unlisted securities of less than 10 per cent of the corpus of the fund will be treated on par with listed securities for the purpose of compliance with the prudential limits prescribed above. While computing the exposure to the unlisted securities for compliance with the norm of less than 10 per cent of the corpus of the mutual fund scheme, T-Bills, collateralised borrowing and lending obligations (CBLO), repo/reverse repo and bank fixed deposits may not be included in the numerator.
- For the purpose of the prudential limits prescribed above, the denominator, namely, 'non-SLR investments', would include investment under four categories in the balance sheet, namely, 'shares', 'bonds and debentures', 'subsidiaries/joint ventures' and 'others'.
- Banks whose investment in unlisted non-SLR securities are within the prudential limit of 10 per cent of its total non-SLR securities as on March 31, of the previous year may make fresh investment in such securities and up to the prudential limits.
- Banks should ensure that their investment policies duly approved by the Board of Directors are formulated after taking into account all the relevant issues specified in these guidelines on investment in non-SLR securities. They should put in place proper risk management systems for capturing and analysing the risk in respect of non-SLR investment and taking remedial measures in time. They should also put in place appropriate systems to ensure that investment in privately placed instruments is made in accordance with the systems and procedures prescribed under respective bank's investment policy.
- The Boards of Directors of banks should review the following aspects of non-SLR investment at least at quarterly intervals: **(a)** Total business (investment and divestment) during the reporting period, **(b)** Compliance with the prudential limits prescribed by the Board for non-SLR investment, **(c)** Compliance with the prudential guidelines issued by Reserve Bank on non-SLR securities, **(d)** Rating migration of the issuers/ issues held in the bank's books and consequent diminution in the portfolio quality, and **(e)** Extent of non performing investments in the non-SLR category.

- In order to help in the creation of a central database on private placement of debt, a copy of all offer documents should be filed with the Credit Information Bureau (India) Ltd. (CIBIL) by the investing banks. Further, any default relating to interest/ instalment in respect of any privately placed debt should also be reported to CIBIL by the investing banks along with a copy of the offer document.
- Banks should disclose the details of the issuer composition of non-SLR investments and the non-performing non-SLR investments in the 'Notes on Accounts' of the balance sheet.
- As per the SEBI guidelines, all trades with the exception of the spot transactions, in a listed debt security, should be executed only on the trading platform of a stock exchange. In addition to complying with the SEBI guidelines, banks should ensure that all spot transactions in listed and unlisted debt securities are reported on the NDS and settled through the CCIL from a date to be notified by the RBI.

Limits on Banks' Exposure to Capital Markets **(A) Solo Basis** The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40 per cent of its net worth as on March 31 of the previous year. Within this overall ceiling, the bank's direct investment in shares, convertible bonds/debentures, units of equity-oriented mutual funds and all exposures to venture capital funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its net worth:

(**B) Consolidated Basis** The aggregate exposure of a consolidated bank to capital markets (both fund based and non-fund based) should not exceed 40 per cent of its consolidated net worth as on March 31 of the previous year. Within this overall ceiling, the aggregate direct exposure by way of the consolidated bank's investment in shares, convertible bonds/debentures, units of equity-oriented mutual funds and all exposures to venture capital funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its consolidated net worth. These ceilings are the maximum permissible and a bank's Board of Directors is free to adopt a lower ceiling for the bank, keeping in view its overall risk profile and corporate strategy.

General

Reconciliation of Holdings of Government Securities Banks should furnish to the RBI the statement of the reconciliation of bank's investments (held in own Investment account, as also under PMS) as at the end of every accounting year duly certified by the their auditors within one month from the close of the accounting year. The requirement of reconciliation may be suitably included by banks in the letters of appointment which may be issued to the bank's external auditors, in future.

Transactions in Securities-Custodial Functions While exercising the custodial functions on behalf of their merchant banking subsidiaries, these functions should be subject to the same procedures and safeguards as would be applicable to other constituents. Accordingly, full particulars should be available with the subsidiaries of banks of the manner in which the transactions have been executed. They should also issue suitable instructions in this regard to the department/office undertaking the custodial functions on behalf of their subsidiaries.

Portfolio Management on Behalf of Clients The general powers vested in banks to operate PMS and similar schemes have been withdrawn. No bank should, therefore, restart or introduce any new PMS or similar scheme in future without obtaining specific prior approval of the RBI However, bank-sponsored NBFCs are allowed to offer discretionary PMS to their clients, on a case to case basis. The following conditions are to be strictly observed by the banks operating

PMS or similar scheme with the specific prior approval of the RBI: **(a)** PMS should be entirely at the customer's risk, without guaranteeing, either directly or indirectly, a predetermined return, **(b)** Funds should not be accepted for portfolio management for a period less than one year, **(c)** Portfolio funds should not be deployed for lending in call/notice money, inter-bank term deposits and bills rediscounting markets and lending to/placement with corporate bodies, **(d)** Banks should maintain client wise account/record of funds accepted for management and investments made there against and the portfolio clients should be entitled to get a statement of account, **(e)** Bank's own investments and investments belonging to PMS clients should be kept distinct from each other, and any transactions between the bank's investment account and client's portfolio account should be strictly at market rates, and **(f)** There should be a clear functional separation of trading and back office functions relating to banks' own investment accounts and PMS clients' accounts.

The PMS clients' accounts should be subjected by banks to a separate audit by external auditors. The violation of the RBI's instructions will be viewed seriously and will invite deterrent action against the banks which will include raising of reserve requirements, withdrawal of facility of refinance and denial of access to money markets, apart from prohibiting the banks from undertaking PMS activity.

The aforesaid instructions will apply, *mutatis mutandis*, to the subsidiaries of banks except where they are contrary to specific regulations of the RBI or the SEBI, governing their operations. The banks/merchant banking subsidiaries of banks operating PMS or similar scheme with the specific prior approval of the RBI are also required to comply with the guidelines contained in the SEBI/Portfolio Managers Rules and Regulations issued from time to time.

Investment Portfolio of Bank—Transactions in Government Securities In the light of fraudulent transactions in the guise of Government securities transactions in physical format by a few co-operative banks with the help of some broker entities, it has been decided to accelerate the measures for further reducing the scope of trading in physical forms. These measures are as under: **(i)** For banks which do not have SGL account with RBI, only one gilt account can be opened, **(ii)** In case the gilt accounts are opened with a scheduled commercial bank, the account holder has to open a designated funds account (for all gilt account related transactions) with the same bank, **(iii)** The entities maintaining the gilt / designated funds accounts will be required to ensure availability of clear funds in the designated funds accounts for purchases and of sufficient securities in the gilt account for sales before putting through the transactions, **(iv)** No transactions by the bank should be undertaken in physical form with any broker, and **(v)** Banks should ensure that brokers approved for transacting in Government securities are registered with the debt market segment of NSE/BSE/OTCEI.

Classification

The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories, namely, **(i)** '**Held to Maturity**', **(ii)** '**Available for Sale**' and **(iii)** '**Held for Trading**'. However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications: **(a)** Government securities, **(b)** Other approved securities, **(c)** Shares, **(d)** Debentures and bonds, **(e)** Subsidiaries/Joint ventures and **(f)** Others (commercial papers, mutual fund units, etc.). Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held to Maturity The securities acquired by the banks with the intention to hold them up to maturity will be classified under Held to Maturity **(**HTM**)**. Banks are allowed to include investments included under this category upto 25 per cent of their total investments. The following investments are required to be classified under "Held to Maturity' but are not counted for the purpose of ceiling of 25 per cent specified for this category:

(a) Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes;

(b) Investment in subsidiaries and joint ventures (A joint venture would be one in which the bank, along with its subsidiaries, holds more than 25 per cent of the equity.); and

(c) The investments in debentures/bonds, which are deemed to be in the nature of advance. Debentures/ bonds must be treated in the nature of an advance when it is issued as part of the proposal for **(i)** project finance and the tenure of the debenture is for a period of three years and above **Or (ii)** for working capital finance and the tenure of the debenture/ bond is less than a period of one year **and (iii)** the bank has a significant stake, that is, 10 per cent or more in the issue **and (iv)** the issue is part of a private placement, that is, the borrower has approached the bank/FI and not part of a public issue where the bank/ FI has subscribed in response to an invitation. Since, no fresh non-SLR securities are permitted to be included in the HTM category, these investments should not be held under HTM category. These investments would be subject to mark to market discipline. They would be subjected to prudential norms for identification of non performing investment and provisioning as applicable to investments.

Banks are, however, allowed to exceed the limit of 25 per cent of total investment under the HTM category provided: **(a)** the excess comprises only of SLR securities, and **(b)** the total SLR securities held in the HTM category is not more than 25 per cent of their DTL (demand and time liabilities) as on the last Friday of the second preceding fortnight.

No fresh non-SLR securities are permitted to be included in the HTM category, except the following: **(a)** Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio. This will not include re-capitalisation bonds of other banks acquired for investment purposes; **(b)** Fresh investment in the equity of subsidiaries and joint ventures; and **(c)** RIDF/SIDBI deposits.

To sum up, banks may hold the following securities under HTM category: **(a)** SLR securities upto 25 per cent of their DTL as on the last Friday of the second preceding fortnight, **(b)** Fresh re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in Investment portfolio, **(c)** Fresh investment in the equity of subsidiaries and joint ventures (a joint venture would be one in which the bank, along with its subsidiaries, holds more than 25 per cent of the equity), and **(d)** RIDF/SIDBI deposits.

Profit on sale of investments in this **(HTM)** category should be first taken to the profit and loss account and thereafter be appropriated to the 'Capital Reserve Account'. Loss on sale should be recognised in the profit and loss account.

Available for Sale and Held for Trading The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements should be classified under **Held for Trading (HT)**. The securities which do not fall within the above two categories should be classified under **Available for Sale (AS)**. The banks will have the freedom to decide on the extent of holdings under the Available for Sale and Held for Trading categories after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position. The investments classified under Held for Trading category would be those from which the bank expects to make a gain by the movement in the interest rates/ market rates. These securities are to be sold within 90 days. Profit or loss on sale of investments in both the categories will be taken to the profit and loss account.

Shifting Among Categories Banks may shift investments to/from Held to Maturity category with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from this category will be allowed during the remaining part of that accounting year. They may shift investments from Available for Sale category to Held for Trading category with the approval of their Board of Directors/ ALCO/ Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/ Head of the ALCO, but should be ratified by the Board of Directors/ ALCO. Shifting of investments from Held for Trading category to Available for Sale category is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ALCO/Investment Committee. Transfer of scrips from one category to another, under all circumstances, should be done at the acquisition cost/ book value/ market value on the date of transfer, whichever is the least, and the depreciation, if any, on such transfer should be fully provided for. Banks may apply the values as on the date of transfer and in case, there are practical difficulties in applying the values as on the date of transfer, banks have the option of applying the values as on the previous working day, for arriving at the depreciation requirement on shifting of securities.

Valuation

The valuation norms for the three categories of investments are as follows.

Held to Maturity Investments classified under Held to Maturity category need not be marked to market and should be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity. Banks should recognise any diminution, other than temporary, in the value of their investments in subsidiaries/ joint ventures which are included under Held to Maturity category and provide therefor. Such diminution should be determined and provided for each investment individually.

Available for Sale The individual scrips in the Available for Sale category should be marked to market at quarterly or at more frequent intervals. Securities under this category should be valued scrip-wise and depreciation/appreciation should be aggregated for each classification. Net depreciation, if any, should be provided for. Net appreciation, if any, should be ignored. Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification. The book value of the individual securities would not undergo any change after the marking of market.

Held for Trading The individual scrips in the Held for Trading category should be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the

Available for Sale category. Consequently, the book value of the individual securities in this category would also not undergo any change after marking to market.

Investment Fluctuation Reserve With a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, banks should build up Investment Fluctuation Reserve (IFR) of a minimum 5 per cent of the investment portfolio within a period of 5 years. To ensure smooth transition to Basel II norms, banks have to maintain capital charge for market risk in a phased manner over a two year period, as under: **(a)** In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005, and **(b)** In respect of securities included in the AFS category by March 31, 2006. With a view to encourage banks for early compliance with the guidelines for maintenance of capital charge for market risks, banks which have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT and AFS category may treat the balance in excess of 5 per cent of securities included under HFT and AFS categories, in the IFR, as Tier II capital. Banks satisfying the above may transfer the amount in excess of the said 5 per cent in the IFR to Statutory Reserve. Banks that have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT and AFS category as on March 31, 2006, may treat the entire balance in the IFR as Tier I capital. For this purpose, banks may transfer the balance in the Investment Fluctuation Reserve '**below the line**' in the profit and loss appropriation account to statutory reserve, general reserve or balance of profit and loss account.

Investment Reserve Account (IRA) In the event provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories are found to be in excess of the required amount in any year, the excess should be credited to the profit and loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total risk weighted assets prescribed for general provisions/loss reserves. Banks may utilise investment reserve account as follows: The provisions required to be created on account of depreciation in the AFS and HFT categories should be debited to the profit and loss account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to statutory reserve), may be transferred from the investment reserve account to the profit and loss account. To illustrate, banks may draw down from the IRA to the extent of provision made during the year towards depreciation in investment in AFS and HFT categories (net of taxes, if any, and net of transfer to statutory reserves as applicable to such excess provision). In other words, a bank which pays a tax of 30 per cent and should appropriate 25 per cent of the net profits to statutory reserves, can draw down ₹52.50 from the Investment Reserve Account, if the provision made for depreciation in investments included in the AFS and HFT categories is ₹100.

The amounts debited to the profit and loss account for provision should be debited under the head "**Expenditure - Provisions & Contingencies**". The amount transferred from the investment reserve account to the profit and loss account should be shown as "**below the line**" item in the profit and loss appropriation account after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account and, hence, should appear in that account before arriving at the profit for the accounting period.

In terms of the RBI guidelines, dividends should be payable only out of current year's profit. The amount drawn down from the investment reserve account (IRA) will, therefore, not be available to a bank for payment of dividend among the shareholders. However, the balance in the investment reserve account transferred 'below the line' in the profit and loss appropriation account to statutory reserve, general reserve or balance of profit and loss account would be eligible to be reckoned as Tier I capital.

Market Value The 'market value' for the purpose of periodical valuation of investments included in the Available for Sale and Held for Trading categories would be the market price of the scrip as available from the trades/quotes on the stock exchanges, SGL account transactions, price list of RBI, prices declared by Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association of India (FIMMDA) periodically. In respect of unquoted securities, the procedure as detailed below should be adopted.

Unquoted SLR Securities **Central Government Securities** Banks should value the unquoted central Government securities on the basis of the prices/ YTM rates put out by the PDAI/ FIMMDA at periodical intervals. The 6 per cent capital indexed bonds may be valued at "cost". The T-Bills should be valued at carrying cost.

State Government Securities The State Government securities should be valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

Other 'Approved' Securities Other approved securities should be valued applying the YTM method by marking it up by 25 basis points above the yields of the Central Government Securities of equivalent maturity put out by PDAI/ FIMMDA periodically.

Unquoted Non-SLR Securities **Debentures/ Bonds** All debentures/ bonds other than debentures/ bonds which are in the nature of advance should be valued on the YTM basis. Such debentures/ bonds may be of different companies having different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government securities as put out by PDAI/ FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the debentures/ bonds by the rating agencies subject to the following: - **(a)** The rate used for the YTM for rated debentures/bonds should be at least 50 basis points above the rate applicable to a Government of India loan of equivalent maturity, **(b)** The rate used for the YTM for unrated debentures/bonds should not be less than the rate applicable to rated debentures/bonds of equivalent maturity. The mark-up for the unrated debentures/ bonds should appropriately reflect the credit risk borne by the bank, and **(c)** Where the debenture/bonds is quoted and there have been transactions within 15 days prior to the valuation date, the value adopted should not be higher than the rate at which the transaction is recorded on the stock exchange.

Zero Coupon Bonds Zero coupon bonds should be shown in the books at carrying cost, that is, acquisition cost plus discount accrued at the rate prevailing at the time of acquisition, which may be marked to market with reference to the market value. In the absence of market value, the zero coupon bonds may be marked to market with reference to the present value of the zero coupon bond. The present value of the zero coupon bonds may be calculated by discounting the face value using the zero coupon yield curve with appropriate mark up as per the zero coupon spreads put out by FIMMDA periodically. In case the bank is still carrying the zero coupon bonds at acquisition cost, the discount accrued on the instrument should be notionally added to the book value of the scrip, before marking it to market.

Preference Shares The valuation of preference shares should be on YTM basis. The preference shares will be issued by companies with different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government securities put out by the PDAI/ FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the preference shares by the rating agencies subject to the following: **(a)** The YTM rate should not be lower than the coupon rate/ YTM for a GOI loan of equivalent maturity, **(b)** The rate used for the YTM for unrated preference shares should not be less than the rate applicable to rated preference shares of equivalent maturity. The mark-up for the unrated preference shares should appropriately reflect the credit risk borne by the bank, **(c)** Investments in preference shares as part of the project finance may be valued at par for a period of two years after commencement of production or five years after subscription whichever is earlier, **(d)** Where investment in preference shares is as part of rehabilitation, the YTM rate should not be lower than 1.5 per cent above the coupon rate/ YTM for GOI loan of equivalent maturity, **(e)** Where preference dividends are in arrears, no credit should be taken for accrued dividends and the value determined on YTM should be discounted by at least 15 per cent if arrears are for one year, and more if arrears are for more than one year. The depreciation/provision requirement arrived at in the above manner in respect of non-performing shares where dividends are in arrears shall not be allowed to be set-off against appreciation on other performing preference shares, **(f)** The preference share should not be valued above its redemption value **(g)** When a preference share has been traded on stock exchange within 15 days prior to the valuation date, the value should not be higher than the price at which the share was traded.

Equity Shares The equity shares in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis. Equity shares for which current quotations are not available or where the shares are not quoted on the stock exchanges, should be valued at break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's latest balance sheet (which should not be more than one year prior to the date of valuation). In case the latest balance sheet is not available the shares are to be valued at ₹1 per company.

Mutual Funds Units Investment in quoted mutual fund units should be valued as per stock exchange quotations. Investment in unquoted mutual fund units is to be valued on the basis of the latest re-purchase price declared by the mutual fund in respect of each particular scheme. In case of funds with a lock-in period, where repurchase price/market quote is not available, units could be valued at the NAV. If the NAV is not available, then these could be valued at cost, till the end of the lock-in period. Wherever the re-purchase price is not available the units could be valued at the NAV of the respective scheme.

Commercial Paper Commercial paper should be valued at the carrying cost.

Investments in RRBs (Regional Rural Banks) Investment in the RRBs is to be valued at carrying cost (i.e. book value) on consistent basis.

Investment in Securities Issued by SC/RC When banks invest in the security receipts/pass-through certificates(PTCs) issued by securitisation company (SC)/reconstruction company (RC) in respect of the financial assets sold by them to the SC/RC, the sale should be recognised in books of the banks at the lower of: **(i)** the redemption value of the security receipts/pass through certificates, and **(ii)** the net book value (NBV) of the financial asset.

The above investment should be carried in the books of the bank at the price as determined above until its sale or realisation, and on such sale or realisation, the loss or gain must be dealt with as under: **(i)** if the sale to SC /RC is at a price below the net book value (NBV) (i.e. book value less provisions held), the shortfall should be debited to the profit and loss account of that year, and **(ii)** If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilised to meet the shortfall/loss on account of sale of other financial assets to SC/RC. All instruments received by banks/FIs from SC/RC as sale consideration for financial assets sold to them and also other instruments issued by SC/RC in which banks/FIs invest will be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by the RBI from time to time would be applicable to bank's investment in debentures/bonds/security receipts/PTCs issued by SC/RC. However, if any of the above instruments issued by SC/RC is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme the bank/FI shall reckon the Net Asset Value (NAV), obtained from SC/RC from time to time, for valuation of such investments.

Valuation and Classification of Investment in VCFs (Venture Capital Funds) The quoted equity shares/bonds/units of VCFs in the bank's portfolio should be held under Available for Sale (AFS) category and marked to market preferably on a daily basis, but at least on a weekly basis in line with valuation norms for other equity shares. Banks' investments in unquoted shares/bonds/units of VCFs will be classified under Held to Maturity (HTM) category for initial period of three years and should be valued at cost during this period. For this purpose, the period of three years should be reckoned separately for each disbursement made by the bank to VCF as and when the committed capital is called up. However, to ensure conformity with the existing norms for transferring securities from HTM category, transfer of all securities which have completed three years, as mentioned above, should be effected at the beginning of the next accounting year in one lot to coincide with the annual transfer of investments from HTM category. After three years, the unquoted units/shares/bonds should be transferred to AFS category and valued as under:

Units In the case of investments in the form of units, the valuation will be done at the net asset value (NAV) shown by the VCF in its financial statements. Depreciation, if any, on the units based on NAV has to be provided at the time of shifting the investments to AFS category from HTM category as also on subsequent valuations which should be done at quarterly or more frequent intervals based on the financial statements received from the VCF. At least once in a year, the units should be valued based on the audited results. However, if the audited balance sheet/financial statements showing NAV figures are not available continuously for more than 18 months as on the date of valuation, the investments are to be valued at Rupee 1 per VCF.

Equity In the case of investments in the form of shares, the valuation can be done at the required frequency based on the break-up value (without considering 'revaluation reserves', if any) which is to be ascertained from the company's (VCF's) latest balance sheet (which should not be more than 18 months prior to the date of valuation). Depreciation, if any on the shares has to be provided at the time of shifting the investments to AFS category as also on subsequent valuations which should be done at quarterly or more frequent intervals. If the latest balance sheet available is more than 18 months old, the shares are to be valued at Rupee 1 per company.

Bonds The investment in the bonds of VCFs, if any, should be valued as per prudential norms for classification, valuation and operation of investment port-folio by banks issued by RBI from time to time.

Non-Performing Investments In respect of securities included in any of the three categories where interest/ principal is in arrears, the banks should not reckon income on the securities and should also make appropriate provisions for the depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

A **non-performing investment** (NPI), similar to a non-performing advance (NPA), is one where: **(i)** Interest/ instalment (including maturity proceeds) is due and remains unpaid for more than 90 days, **(ii)** The above would apply *mutatis-mutandis* to preference shares where the fixed dividend is not paid, **(iii)** In the case of equity shares, in the event the investment in the shares of any company is valued at ₹1 per company on account of the non availability of the latest balance sheet, those equity shares would also be reckoned as NPI. **(iv)** If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities issued by the same issuer would also be treated as NPI and *vice versa*. **(v)** The investments in debentures / bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

State Government Guaranteed Investments Investment in State Government guaranteed securities, including those in the nature of 'deemed advance', will attract prudential norms for identification of non performing investments and provisioning, when interest/ instalment of principal (including maturity proceeds) or any other amount due to the bank remains unpaid for more than 90 days.

Income Recognition

Banks may book income on accrual basis on securities of corporate bodies/ public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears. They may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. They may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided interest is serviced regularly and is not in arrears. They should book income from units of mutual funds on cash basis.

Broken Period Interest Banks should not capitalise the broken period interest paid to seller as part of cost, but treat it as an item of expenditure under profit and loss account in respect of investments in Government and other approved securities. It is to be noted that the above accounting treatment does not take into account taxation implications and, hence, the banks should comply with the requirements of Income Tax Authorities in the manner prescribed by them.

EXPOSURE NORMS

As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, the RBI has fixed limits on the exposure of banks to specific industry/sectors and prescribed regulatory limits on their exposure to individual and group borrowers. In addition, banks are also required to observe certain statutory and regulatory exposure limits in respect of advances against investments in shares, convertible debentures/bonds, units of equity-oriented mutual funds and all exposures to venture capital funds (VCFs). The guidelines relating to these norms are discussed in this Section.

Credit Exposures to Individual/Group Borrowers

The exposure ceiling limits would be 15 and 40 per cent of capital funds in the case of a single borrower and borrower group respectively. The capital funds comprise Tier-I and Tier-II capital as defined under capital adequacy standards (**discussed in Chapter 12**). The credit exposure to a single borrower and borrower group may be up to 20 and 50 per cent respectively, the additional (5 and 10 per cent) exposure being on account of infrastructure projects. Banks may, in exceptional circumstances, with the approval of their Board of Directors, enhance the exposure to a single as well as group borrower up to a further 5 per cent subject to appropriate disclosures in their annual reports. The exposure limit in respect of a single borrower is 25 per cent in case of oil companies who have been issued oil bonds (which do not have SLR status) by the Government of India. In exceptional circumstances, the exposure may be enhanced up to a further 5 per cent of their capital funds.

The exposure (both lending and investment, including off-balance sheet exposures) of a bank to a single NBFC/NBFC-AFC (asset financing companies) should not exceed 10/15 per cent respectively, of the bank's capital funds as per its last audited balance sheet. Banks may, however, assume exposures on a single NBFC/NBFC-AFC up to 15/20 per cent respectively provided the excess exposure is on account of funds on-lent by the NBFC/NBFC-AFC to the infrastructure sector. Exposure of a bank to infrastructure finance companies (IFCs) should not exceed 15 per cent of its capital funds with a provision to increase it to 20 per cent if the same is on account of funds on-lent to the infrastructure sector. Further, banks may also consider fixing internal limits for their aggregate exposure to all NBFCs put together. The exposure limits will also be applicable to lending under consortium arrangements. Bills purchased/discounted/negotiated under the letter of credit (LC) where the payment to the beneficiary is not made **"under reserve**" will be treated as an exposure on the LC issuing bank and not on the borrower. In the case of negotiations "under reserve", the exposure should be treated on the borrower.

Exemptions The ceilings on single/group exposure limits are not applicable to: **(i)** existing/additional credit facilities (including funding of interest and irregularities) granted to weak/sick industrial units under rehabilitation packages, **(ii)** borrowers to whom limits are allocated directly by the RBI for food credit, **(iii)** where principal and interest are fully guaranteed by the Government of India, **(iv)** loans and advances (both funded and non-funded facilities) granted against the security of a bank's own term deposits to the extent that the bank has a specific lien on such deposits, and **(v)** exposure assumed by banks on NABARD. The individual banks are free to determine the size of the exposure to NABARD as per the policy framed by their respective Board of Directors. However, there is no exemption from the prohibitions relating to investments in unrated non-SLR securities prescribed in terms of the prudential norms for classification, valuation and operations of investment portfolio by banks (**discussed earlier in this Chapter**).

Definitions of Exposure Exposure would include credit exposure (funded and non-funded credit limits) and investment exposure (including underwriting and similar commitments). The higher of the sanctioned limits or outstandings should be reckoned for arriving at the exposure limit. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit, the outstanding may be reckoned as the exposure.

Measurement of Credit Exposure of Derivative Products Banks should compute their credit exposures, arising on account of the interest rate, foreign exchange derivative transactions and gold, using the **"current exposure method"**, as detailed below:

(i) The credit equivalent amount of a market-related off-balance sheet transaction calculated using the current exposure method **is the sum of current credit exposure and potential future credit exposure of these contracts**. While computing the credit exposure, banks may exclude "sold options", provided the entire premium/fee or any other form of income is received/ realised.

(ii) Current credit exposure is defined as the sum of the positive mark-to-market value of these contracts. The current exposure method requires periodical calculation of the current credit exposure by marking these contracts to market, thus capturing the current credit exposure.

(iii) Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument:

CCF for Market-related Off-balance Sheet Items

Residual maturity	*Credit conversion factors*	
	Interest rate contracts (%)	*Exchange rate contracts and gold (%)*
One year or less	0.5	2.0
Over one year to five years	1.0	10.0
Over five years	3.0	15.0

(iv) For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

(v) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the foregoing criteria, the CCF or "add-on factor" applicable would be subject to a floor of 1 per cent.

(vi) No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

(vii) Potential future exposures should be based on effective rather than apparent notional amounts. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, banks must use the effective notional amount when determining potential future exposure. For example, for a stated notional amount of USD 1 million with payments based on an internal rate of 2 times, the BPLR would have an effective notional amount of USD 2 million.

Credit Exposure Credit exposure comprises the following elements: **(a)** all types of funded and non-funded credit limits, and **(b)** facilities extended by way of equipment leasing, hire-purchase finance and factoring services.

Investment Exposure Investment exposure comprises the following elements: **(i)** investments in shares and debentures of companies, **(ii)** investment in PSU bonds, and **(iii)** investments in commercial papers (CPs). Banks' investments in debentures/bonds/security receipts (SRs)/pass-through certificates (PTCs) issued by a securitisation/reconstruction company (SC/RC) as compensation consequent upon sale of financial assets will constitute exposure on the SC/RC. In view of the extraordinary nature of the event, banks will be allowed, in the initial years, to exceed the prudential exposure ceiling on a case-to-case basis. The investment in bonds and debentures of corporates, which are guaranteed by a public financial institution (PFI), will be treated as an exposure on the PFI and not on the corporate. Guarantees issued by the PFI to the bonds of corporates will be treated as an exposure by the PFI to the corporates to the extent of 50 per cent, being a non-fund facility, whereas the exposure of the bank on the PFI guaranteeing the corporate bond will be 100 per cent. The PFI before guaranteeing the bonds/debentures should, however, take into account the overall exposure of the guaranteed unit to the financial system.

Capital Funds Capital funds will comprise Tier-I and Tier-II capital as defined under capital adequacy standards (**discussed in Chapter 12**) and as per the published accounts as on March 31 of the previous year. However, the infusion of capital under Tier-I and Tier-II, either through domestic or overseas issue (in the case of branches of foreign banks operating in India, capital funds received by them from their Head Office), after the published balance sheet date will also be taken into account for determining the exposure ceiling. Other accretions to capital funds by way of quarterly profits and so on would not be eligible to be reckoned for determining the exposure ceiling. Banks are also prohibited from taking exposure in excess of the ceiling in anticipation of infusion of capital at a future date.

Meaning of Group The concept of "**group**" and the task of identification of the borrowers belonging to specific industrial groups is left to the perception of the banks. They are generally aware of the basic constitution of their clientele for the purpose of regulating their exposure to risk assets. The group to which a particular borrowing unit belongs may, therefore, be decided by them on the basis of the relevant information available with them, the guiding principle being the commonality of management and effective control. **In so far as public sector undertakings are concerned, only single borrower exposure limit would be applicable.**

Credit Exposure to Industry and Certain Sectors

Apart from limiting the exposures to an individual or a group of borrowers, indicated above, banks may also consider fixing internal limits for aggregate commitments to specific sectors, for example, textiles, jute, tea, and so on so that the exposures are evenly spread over various sectors. These limits could be fixed by them having regard to the performance of different sectors and the risks perceived. The limits may be reviewed periodically and revised, as necessary.

Unhedged Foreign Currency Exposure of Corporates To ensure that each bank has a policy that explicitly recognises and takes account of the risks arising out of foreign exchange exposure of their clients, foreign currency loans above US $10 million, or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolios of such exposures, should be extended only on the basis of a well laid out policy of their Boards of Directors with regard to hedging of such loans. Further, the policy for hedging, to be framed by their Boards, may exclude the following: **(i)** Where forex loans are extended to finance exports, banks may not insist on hedging but assure themselves that such customers have uncovered receivables to cover the loan amount; and **(ii)** Where they are extended for meeting forex expenditure. The Board policy should cover unhedged foreign exchange exposure of all their clients, including small and medium enterprises (SMEs). Further, for arriving at the aggregate unhedged foreign exchange exposure of clients, their exposure from all sources including foreign currency borrowings and external commercial borrowings should be taken into account.

Banks which have large exposures to clients should monitor and review on a monthly basis, through a suitable reporting system, the unhedged portion of the foreign currency exposures of those clients, whose total foreign currency exposure is relatively large (say, about US$ 25 million or its equivalent). The review of unhedged exposure for SMEs should also be done on a monthly basis. In all other cases, banks are required to put in place a system to monitor and review such position on a quarterly basis. In the case of consortium/multiple banking arrangements, the lead role in monitoring unhedged foreign exchange exposure of clients, as indicated above, would have to be assumed by the consortium leader/bank having the largest exposure.

Exposure to Real Estate Comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits for such loans, margins, security, repayment schedule and availability of supplementary finance should be framed and approved by their Boards of Directors. While appraising loan proposals involving real estate, it should be ensured that the borrowers have obtained the required prior permission from government/local governments/other statutory authorities for the project. In order that the loan approval process is not hampered on account of this, while the proposals could be sanctioned in the normal course, the disbursements should be made only after the borrower has obtained the requisite clearances. Banks may also consider incorporation of aspects relating to adherence to national building code (NBC) in their policies on exposure to real estate.

The exposure of banks to entities for setting up special economic zones (SEZs) or for acquisition of units which includes real estate would be treated as exposure to commercial real estate sector for the purpose of risk weight and capital adequacy from a prudential perspective. Banks would, therefore, have to make provisions, as also assign appropriate risk weights for such exposures, as per the existing guidelines. The above exposure may be treated as exposure to infrastructure sector only for the purpose of exposure norms which provide some relaxations for the sector.

While framing the policy, banks should ensure that the credit is used for productive construction activity and not for any activity connected with speculation in real estate.

Exposure to Leasing, Hire-Purchase and Factoring Services Banks undertake leasing, hire-purchase and factoring activities departmentally. They should maintain a balanced portfolio of these *vis-à-vis* the aggregate credit. Their exposure to each of these activities should not exceed 10 per cent of total advances.

Exposure to Indian Joint Ventures/Wholly-owned Subsidiaries Abroad and Overseas Step-down Subsidiaries of Indian Corporates Credit/non-credit facilities (viz. letters of credit and guarantees) to Indian joint ventures/wholly-owned subsidiaries abroad and step-down subsidiaries, which are wholly owned by the overseas subsidiaries of Indian corporate by banks. They provide at their discretion, buyer's credit/acceptance finance to overseas parties for facilitating export of goods and services from India. This exposure is be subject to a limit of 20 per cent of unimpaired capital funds (Tier-I and Tier-II capital), of banks, subject to the following conditions: **(i)** Loan will be granted only to those joint ventures where the holding by the Indian company is more than 51 per cent, **(ii)** Proper systems for management of credit and interest rate risks arising out of such cross border lending are in place, **(iii)** While extending such facilities, banks will have to ensure that their aggregate assets outside India do not exceed 25 per cent of their demand and time liabilities in India, **(iv)** The resource base for such lending should be funds held in foreign currency accounts such as FCNR(B), EEFC, RFC, and so on in respect of which banks have to manage exchange risk, **(v)** Maturity mismatches arising out of such transactions are within the overall gap limits approved by the RBI, **(vi)** Adherence to all existing safeguards/prudential guidelines relating to capital adequacy, exposure norms and so on applicable to domestic credit/non-credit exposures, and **(vii)** The set up of the step-down subsidiary should be such that banks can effectively monitor the facilities granted by them. Further, the loan policy for such credit/non-credit facility should be, *inter alia*, in keeping with the following: **(a)** Grant of such loans is based on proper appraisal and commercial viability of the projects and not merely on the reputation of the promoters backing the project. Non-fund based facilities should be subjected to the same rigorous scrutiny as fund-based limits, **(b)** The countries where the joint ventures/wholly owned subsidiaries are located should have no restrictions applicable to these companies in regard to obtaining foreign currency loans or for repatriation, etc. and should permit non-resident banks to have legal charge on securities/assets abroad and the right of disposal in case of need. Banks should also comply with all existing indicated safeguards/prudential guidelines relating to capital adequacy, and exposure norms.

Exposure to Capital Markets

The capital market exposures of banks would include both their direct exposures and indirect exposures. The aggregate exposure (both fund and non-fund based) in all forms would **include** the following:

- Direct investment in equity shares, convertible bonds/debentures and units of equity-oriented mutual funds the corpus of which is not exclusively invested in corporate debt;
- Advances against shares/bonds/debentures or other securities or on clean basis to individuals for investment in shares (including IPOs/ESOPs), convertible bonds/debentures, and units of equity-oriented mutual funds;
- Advances for any other purposes where shares or convertible bonds/debentures/units of equity oriented mutual funds are taken as primary security;
- Advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds/debentures/units of equity oriented mutual funds, that is, where the primary security other than shares/convertible bonds, debentures/units of equity-oriented mutual funds does not fully cover the advances;
- Secured and unsecured advances to, and guarantees issued on behalf of, stockbrokers and market makers;

- Loans sanctioned to corporates against the security of shares/bonds/debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources;
- Bridge loans to companies against expected equity flows/issues;
- Underwriting commitments taken up by the banks in respect of primary issue of shares or convertible bonds, debentures/units of equity-oriented mutual funds. However, banks may exclude their own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process for the purpose of arriving at the capital market exposure of the solo/consolidated bank.
- Financing to stockbrokers for margin trading; and
- All exposures to venture capital funds (both registered and unregistered).

Limits on Exposure No bank should hold shares in any company, whether as pledgee, mortgagee or absolute owner, exceeding 30 per cent of the paid-up share capital of that company/its own paid-up share capital and reserves, whichever is less.

Regulatory Limit on Exposure The aggregate exposure of a bank to the capital markets in all forms (both fund based and non-fund based) should not exceed 40 per cent of its net/**consolidated net worth**. Within this overall ceiling, the direct investment in shares, convertible bonds/debentures, units of equity-oriented mutual funds and all exposures to venture capital funds (VCFs) [both registered and unregistered] should not exceed 20 per cent of its net worth. A consolidated net worth is the net worth of a "**consolidated bank"** defined as a group of entities including a bank, which may or may not have subsidiaries. **Net worth** would comprise **(i)** paid-up capital **plus** free reserves including share premium but excluding revaluation reserves, plus investment fluctuation reserve and credit balance in profit and loss account, **less** debit balance in profit and loss account, accumulated losses and intangible assets. No general or specific provisions should be included in computation of net worth. Infusion of capital through equity shares, through domestic issues or overseas floats after the published balance sheet date, may also be taken into account for determining the ceiling on exposure to capital market.

Items Excluded From Capital Market Exposure The following items would be excluded from the aggregate exposure ceiling of 40 per cent of net worth and direct investment exposure ceiling of 20 per cent of net worth (wherever applicable): **(i)** Investments in **(a)** own subsidiaries, joint ventures (JVs) sponsored regional rural banks (RRBs) and **(b)** shares and convertible debentures/bonds issued by institutions forming crucial financial infrastructure such as NSDL, CDSL, NSCCL, NSE, CCIL, CIBIL, MCX, NCDX, NMCEIL, NCMSL and other all-India financial institutions. After listing, the exposures in excess of the original investment (i.e. prior to listing) would form part of the capital market exposure; **(ii)** Tier-I and Tier-II debt instruments issued by other banks; **(iii)** Investment in CDs of other banks; **(iv)** Preference shares; **(v)** Non-convertible debentures/bonds; **(vi)** Units of mutual funds under schemes where the corpus is invested exclusively in debt instruments; **(vii)** Shares acquired by banks as a result of conversion of debt/overdue interest into equity under corporate debt restructuring (CDR) mechanism; **(viii)** Term loans sanctioned to Indian promoters for acquisition of equity in overseas joint ventures/wholly owned subsidiaries under the refinance scheme EXIM Bank; **(ix)** Own underwriting commitments, as also the underwriting commitments of their subsidiaries, through the book running process; and **(x)** Promoters' shares in the special purpose vehicle (SPV) of an infrastructure project pledged to the lending bank for infrastructure project lending.

Computation of Exposure Loans/advances sanctioned and guarantees issued for capital market operations would be reckoned with reference to sanctioned limits or outstanding, whichever is higher. However, in the case of fully drawn term loans, where there is no scope for re-drawal of any portion of the sanctioned limit, banks may reckon the outstanding as the exposure. Further, direct investment in shares, convertible bonds, debentures and units of equity-oriented mutual funds would be calculated at their cost price.

Intra-day Exposures The Board of Directors of each bank should evolve a policy for fixing intra-day limits and put in place an appropriate system to monitor such limits on an ongoing basis.

Enhancement in Limits Banks having sound internal controls and robust risk management systems can approach the RBI for higher limits together with details thereof.

Financing of Equities and Investments in Shares

Loans against security of shares, convertible bonds/debentures and units of equity-oriented mutual funds to individuals from the banking system should not exceed ₹10 lakh and ₹ 20 lakh, if the securities are held in physical form and in demat form respectively. Such loans are meant for genuine individual investors and banks should not support collusive action by a large group of individuals belonging to the same corporate or their inter-connected entities to take multiple loans in order to support particular scrips or stock-broking activities of the concerned firms. Such finance should be reckoned as an exposure to the capital market. Banks should formulate, with the approval of their Board of Directors, a loan policy for granting advances to individuals against shares, debentures, and bonds keeping in view the RBI guidelines. As a prudential measure, banks may also consider laying down appropriate aggregate sub-limits of such advances.

Financing of Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) Banks may grant advances to individuals for subscribing to IPOs/FPOs. Loans/advances to any individual from the banking system against security of shares, convertible bonds debentures, units of equity-oriented mutual funds and PSU bonds should not exceed ₹10 lakh. The corporates should not be extended credit by banks for investment in the IPOs of other companies. Similarly, finance funds should not be provided to NBFCs for further lending to individuals for IPOs/FPOs. Finance extended by a bank for IPOs/FPOs should be reckoned as an exposure to capital market.

Bank Finance to Assist Employees to Buy Shares of Their Own Companies Banks may extend finance to employees other than bank employees for purchasing shares of their own companies under employees stock option plan (ESOP)/reserved by way of employees' quota under IPO to the extent of 90 per cent of the purchase price of the shares or ₹20 lakh, whichever is lower. Such finance would be treated as an exposure to the capital market within the overall ceiling of 40 per cent of their net worth. They should obtain a declaration from the borrower indicating the details of the loans/advances availed against shares and other securities specified above from any other bank(s) in order to ensure compliance with the ceilings prescribed for the purpose.

Advances Against shares to Stock Brokers and Market Makers Credit facilities can be freely provided to stockbrokers and market makers on the basis of their commercial judgment, within the policy framework approved by their Boards. However, in order to avoid any nexus emerging between inter-connected stock broking entities and banks, the Board of each bank should fix, within the overall ceiling of 40 per cent of their net worth, a sub-ceiling for total advances to **(i)** all the stockbrokers and market makers (both fund based and non-fund based, i.e. guarantees); and **(ii)** any single stock broking entity, including its associates/inter-connected companies. Further, banks should not extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in stock exchanges.

Bank Financing to Individuals Against Shares to Jointholders or Third Party Beneficiaries While granting advances against shares held in joint names, banks should ensure that the objective of the regulation is not defeated by granting advances to other joint holders or third party beneficiaries to circumvent the above limits.

Advances Against Units of Mutual Funds The banks should adhere to the following guidelines: **(i)** The units should be **(a)** listed in the stock exchanges or repurchase facility should be available at the time of lending, **(b)** have completed the minimum lock-in-period stipulated in the relevant scheme; **(ii)** The amount of advances should be linked to the net asset value (NAV)/ repurchase price or the market value, whichever is less; **(iii)** Advances against units of mutual funds (except units of exclusively debt-oriented mutual funds) would attract the quantum and margin requirements as are applicable to advances against shares and debentures. However, the quantum and margin requirement for loans/ advances to individuals against units of exclusively debt-oriented mutual funds may be decided by individual banks themselves in accordance with their loan policy; and **(iv)** They should be purpose-oriented taking into account the credit requirement of the investor. They should not be granted for subscribing to or boosting up the sales of another scheme of a mutual fund or for the purchase of shares/ debentures/ bonds and so on.

Advances to Other Borrowers Against Shares/Debentures/Bonds Advances against primary security of shares and debentures including promoters' shares to industrial, corporate or other borrowers are not normally permitted. However, such securities can be accepted as collateral for secured loans granted as working capital or for other productive purposes from borrowers other than NBFCs. In such cases, banks should accept shares only in dematerialised form.

In the course of setting up of new projects or expansion of existing business or for the purpose of raising additional working capital required by units other than NBFCs, there may be situations where such borrowers may not be able to find the required funds towards margin, in anticipation of mobilising of long-term resources. In such cases, banks can obtain collateral security of shares and debentures by way of margin. Such arrangements would be of a temporary nature and may not be continued beyond a period of one year.

Bank Loans for Financing Promoters' Contribution Loans sanctioned to corporates against the security of demat shares for meeting promoters' contribution to the equity of new companies in anticipation of raising resources, should be treated as a bank's investments in shares under the 40 per cent ceiling to capital market in all forms. These loans will also be subject to individual/ group exposure norms as well as the statutory limit on shareholding in companies.

Bridge Loans Against Expected Equity Funds Banks have been permitted to sanction bridge loans to companies for a period not exceeding one year against expected equity flows/issues within the ceiling of 40 per cent. They should formulate their own internal guidelines with the approval of their Board of Directors for grant of such loans, exercising due caution and attention to security. They may also extend bridge loans against the expected proceeds of non-convertible debentures, external commercial borrowings, global depository receipts and/or funds in the nature of foreign direct investments, provided the banks are satisfied that the borrowing company has already made firm arrangements for raising these resources/funds.

Investments in Venture Capital Funds (VCFs) Exposures to VCFs (both registered and unregistered) will be deemed to be on par with equity and, hence, will be reckoned for compliance with the capital market exposure ceilings (both direct and indirect) of banks.

Margins on Advances Against Shares/Issue of Guarantees A uniform margin of 50 per cent should be applied on all advances/financing of IPOs /issue of guarantees on behalf of stockbrokers and market makers. A minimum cash margin of 25 per cent (within the margin of 50 per cent) should be maintained in respect of **(i)** guarantees issued by banks for capital market operations, and **(ii)** bank finance to stock brokers by way of temporary overdrafts for DVP (delivery vs payment) transactions.

Disinvestment Programme of the Government of India In the context of the Government's disinvestments of its holdings in some public sector undertakings (PSUs), banks can extend finance to the successful bidders for acquisition of their shares. If on account of financing acquisition of PSU shares, any bank is likely to exceed the regulatory ceiling of 40 per cent of its net worth, such requests for relaxation of the ceiling would be considered by the RBI on a case by case basis, subject to adequate safeguards regarding margin, overall exposure to capital market, internal control and risk management systems, and so on. The relaxation would be considered in such a manner that the exposure in all forms, net of its advances for financing of acquisition of PSU shares, should be within the regulatory ceiling of 40 per cent. The RBI would also consider relaxation on specific requests from banks in the individual/group credit exposure norms on a case by case basis, provided that the total exposure to the borrower, net of its exposure due to acquisition of PSU shares, should be within the prudential individual/group borrower exposure ceiling prescribed by the RBI.

Financing for Acquisition of Equity in Overseas Companies Financial assistance may be extended to Indian companies for acquisition of equity in overseas joint ventures/wholly owned subsidiaries or in other new or existing overseas companies as a strategic investment, in terms of a Board approved policy, duly incorporated in the loan policy of the banks. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, and so on. While the Board may frame its own guidelines and safeguards for such lending, such acquisition(s) should be beneficial to the company and the country.

Arbitrage Operations Banks should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations in stock exchanges. They are permitted to acquire shares from the secondary market, but they should ensure that no sale transaction is undertaken without actually holding the shares in their investment accounts.

Margin Trading Finance may be extended to stockbrokers for margin trading. The Board of Directors of each bank should formulate detailed guidelines for lending for margin trading, subject to the following parameters: **(i)** The finance should be within the overall ceiling of 40 per cent of net worth prescribed for exposure to the capital market; **(ii)** A minimum margin of 50 per cent should be maintained on the funds; **(iii)** The shares purchased should be in dematerialised mode under pledge to the lending bank. The bank should put in place an appropriate system for monitoring and maintaining the margin of 50 per cent on an ongoing basis; and **(iv)** The Board should prescribe necessary safeguards to ensure that no "nexus" develops between inter-connected stock broking entities/stockbrokers and the bank in this respect. Margin trading should be spread out by the bank among a reasonable number of stockbrokers and stock broking entities. The audit committee of the Board should monitor periodically the exposure by way of financing for margin trading and ensure that the guidelines formulated by the Board are duly complied with.

Risk Management and Internal Control System

Banks desirous of making investment in equity shares/ debentures, financing of equities and issue of guarantees and so on within the above ceiling, should observe the following guidelines:

Investment Policy They should formulate transparent policy and procedure for investment with the approval of their Board of Directors. They should build up adequate expertise in equity research by establishing a dedicated equity research department, as warranted by their scale of operations.

Investment Committee The decision in regard to direct investment should be taken by an investment committee set up by the Board. It should be held accountable for all investments made by the bank.

Risk Management Banks should ensure that their exposure to stockbrokers is well diversified in terms of number of broker clients, and individual inter-connected broking entities. While sanctioning advances to stockbrokers, they should take into account the track record and credit worthiness, financial position of the broker, operations on his own account and on behalf of clients, average turnover period of stocks and shares, the extent to which his funds are required to be involved in his business operations, and so on. While processing proposals for loans to stockbrokers, banks should obtain details of facilities enjoyed by him and all his connected companies from other banks. While granting advances against shares and debentures to other borrowers, banks should obtain details of credit facilities availed by them or their associates/inter-connected companies from other banks for investment in shares in order to ensure that high leverage is not built up by them/associates/inter-connected companies with bank finance.

Audit Committee The surveillance and monitoring of investment in shares/advances against shares should be done by the Audit Committee of the Board, which should review in each meeting, the total exposure of the bank to the capital market both fund based and non-fund based, in different forms and ensure that the guidelines issued by the RBI are complied with and adequate risk management and internal control systems are in place. It should keep the Board informed about the overall exposure to the capital market, the compliance with the RBI and Board guidelines, adequacy of risk management and internal control systems. In order to avoid any possible conflicts of interest, it should be ensured that the stockbrokers as directors on the Boards of banks or in any other capacity, do not involve themselves in any manner with the investment committee or in the decisions in regard to making investments in/advances against shares.

Valuation and Disclosure

Equity shares in the portfolio of a bank as primary security/collateral for advances/for issue of guarantees/as an investment should be marked to market preferably on a daily basis, but at least on weekly basis. The total investments made in equity shares, convertible bonds and debentures and units of equity-oriented mutual funds as also aggregate advances against shares should be discussed in the "Notes on Account" to their balance sheets.

Cross Holding of Capital Among Banks/Financial Institutions

Investment in the following instruments issued by other banks/FIs and eligible for capital status for the investee bank/FI, should not exceed 10 per cent of the investing bank's capital funds (Tier-I plus Tier-II): **(a)** Equity shares; **(b)** Preference shares eligible for capital status; **(c)** Subordinated debt instruments; **(d)** Hybrid debt capital instruments; and **(e)** Any other instrument approved as in the nature of capital. Banks should not acquire any fresh stake in the equity shares, if by such acquisition, the investing bank's holding except bank's equity holdings in another bank held under provisions of a statute exceeds 5 per cent of the investee bank's equity capital.

Capital Adequacy Norms Investments in the equity capital of subsidiaries are at present deducted from their Tier-I capital for capital adequacy purposes. Investments in the other instruments issued by banks/FIs will attract 100 per cent risk weight for credit risk for capital adequacy purposes.

Margin for Exposure to Commodity Markets

Banks may issue guarantees on behalf of share and stock brokers in favour of stock exchanges in lieu of margin requirements. While issuing such guarantees, they should obtain a minimum margin of 50 per cent. A minimum cash margin of 25 per cent (within the above margin of 50 per cent) should be maintained in respect of such guarantees issued by them. The minimum margin will also apply to guarantees issued by banks on behalf of commodity brokers in favour of the national level commodity exchanges, namely, National Commodity and Derivatives Exchange (NCDEX), Multi Commodity Exchange of India Limited (MCX) and National Multi-Commodity Exchange of India Limited (NMCEIL), in lieu of margin requirements as per their regulations.

Provision of Buy Back Facilities

In some cases, the issuers provide buy-back facilities to original investors up to ₹40,000 in respect of non-convertible debentures after a lock-in-period of one year, to provide liquidity to debentures issued by them. If, at the request of the issuers, the banks or their subsidiaries provide additional facilities to small investors subscribing to new issues, such buy-back arrangements should not entail commitments to buy the securities at pre-determined prices. Prices should be determined from time to time, keeping in view the prevailing stock market prices for the securities. Commitments should also be limited to a moderate proportion of the total issue in terms of the amount and should not exceed 20 per cent of the owned funds of the banks/their subsidiaries. These commitments will also be subject to the overall exposure limits which have been or may be prescribed from time to time.

CONCLUDING OBSERVATIONS

- The focus of management of bank funds in recent years has shifted to internal financial management. One element of the financial management framework is the prudential accounting norms relating to their credit/advances portfolio and investment portfolio
- Prudential norms relating to the credit/advances portfolio of banks pertain to: income recognition, asset classification and provisioning.
- The income recognition should be based on the record of recovery and banks should not account for any income/interest on an NPA, that is, a credit facility on which interest/repayment of principal is overdue for more than 90 days.
- The NPAs should be classified, based on the period for which they have remained NPAs and the realisability of dues, into sub-standard assets, doubtful assets and loss assets. A substandard asset is one which has been classified as an NPA for not more than 12 months; a doubtful asset has been an NPA for more than 12 months. A loss asset is identified by the bank/internal and external auditors/RBI inspection, though the amount has not been written off wholly, that is, it is incollectible.
- The asset classification should be based on well-defined credit weaknesses and the extent of dependence on the collateral security for the realisation of dues. The RBI guidelines for asset classification relate to: **(i)** accounts with temporary difficulties, **(ii)** accounts regularised near balance sheet dates, **(iii)** borrower-wise asset-classification, **(iv)** advances under consortium arrangements, **(v)** accounts with no erosion in to value of security, **(vi)** loans with moratorium, **(vii)** government guaranteed advances, and **(viii)** rescheduling of loans.
- Provisions should be made for the NPAs on the basis of the above classification. The entire loss assets should be written off or 100 per cent of the outstanding should be provided for. In case of doubtful assets, 100 per cent of the unsecured portion should be provided for. For the secured portion, provision should be made at rates ranging from 20 per cent and 100 per cent, depending upon the period for which the asset has remained doubtful. A general provision of 10 per cent on the total sub-standard assets outstanding should be made. The unsecured exposure identified as sub-standard would attract an additional provision of 10 per cent. A general provision of a minimum of 0.25 per cent of the standard assets (i.e., assets which are not NPAs) on global loan portfolio basis should be made. Specified provisions should also be made under special circumstances, namely, government guaranteed advances; advances granted under a rehabilitation package; advances covered by an ECGC/DICGC guarantee; advances covered by CGTSI, taken-out finance, reserve for exchange rate fluctuations, provision for country risk and provisioning for sale of financial assets to SCs/RCs.
- The main elements of the prudential norms for the investment portfolios of banks are: investment policy, classification of investments, their valuation, and income recognition.
- Banks should frame and implement a suitable investment policy to ensure that operations in securities are conducted in accordance with sound and acceptable business practices. The internal investment policy guidelines of a bank should be in accordance with the RBI guidelines. The investment portfolio of banks consist of SLR and non-SLR investment.

- Banks should formulate their investment policy, duly approved by their Board of Directors, in the light of the RBI guidelines on non-SLR investments. They should prescribe a minimum disclosure standard as a policy. There should be prudential limits on investments in various types of instruments including unrated issues. Investment proposals should be subjected to the same degree of credit risk analysis as any loan proposal. For unrated issues, they should have an internal system of rating. As a matter of prudence, banks should stipulate entry level minimum rating/quality standards and industry-wise, maturity-wise, duration-wise and issuer-wise limits. They should put proper risk management systems in place. Within the overall ceiling of 5 per cent of total exposure (i.e., 5 per cent of outstanding domestic credit), total investment in securities (i.e., shares, debentures, units of mutual funds, underwriting commitments, venture capital funds, CPs, CDs, capital gains bonds and bonds eligible for priority sector status etc.) should not exceed 20 per cent of they net worth. Investment by banks in unlisted securities should not exceed 10 per cent of the total investment in non-SLR securities. An additional 10 per cent can be invested in unlisted securitisation papers issued for infrastructure projects and bonds issued by SCs/RCs.
- The entire investment portfolio of banks (in SLR securities as well as in non-SLR securities) should be classified under three categories: **(i)** held to maturity (HTM), **(ii)** available for sale (AFS) and **(iii)** held for trading (HFT) at the time of acquisition.
- The HTM category should include securities acquired to be held upto maturity. Such investment should not exceed 25 per cent of the total investments. However, recapitalisation bonds, investments in subsidiaries and joint ventures and investments in debentures/bonds in the nature of an advance, would not be included in the 25 per ceiling. Any profit/loss on the sale of an investment in the HTM category should be recognised in the profit and loss account and appropriated to the capital reserve account. Shifting of investment from/to this category is permitted once at the beginning of each year.
- The securities acquired to take advantage of short-term price/interest rate movements should be included under the HFT category. The securities under the HFT should be sold within 90 days. Securities not falling within the HTM or HFT categories should be classified as AFS. A bank is free to decide the extent of holding in these two categories, taking into account the intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position and so on. Any profit/loss on their sale should be taken to the profit and loss account.
- The valuation of investments should be done according to the three-fold classification. The investments in the HTM category should be valued/carried at the acquisition cost. If the cost exceeds the face value, the premium should be amortised over the period remaining upto maturity. The individual scrips in the AFS category should be marked to market. Net appreciation should be ignored but net depreciation should be recognised and provided for and an equivalent amount should be transferred from the investment fluctuation reserve account to the profit and loss account. The individual scrips in the HFT category should be marked to market. Their book value would not change after marking to market.
- The value of quoted securities should be the available market price. Unquoted SLR securities and preference shares should be valued on the YTM basis. Unquoted equity shares should be valued at the break-up value based on the latest balance sheet, in the absence of which the shares should be valued at ₹1 per company. The basis of valuation for mutual funds' units should be the stock exchange quotation. The CPs and investments in RRBs should be valued at the carrying cost. Security receipts and pass through certificates issued by SCs/RCs, should be carried at the lower of their redemption value and the net book value.
- Banks should book dividends from mutual funds' units on cash basis only. They can book income on accrued basis in case of **(i)** Government-guaranteed, if interest is serviced regularly

and is not in arrears, **(ii)** dividends on shares of corporates if declared and right to receive is established, and **(iii)** Government securities/corporate bonds if interest rate is predetermined and interest is serviced regularly.

As a prudential measure for better risk management and avoidance of concentration of credit risks, the RBI has fixed limits on the exposure of banks to specific industry/sectors. It has prescribed regulatory limits on their exposure to individual/grab borrowers. Banks have also to observe statutory/regulatory exposure limits in respect of advances against, investment in, shares, debentures/bonds, units of mutual funds and all exposures to VCFs. The main elements of the norms are: **(i)** credit exposure to individual/group borrowers, **(ii)** credit exposure to industry/sectors, **(iii)** exposure to capital markets, **(iv)** financing of equity and investment in shares, **(v)** risk management and internal control systems, **(vi)** valuations and disclosures, **(vii)** cross holdings among banks/FIs **(viii)** margin for exposure to commodity exchange, and **(ix)** provision of buy-back facilities.

- The credit exposure limit of capital funds of a bank to individual and group borrowers are 15 and 40 per cent respectively. These should be raised respectively by additional 5 and 10 per cent in infrastructure projects. A further additional 5 per cent in both cases is allowed subject to appropriate disclosures. The limit of 25 per cent in case of oil companies which have been issued oil bonds could be raised to 30 per cent in exceptional circumstances. The exposure limit in terms of both lending and investment to the NBFCs are 10-15 per cent to be increased to 15-20 per cent for on-lending to infrastructure sector. Exposure would include credit as well as an investment exposure. Credit exposure includes all types of credit limits and facilities by way of leasing/hire-purchase finance and factoring service. Investment exposure comprises investment in shares/debentures/bonds/CPs/ SRs/PTCs.
- Banks may fix internal limits for aggregate commitments to specific sectors such as textile, jute, tea and so on so that exposures are evenly spread over various sectors having regard to the performance of different sectors and the perceived risk. The foreign currency exposures of corpoates should be appropriately hedged. Comprehensive prudential norms relating to the ceiling on the total amount of real estate loans, single/group exposure limits, margins, security repayment schedule and availability of supplementary finance should be framed/approved by Boards of Directors of banks. There should be a balanced portfolio of leasing/hire-purchase and factoring in the aggregate credit and the exposure to each of these should not exceed 10 per cent of the total advances. The exposure to Indian joint ventures/wholly-owned subsidiaries abroad and overseas step-loan subsidiaries is subject to a limit of 20 per cent of the unimpaired capital funds. The banks have to ensure that their aggregate assets outside India do not exceed 25 per cent of their liabilities in India.
- The capital market exposure includes: **(i)** direct and **(ii)** indirect exposure. Included in the aggregate exposures are: **(a)** direct investment in advances against shares/debentures/mutual fund units, **(b)** advances for any other purpose against their security, **(c)** advances to brokers and market makers, **(d)** loans to corporates against securities for meeting promoters' contributions, **(e)** bridge loans, **(f)** underwriting commitments excepting those through book building process, **(g)** margin financing of brokers, and **(h)** all exposures to VCFs. The limit on exposure is 30 per cent of the lower of the paid-up capital of the company concerned or capital and reserves of the bank. The aggregate exposure to capital market in all forms should not exceed 40 per cent networth of the bank including 20 per cent as direct investment. The following items are excluded from the aggregate ceiling of 40 per cent and direct investment exposure of 20 per cent: **(i)** investment in **(a)** own subsidiaries/JVs/RRBs and **(b)** shares/convertibles issued by infrastructure financing institutions, **(ii)** tier-I/II debt instruments of other banks, **(iii)** investments in CDs/preference shares/Non-convertibles/mutual fund units, **(iv)** shares

acquired under CDR mechanism, **(v)** term loans to Indian promoters for acquisition of equity in overseas JVs/wholly-owned subsidiaries, **(vi)** underwriting commitments through book running process and **(vii)** promoters' shares in SPVs of an infrastructure project pledged for project lending.

- Loan against shares/convertible bonds/debentures/equity-oriented mutual fund units and subscription to IPOs/FPOs to individuals from the banking system cannot exceed ₹20 lakh. The limit for financing of ESOPs is 90 per cent of the purchase price or ₹20 lakh whichever is lower. Within the overall ceiling of 40 per cent, credit facilities can be freely provided to brokers and market makers within the policy framework approved by the Board of Directors. Bridge loans can be sanctioned to companies for a period up to one year against expected equity flows/issues. A uniform margin of 50 per cent should be applied on all advances/financing of IPOs/issue of guarantees on behalf of brokers and market makers. Within the 50 per cent margin, a minimum cash margin of 25 per cent should be maintained in respect of guarantees for capital market operation/bank finance to brokers by way of temporary overdrafts for DVP transactions. Banks can finance successful bidders for acquisition of shares under the disinvestment programme of the PSUs. The RBI would consider on a case by case basis relaxation in the regulatory ceiling of 40 per cent caused by the financing of such acquisition. Within the 40 per cent ceiling, finance to brokers may be extended for margin trading, subject to a minimum margin of 50 per cent.
- In the context of risk management and internal control system, banks should formulate a transparent policy and procedure for investment and build adequate expertise in equity research. The direct investment should be made by a Board-appointed Investment Committee. Exposure to brokers should be well diversified in terms of broker-clients and individual inter-connected broking entities. The surveillance and monitoring of investment in shares/advances against shares should be done by the Audit Committee of the Board of Directors to ensure compliance with the RBI guidelines and adequate risk management and internal control systems.
- Equity shares in the portfolio of banks should be marked to market preferably on a daily basis, but at least once a week.
- Investment in the following instruments issued by other banks/FIIs should not exceed 10 per cent of the capital funds of the investee bank: equity/preference shares, subordinated debt instruments, hybrid debt capital instruments, and any other instrument in the nature of capital. A bank cannot hold more than 5 per cent of the equity capital of another bank.
- The margin requirements applicable to stock brokers, namely 50 per cent in the aggregate and 25 per cent in cash for guarantees are also applicable to commodity brokers in favour of national commodity exchanges, namely NCDEX, MCX and NMCEIL.

CHAPTER 11

Management of Non-Performing Assets

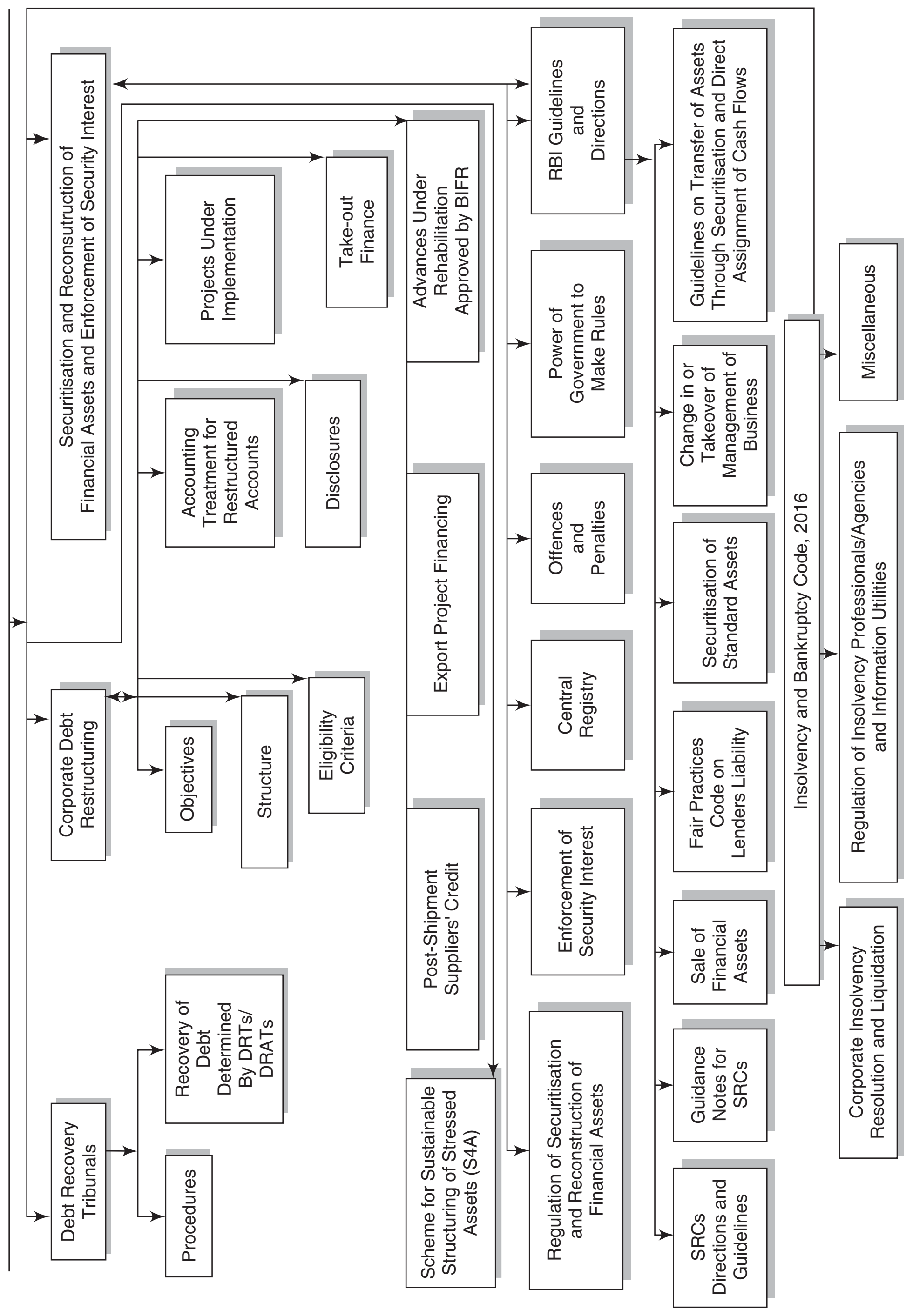
INTRODUCTION

The quality of assets/loan portfolio held by banks is a critical indictor of the health of the banking/financial system. It mirrors the level of credit risk and efficiency in the allocation of bank funds. As observed in an earlier chapter, there was considerable decline in the quality of the asset/loan portfolio of the Indian banks in the 1970-90 period with adverse implications for the profitability/viability of the banking system. This was reflected in widespread default in timely payment of dues by the borrowers. In order to arrest the deterioration in the quality of the credit/advances portfolios of banks, prudential norms relating to income recognition, asset classification and provisioning were put in place since the early nineties. The borrowal accounts which defaulted in timely payment of dues were termed as non-performing assets (NPAs). Depending on the record of repayment of the borrowers, the NPAs are categorised into **(i)** standard, **(ii)** sub-standard, **(iii)** doubtful and **(iv)** loss. **(These are elaborated in the preceding chapter).** The management of the NPAs represents one of the critical challenges for the internal financial management of Indian banking. This Chapter examines on the recovery mechanism for the NPAs. The tools available to banks to mange their NPAs, are recovery camps, lok adalats, debt recovery tribunals, BIFR scheme, corporate debt restructuring (CDR) and securitisation and reconstruction of financial assets through securitisation and asset reconstruction companies (SCs/RCs). Sections 1-5 focus on Debt Recovery Tribunals, Corporate Debt Restructuring, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest, Insolvency and Bankruptcy (IB) Code 2016 and Scheme for Sustainable Structuring of Stressed Assets (S4A). **The major elements of these are depicted in Exhibit 11.1.** Some concluding observations are given in the last Section.

DEBT RECOVERY TRIBUNALS (DRTs)

The DRTs, as a recovery mechanism for NPAs, are setup under the Recovery of Debt and Bankruptcy (code) Act. It provides for expeditions adjudication and recovery of debts to banks/FIs, and insolvency resolution and bankruptcy, and connected matters. The mechanism comprises **(1)** DRTs, **(2)** Recovery officers and **(3)** Debt Recovery Appellate Tribunals (DRATs).

Exhibit 11.1 Recovery Mechanism for Non-Performing Assets



Procedure of DRTs

A **bank** (i.e. bank/corresponding new bank/SBI/its Subsidiary bank/regional rural bank/multi-state cooperative bank) or a **financial institution** (i.e. public financial institution/securitisation/asset reconstruction company/debenture trustee appointed for secured debt securities/other institutions notified by the government) which has to recover any debt from any person has to apply in the prescribed form together with document/other evidence and the specified fee to the appropriate DRT. A **debt** means any liability (including interest) which is claimed as dues from any person by a bank/a consortium of banks during the course of any business activity undertaken under any law in cash or otherwise, whether secured or unsecured or assigned or whether payable under a decrease or order of any civil court or any arbitration award or otherwise or under a mortgage and subsisting on and legally recoverable on the date of application including any liability towards debt securities which remain unpaid after 90-day notice on the borrower. On receipt of the application, the DRT would issue a summon to the defendant (borrower) to **(i)** show cause within 30 days as to why the relief should not be granted to the bank/applicant, **(ii)** direct him to disclose particulars of properties/assets other than those specified by the applicant, **(iii)** restrain him from dealing with/disposing of the concerned assets/properties pending the hearing/disposal of the application for their attachment. The defendant should within 30 days present a written statement of his defence accompanied with the original documents/true copies relied by him for his defence. The written statement would have the same effect as a plaint in a cross-suit to enable the DRT to pass a final order.

Where at any stage of the proceedings, the DRT is satisfied that the defendant, with intent to obstruct/delay/frustrate the execution of any order for recovery of debt against him, is about to **(a)** dispose of the whole/part of his property, **(b)** remove whole/part of his property from the jurisdiction of the DRT or is likely to cause any damage/mischief to the property or affect its value by misuse/creating third party interest, the DRT may direct the defendant to furnish specified security or procedure/place at the DRT's disposal the property or its value/a portion of its value sufficient enough for recovery of the debt. The DRT may also order attachment of the property. Any disobedience of an order of the DRT may result in detention in civil prison upto 3 months.

The DRT may **(1)** appoint a receiver of any property, **(2)** remove any person from the possession/custody of the property, **(3)** commit the same to the possession/ custody/management of the receiver, **(4)** confer upon the receivers all powers to bring and defend suits in courts or file/defend application before the DRT and for realisation/management/protection/preservation/improvement of the property, collection /disposal of rents/profits and the execution of documents as the owner himself has, and **(5)** appoint a Commissioner for preparation of an inventory of the properties of the defendants or their sales.

The application to the DRT for exercising the authority of the adjudicating authority under the Insolvency and Bankruptcy Code 2016 would be dealt within the manner provided under the code **(discussed in another section of this chapter)**.

The DRT would ordinarily dispose of an application within 180 days from the date of application. An aggrieved party may prefer an appeal against the order of the DRT to an DRAT on depositing with the DRTA at least 75 per cent of the amount of the debt due from his.

Recovery of Debt Determined By DRTs/DRATs

There are two modes of recovery of debts as discussed below.

Recovery of Debts The recovery officer would recover the debt specified by the DRT/DRAT by one or more of the following modes:

- Attachment and sale of the movable/immovable property of the defendant/borrower;
- Take possession of the concerned property and appoint receiver to sell it;
- Arrest of the defendant and his detention in prison; and
- Appoint a receiver for the management of the property;
- Any other Government-prescribed mode.

Other Modes of Recovery The recovery officer may recover the amount of debt specified by the DFT/DRAT by one/more of the modes listed below:

- If any amount is due from any person to the defendant, the recovery officer may require him to deduct the amount of debt due from him and pay the deducted amount to the recovery officer.
- The recovery officer may require (notice) any person from whom money is due/may become due to the defendant (borrower) or any person who holds/may subsequently hold money for/on account of the defendant, to pay the recovery officer the money becoming due/being held sufficient to cover the amount of debt due from the defendant. If a person fails to comply with the requirement of the recovery officer, he would be deemed to be a defendant in default in respect of the specified amount and proceedings may be taken against him for the realisation of the amount as if it were a debt from him. The requirement (notice) would have the safe effect as an attachment of debt by the recovery officers.
- He may apply to the court in whose custody there is money belonging to the defendant for payment to him in discharge of the amount of debt due.
- He may require any person to declare on affidavit the particular of his assets.
- He may recover any amount of the debt from the defendant by distraint and sale of his movable property in the manner laid down by the Income-tax Act.

Any person aggrieved by an order of the recovery officer may within 30 days prefer an appeal to the DRT. He should deposit 50 per cent of the debt due determined by the DRT.

The rights of secured creditors to realise secured debts due/payable to them by sale of assets over which security interest is created would have priority/paid in priority over all other debts and Government dues including revenues/taxes/cesses/rates due to Government/local authority. In cases where insolvency/bankruptcy proceedings are pending, their priority would be subject to the provisions of the Insolvency/Bankruptcy Code, 2016 **(discussed in a subsequent section of this chapter).**

CORPORATE DEBT RESTRUCTURING (CDR) SYSTEM

In spite of their best efforts and intentions, sometimes corporates find themselves in financial difficulty because of factors beyond their control and also due to certain internal reasons. For the revival of such corporates as well as for the safety of the money lent by the banks and FIs, timely support through restructuring in genuine cases is called for. However, delay in agreement amongst different lending institutions often comes in the way of such endeavaours. The main features of the CDR system are given below.

Objective

The objective of the CDR framework is to ensure timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT (Debt Recovery Tribunal) and other legal proceedings, for the benefit of all concerned. In particular, the framework aims at preserving viable corporates that are affected by certain internal and external factors and minimise losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

Structure

The CDR system would have a three-tier structure: **(1)** CDR Standing Forum and its Core Group, **(2)** CDR Empowered Group, and **(3)** CDR Cell.

CDR Standing Forum The forum would be the representative general body of all financial institutions and banks participating in the CDR system. It would be a self-empowered body, which would lay down policies and guidelines, and monitor the progress of corporate debt restructuring. It would also provide an official platform for both the creditors and borrowers (by consultation) to amicably and collectively evolve policies and guidelines for working out debt restructuring plans in the interest of all concerned. It would also lay down policies and guidelines to be followed by the CDR Empowered Group and the CDR Cell for Debt Restructuring, and would ensure their smooth functioning and adherence to the prescribed time schedules for debt restructuring. It can also review any individual decisions of CDR Empowered Group and the CDR Cell. It may also formulate guidelines for dispensing special treatment to those cases which are complicated and are likely to be delayed beyond the timeframe for processing.

A CDR Core Group would be carved out of the CDR Standing Forum to assist it in convening the meetings and taking decisions relating to policy, on behalf of the Standing Forum. The CDR Core Group would lay down the policies and guidelines to be followed by the CDR Empowered Group and the CDR Cell for Debt Restructuring. These guidelines would also suitably address the operational difficulties experienced in the functioning of the CDR Empowered Group. It would also prescribe the PERT chart for processing of cases referred to the CDR system and decide on the modalities for enforcement of the timeframe. It would also lay down guidelines to ensure that over-optimistic projections are not assumed while preparing/approving restructuring proposals especially with regard to capacity utilisation, price of products, profit margin, demand, availability of raw materials, input-out-put ratio and likely impact of imports/international cost competitiveness.

CDR Empowered Group The individual cases of corporate debt restructuring would be decided by the CDR Empowered Group, consisting of ED level representatives of IDBI, ICICI Bank Ltd. and SBI as standing members, in addition to ED level representatives of financial institutions and banks who have an exposure to the concerned company.

The group would consider the preliminary report of all cases of requests of restructuring submitted to it by the CDR Cell. After its decision that restructuring of the company is *prima facie* feasible and the enterprise is potentially viable in terms of the policies and guidelines evolved by the CDR Standing Forum, the detailed restructuring package would be worked out by the CDR Cell in conjunction with the lead institution. However, if the lead institution faces difficulties in working out the detailed structuring package, the participating banks/FIs should decide upon the alternate institution/bank which would work out the detailed restructuring package. The CDR Empowered Group would look into each case of debt restructuring, examine the viability and rehabilitation potential of the company and approve the restructuring package within a specified timeframe of 90 days, or at best within 180 days of reference to it. It would decide on the acceptable viability benchmark levels on the following illustrative parameters, which may be applied on a case-by-case basis, based on the merits of each case, namely: **(a)** Return on capital employed (ROCE), **(b)** Debt service coverage ratio (DSCR), **(c)** Gap between the internal rate of return (IRR) and the cost of fund (CoF), and **(d)** Extent of sacrifice.

The Boards of Directors of each bank/FI should authorise its Chief Executive Officer (CEO) and/or Executive Director (ED) to decide on the restructuring package in respect of cases referred to the CDR system, with the requisite requirements to meet the control needs. The decisions of the CDR Empowered Group would be final. If restructuring of debt is found to be viable and feasible, and approved by it, the company would be put on the restructuring mode. If restructuring is not found viable, the creditors would then be free to take necessary steps for immediate recovery of dues and/or liquidation or winding up of the company, collectively or individually.

CDR Cell The CDR Standing Forum and the CDR Empowered Group would be assisted by a CDR Cell in all their functions. The Cell would make the initial scrutiny of the proposals received from borrowers/lenders, by calling for the proposed rehabilitation plan and other information and put up the matter before the CDR Empowered Group, within one month to decide whether rehabilitation is *prima facie* feasible. If found feasible, the Cell would proceed to prepare detailed rehabilitation plan with the help of lenders and, if necessary, experts to be engaged from outside. If not found *prima facie* feasible, the lenders may start action for recovery of their dues.

All references for corporate debt restructuring by lenders or borrowers would be made to the Cell. It would be the responsibility of the lead institution/major stakeholder to the corporate, to work out a preliminary restructuring plan in consultation with other stakeholders and submit to the Cell within one month. The Cell would prepare the restructuring plan in terms of the general policies and guidelines approved by the CDR Standing Forum, and place for consideration of the Empowered Group within 30 days for decision. The Empowered Group can approve or suggest modifications but ensure that a final decision is taken within a total period of 90 days. However, for sufficient reasons the period can be extended up to a maximum of 180 days from the date of reference to the Cell.

Eligibility Criteria

The scheme would not apply to accounts involving only one financial institution or one bank. The CDR mechanism would cover only multiple banking accounts/syndication/consortium accounts with outstanding exposure of ₹20 crore and above by banks and institutions. There are two categories of debt restructuring under the CDR system: **(i)** Category 1 under which accounts classified as standard/sub-standard in the books of the lender would be restructured; **(ii)** Category 2 under which accounts which are classified as doubtful would be restructured.

Category 1 CDR System The Category 1 CDR system would be applicable only to accounts classified as 'standard' and 'sub-standard'. There may be a situation where a small portion of debt by a bank might be classified as doubtful. In that situation, if the account has been classified as 'standard'/`sub-standard' in the books of at least 90 per cent of lenders (by value), the same would be treated as standard/sub-standard, only for the purpose of judging the account as eligible for CDR, in the books of the remaining 10 per cent of lenders. There would be no requirement of the account/company being sick, or being in default for a specified period before reference to the CDR system. However, potentially viable cases of NPAs would get priority. This approach would provide the necessary flexibility and facilitate timely intervention for debt restructuring. In no case, the requests for any corporate indulging in willful default, fraud or misfeasance, even in a single bank, would be considered for restructuring under the CDR system. The accounts where recovery suits have been filed by the lenders against the company, may be eligible for consideration under the CDR system provided the initiative to resolve the case under the CDR system is taken by at least 75 per cent of the lenders (by value). However, for restructuring of such accounts under the CDR system, it should be ensured that they meet the basic criteria for becoming eligible under the CDR. The BIFR cases are not eligible for restructuring under the CDR system. However, large value BIFR cases may be eligible if specifically recommended by the CDR Core Group. It should be ensured that the lending institutions complete all formalities in seeking the approval from BIFR before implementing the package.

The reference to the CDR system could be triggered by **(i)** any or more of the creditor(s) who have a minimum 20 per cent share in either working capital or term finance, or **(ii)** by the concerned corporate, if supported by a bank or financial institution having stake as in **(i)** above.

Though flexibility is available, whereby the lenders could either consider restructuring outside the purview of the CDR system or even initiate legal proceedings where warranted, the banks/FIs should review all eligible cases where the exposure of the financial system is more than ₹100 crore and decide about referring the case to CDR system or to proceed under the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (which are elaborated in a subsequent section of this chapter) or to file a suit in DRT and so on.

The CDR is a non-statutory mechanism which would be a voluntary system based on a Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The DCA and the ICA provides legal basis to the CDR mechanism. The debtors would have to accede to the DCA, either at the time of original loan documentation (for future cases) or at the time of reference to the Cell. Similarly, all participants in the CDR mechanism through their membership of the Standing Forum would have to enter into a legally binding agreement, with necessary enforcement and penal clauses, to operate by system through laid-down policies and guidelines. The ICA signed by the creditors would be initially valid for a period of 3 years and subject to renewal for a further period of three years thereafter. The lenders in foreign currency outside the country are not a part of the CDR system. Such lenders and also lenders like GIC, LIC, UTI and so on, and other third parties, could join the CDR mechanism of a particular corporate by signing transaction to transaction ICA, wherever they have exposure to such corporate. The ICA would be a legally binding arrangement amongst the creditors, with necessary enforcement and penal clauses, wherein the creditors would commit themselves to abide by various elements of the CDR system. Further, the creditors should agree that if 75 per cent of creditors by value, agree to a restructuring package of an existing debt (i.e. debt outstanding), the same would be binding on the remaining creditors. Since Category 1 CDR Scheme covers only standard and sub-standard accounts, which, in the opinion of 75 per cent of creditors, are likely to become performing after introduction of the CDR package, it is expected that all other creditors (i.e., those outside the minimum 75 per cent) would be willing to participate in the entire CDR package, including the agreed additional financing. However, in case for any internal reason, any creditor (outside the minimum 75 per cent) does not wish to commit additional financing, that creditor would have the option. At the same time, in order to avoid that creditor 'free rider' problem, it is necessary to provide some disincentive to the creditor who wishes to exercise these options. Such creditor can either **(a)** arrange for his share of additional financing to be provided by a new or existing creditor, or **(b)** agree to a deferment of the first year's interest due to him after the CDR package becomes effective. The first year's deferred interest without compounding would be payable along with the last instalment of the principal due to the creditor.

One of the most important elements of the DCA would be the 'stand-still' agreement binding for 90 days, or 180 days by both sides. Under this clause, both the debtor and creditor(s) should agree to a legally binding 'stand-still' whereby both parties commit themselves not to take recourse to any other legal action during the 'stand-still' period. This would be necessary for enabling the CDR system to undertake the necessary debt restructuring exercise without any outside intervention, judicial or otherwise. However, the stand-still clause would be applicable only to any civil action either by the borrower or any lender against the other party and would not cover any criminal action. Further, during the stand-still period, outstanding foreign exchange forward contracts, derivative products, and so on can be crystallised, provided the borrower is agreeable to such crystallisation. The borrower would additionally undertake that during the stand-still period the documents would stand extended for the purpose of limitation, and also that he would not approach any other authority for any relief and the Directors of the borrowing company would not resign from the Board of Directors during the stand-still period. During the pendency of the case with the CDR system, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because the case is referred to the CDR Cell. However, if restructuring under the CDR system takes place, the asset classification status should be restored to the position which existed when the reference to the Cell was made. Consequently, any additional provision made by banks towards deterioration in the asset classification status during the pendency of the case with the CDR system may be reversed.

The lenders of additional finance, whether existing or new would have a preferential claim, to be worked out under the restructuring package, over the providers of existing finance with respect to the cash flows out of recoveries, in respect of the additional exposure. The additional finance extended to borrowers in terms of restructuring packages approved under the CDR system may be exempted from provisioning requirement for the specified period as defined subsequently.

As mentioned earlier, the proposal for restructuring package should provide for option to a particular lender(s) (outside the minimum 75 per cent who have agreed for restructuring) who for any internal reason, does/do not fully abide by the CDR Empowered Group's decision on restructuring. The lenders who wish to exit from the package would have the option to sell their existing share to either the existing lenders or fresh lenders, at an appropriate price, which would be decided mutually between the existing lender and the taking over lender. The new lenders would rank on par with the existing lenders for the repayment and servicing of the dues, since they have taken over the existing dues to the existing lender. In addition, the 'exit option' would also be available to all other lenders within the minimum 75 per cent, provided the purchaser agrees to abide by the restructuring package approved by the Empowered Group. The existing lenders may be allowed to continue with their existing level of exposure to the borrower provided they tie up with either the existing lenders or fresh lenders for taking up their share of additional finance.

The CDR Empowered Group, while deciding the restructuring package, should decide on the issue regarding convertibility (into equity) option as part of restructuring exercise whereby the banks/FIs would have the right to convert a portion of the restructured amount into equity, keeping in view the statutory requirement under Section 19 of the Banking Regulation Act (in case of banks) and the relevant SEBI regulations. The exemptions from the capital market exposure ceilings prescribed by the RBI in respect of such equity acquisitions should be obtained on a case-to-case basis by the concerned lenders.

Category 2 CDR System There have been instances where the projects have been found to be viable by the lenders but the accounts could not be taken up for restructuring under the CDR system as they fell under 'doubtful' category. Hence, a second category of CDR is introduced for cases where the accounts have been classified as 'doubtful' in the books of lenders, and if a minimum of 75 per cent (by value) of the lenders satisfy themselves of the viability of the account and consent for such restructuring, subject to the following conditions:

(i) It would not be binding on the creditors to take up additional financing worked out under the debt restructuring package and the decision to lend or not to lend would depend on each creditor bank/FI separately. In other words, under the proposed second category of the CDR mechanism, the existing loans would only be restructured and it would be up to the promoter to firm up additional financing arrangement with new or existing lenders individually.

(ii) All other norms under the CDR mechanism such as the stand-still clause, asset classification status during the dependency of restructuring under the CDR and so on, would continue to be applicable to this category also.

No individual case should be referred to the RBI. The CDR Core Group may take a final decision whether a particular case falls under the CDR guidelines or not. All other features of the CDR system as applicable to the Category I are also applicable to cases restructured under the Category 2.

Accounting Treatment for Restructured Accounts

The accounting treatment of the accounts restructured under the CDR system, including accounts classified as 'doubtful' under Category 2 CDR, would be governed by the applicable prudential norms. The restructuring of corporate debts under the CDR system could take place in the following stages: **(a)** before commencement of commercial production; **(b)** after commencement of commercial production but before the asset has been classified as 'sub-standard'; and **(c)** after commencement of commercial production and the asset has been classified as 'sub-standard' or 'doubtful'. The prudential treatment of accounts, subjected to restructuring under the CDR system, would be governed by the following norms:

Treatment of 'Standard' Accounts Restructured Under CDR **(a)** A rescheduling of the instalments of principal alone, at any of the aforesaid first two stages would not cause a standard asset to be classified in the sub-standard category, provided the loan/credit facility is fully secured; **(b)** A rescheduling of interest element at any of the foregoing first two stages would not cause an asset to be downgraded to the sub-standard category subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written-off or provision is made to the extent of the sacrifice involved. For this purpose, the future interest due as per the original loan agreement in respect of an account should be discounted to the present value at a rate appropriate to the risk category of the borrower (i.e. current PLR

+ appropriate credit risk premium for the borrower category) and compared with the present value of dues expected to be received under the restructuring package, discounted on the same basis; and **(c)** In case there is a sacrifice involved in the amount of interest in present value terms, as at clause **(b)** mentioned above, the amount of sacrifice should either be written-off or provision made to the extent of the sacrifice involved.

Treatment of 'Sub-standard'/'Doubtful' Accounts Restructured Under CDR **(a)** A rescheduling of the instalments of principal alone, would render a sub-standard/doubtful asset eligible to be continued in the sub-standard/doubtful category for the specified period, provided the loan/credit facility is fully secured; **(b)** A rescheduling of interest element would render a sub-standard/doubtful asset eligible to be continued to the classified in sub-standard/doubtful category for the specified period subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written-off or provision is made to the extent of sacrifice involved. For this purpose, the future interest due as per the original loan agreement in respect of an account should be discounted to the present value at a rate appropriate to the risk category of the borrower (i.e., current PLR + appropriate credit risk premium for the borrower-category), and compared with the present value of dues expected to be received under the restructuring package, discounted on the same basis; and **(c)** In case there is a sacrifice involved in the amount of interest in present value terms, as at clause **(b)** mentioned above, the amount of sacrifice should either be written-off or provision made to the extent of sacrifice involved. Even in cases where the sacrifice is by way of write-off of the past interest dues, the asset should continue to be treated as sub-standard/doubtful.

The sub-standard/doubtful accounts above, which have been subjected to restructuring and so on, whether in respect of principal instalment or interest amount, by whatever modality, would be eligible for upgradation to the standard category only after the specified period, that is, a period of one year after the date when the first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The amount of provision made earlier, net of the amount provided for the sacrifice in the interest amount in present value terms, as aforesaid, could also be reversed after the one-year period.

During this one year period, the sub-standard/doubtful asset would not deteriorate in its classification if satisfactory performance of the account is demonstrated during the period. In case, however, the satisfactory performance during the one year period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

The asset classification under CDR would continue to be bank-specific, based on record of recovery of each bank, as per the existing prudential norms applicable to them.

Disclosure

The banks/FIs should also disclose in their published annual balance sheets, under Notes on Accounts, the following information in respect of corporate debt restructuring undertaken during the year: **(a)** total amount of loan assets subjected to restructuring under CDR: [(a) = (b)+(c)+(d)]; **(b)** the amount of standard assets subjected to the CDR; **(c)** the amount of sub-standard assets subjected to CDR; and **(d)** the amount of doubtful assets subjected to CDR.

Projects Under Implementation

The norms on income recognition, asset classification, and provisioning to banks with respect to industrial projects under implementation, which involves time overrun would be as detailed below.

Asset Classification The projects under implementation should be grouped into three categories for the purpose of determining the date when the project ought to be completed: **(A)** Category I: Projects where financial closure had been achieved and formally documented; **(B)** Category II: Projects sanctioned before 1997 with original project cost of ₹100 crore or more where financial closure was not formally documented and **(C)** Category III: Projects sanctioned before 1997 with original project cost of less than ₹100 crore where financial closure was not formally documented. In case of each of the three categories, the date when the project ought to be completed and the classification of the underlying loan asset should be determined in the following manner:

(a) In case of Category I projects, all assets may be treated as standard asset for a period not exceeding two years beyond the date of completion of the project, as originally envisaged at the time of initial financial closure of the project**.** In respect of projects financed after 1997 if the financial closure had not been formally documented, the norms applicable to category III would apply.

(b) For projects in Category II, the assets may be treated as standard asset for a period not exceeding two years beyond the deemed date of completion of the project, as decided by the independent Expert Group consisting of experts from the lending institutions as well as the outside experts. The banks, which have extended finance towards such projects, may approach the lead financial institution to which a copy of the independent group's report has been furnished for obtaining the particulars relating to the deemed date of completion of project concerned.

(c) In case of Category III projects, the asset may be treated as standard asset only for a period not exceeding two years beyond the date of completion of the project as originally envisaged at the time of sanction.

In all the three foregoing categories, in case of time overruns beyond the aforesaid period of two years, the asset should be classified as sub-standard regardless of the record of recovery and provided for accordingly. As regards the projects to be financed by the FIs/banks in future, the date of completion of the project should be clearly spelt out at the time of financial closure of the project. In such cases, if the date of commencement of commercial production extends beyond a period of six months after the date of completion of the project, as originally envisaged at the time of initial financial closure of the project, the account should be treated as a sub-standard asset.

Income Recognition Banks may recognise income on accrual basis in respect of three categories of projects under implementation which are classified as standard in terms of the guidelines discussed earlier. They should recognise income on such accounts classified as sub-standard only on realisation on cash basis. Consequently income wrongly recognised in the past should reverse the interest/make provision for an equivalent amount.

Banks should adopt the following in respect of regulatory treatment of "funded interest" recognised as income and conversion into equity/debentures/any other instrument:

(a) *Funded Interest:* Any funding of interest in respect of NPAs, if recognised as income, should be fully provided for.

(b) *Conversion into Equity/Debentures/other Instruments:* If the amount of the outstanding interest component is converted and income is recognised in consequence, full provision should be made to offseat its effect, in addition to the provisioning necessary for the depreciation in value of the concerned instrument as per the investment valuation norms. In case of conversion of interest into quoted equity shares, interest income can be recognised at market value of equity on the date of conversion upto a maximum of the amount converted. Such equity should be classified in the "available for sale category" and valued at the lower of the cost or the market value.

In case of conversion of principal and/or interest in respect of NPAs into debentures/zero coupon bonds/other instruments seeking to defer the liability of the issuer, they should be treated as NPA, *ab initio*, in the same asset classification as was applicable to the loan before conversion and provision should be made as per applicable norms. Income should be recognised only on realisation basis. The income in respect of unrealised interest should be recognised only on redemption of such instrument.

The equity shares/other instruments arising from conversion of the principal amount of loan would also be subject to the usual applicable prudential valuation norms.

Provisioning Banks which are already holding provisions against some of the accounts, which may now be classified as 'standard', should continue to hold the provisions and should not reverse the same.

Availability of Security/Net Worth of Borrower/Guarantor The availability of security or net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise, as income recognition is based on record of recovery.

Take-out Finance

Take-out finance is the product emerging in the context of the funding of long-term infrastructure projects. Under this arrangement, the FI/bank financing infrastructure projects would have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books on a predetermined basis. In view of the time lag involved in taking-over, the possibility of a default in the mean time cannot be ruled out. The norms of asset classification would have to be followed by the concerned bank/FI in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution should not recognise income on accrual basis and account for the same only when it is paid by the borrower/taking over institution (if the arrangement so provides). The lending institution should also make provisions against any asset turning into NPA pending its take over by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be reversed. However, the taking over institution, on taking over such assets, should make provisions treating the account as NPA from the actual date of it becoming NPA, even though the account was not in its books as on that date.

Post-shipment Supplier's Credit

In respect of post-shipment credit extended by the banks covering export of goods to countries for which the ECGC's (Export Credit Guarantee Corporation) cover is available, EXIM Bank has introduced a guarantee-cum-refinance programme whereby, in the event of default, it would pay the guaranteed amount to the bank within a period of 30 days from the day the bank invokes the guarantee after the exporter has filed claim with the ECGC. Accordingly, to the extent payment has been received from the EXIM Bank, the advance may not be treated as NPA for asset classification and provisioning purposes.

Export Project Financing

In respect of export project finance, there could be instances where the actual importer has paid the dues to the bank abroad but the bank in turn is unable to remit the amount due to political developments such as war, strife, UN embargo and so on. In such cases, where the lending bank establish through documentary evidence that the importer has cleared the dues in full by depositing the amount in the bank abroad before it turned into NPA in the books of the bank, but the importer's country is not allowing the funds to be remitted due to political or other reasons, the asset classification may be made after a period of one year from the date the amount was deposited by the importer in the bank abroad.

Advances Under Rehabilitation Approved by BIFR/Term Lending Institution (TLI)

Banks are not permitted to upgrade the classification of any advance in respect of which the terms have been renegotiated unless the package of renegotiated terms has worked satisfactorily for a period of one year. While the existing credit facilities sanctioned to a unit under rehabilitation packages approved by BIFR/TLI would continue to be classified as sub-standard or doubtful as the case may be, in respect of additional facilities sanctioned under the rehabilitation packages, the income recognition, asset classification norms would become applicable after a period of one year from the date of disbursement.

SCHEME FOR SUSTAINABLE STRUCTURING OF STRESSED ASSETS (S4A)

In order to strengthen the lenders' ability to deal with stressed assets, RBI has been issuing, from time to time, guidelines and prudential norms on stressed assets resolution by the regulated lenders. The resolution of large borrowal accounts which are facing severe financial difficulties may, *inter-alia*, require co-ordinated deep financial restructuring which often involves a substantial write-down of debt and/or making large provisions. Citing the case of the strategic debt restructuring (SDR) mechanism which provides 18 months for banks to make prescribed provisions for the residual debt and mark-to-market (MTM) provisions on their equity holding arising from conversion of debt, banks have represented for allowing more time to write down the debt and make the required provisions in cases of resolution of large accounts. In order to ensure that adequate deep financial restructuring is done to give projects a chance of sustained revival, the RBI has decided to facilitate the resolution of large accounts, which satisfy the stipulated conditions. The main elements of the S4A are: **(i)** eligible accounts, **(ii)** debt sustainability, **(iii)** sustainable debt, **(iv)** resolution plan, **(v)** asset classification and provisioning, **(vi)** fee/charges and **(vii)** mandatory implementation.

Eligible Accounts

For being eligible under the scheme, the account should meet all the following conditions: **(i)** The project has commenced commercial operations, **(ii)** The aggregate exposure (including accrued interest) of all institutional lenders in the account is more than ₹500 crore (including rupee loans, foreign currency loans/external commercial borrowings), and **(iii)** The debt meets the stipulated test of sustainability. In respect of securitisation companies/reconstruction companies (SCs/RCs), only those accounts are eligible which, in addition to meeting the listed criteria, have been acquired against consideration in cash only, that is, not by issuing any security receipts.

Debt Sustainability

A debt level will be deemed sustainable if the joint lenders forum (JLF)/Consortium of lenders/bank conclude through independent techno-economic viability (TEV) that debt of that principal value amongst the current funded/non-funded liabilities owed to institutional lenders can be serviced over the same tenor as that of the existing facilities even if the future cash flows remain at their current level. The sustainable debt should not be less than 50 per cent of current funded liabilities referred to as **Part A** (**discussed subsequently**).

Sustainable Debt

- The resolution plan may involve one of the following options with regard to the post-resolution ownership of the borrowing entity. **(1)** The current promoter **(a)** continues to hold majority of the shares/shares required to have control, **(b)** has been replaced with a new promoter, in one of the following ways: **(i)** Through conversion of a part of the debt into equity under **SDR** (strategic debt restructuring) mechanism which is thereafter sold to a new promoter, **(ii)** In the manner contemplated as per prudential norms on change in ownership of borrowing entities (outside SDR scheme), **(2)** The lenders have acquired majority shareholding in the entity through conversion of debt into equity either under SDR or otherwise and **(i)** allow the current management to continue or **(ii)** hand over management to another agency/professionals under an operate and manage contract. Where malfeasance on the part of the promoter has been established through a forensic audit or otherwise, the scheme would not be applicable if there is no change in promoter or the management is vested in the delinquent promoter.
- In any of the above circumstances, the JLF/consortium/bank should, after an independent TEV, bifurcate the current dues of the borrower into **Part A** and **Part B** as described below:

  Determine the level of debt (including new funding required to be sanctioned within next 6 months and non-funded credit facilities crystallising within next 6 months) that can be serviced (both interest and principal) within the respective residual maturities of existing debt, from all sources, based on the cash flows available from the current as well as immediately prospective (not more than 6 months) level of operations. ***Free cash flows*** (i.e., cash flow from operations minus committed capital expenditure) available for servicing debt as per the latest audited/reviewed financial statement will be considered. Where there is more than one debt facility, the maturity profile of each facility should be that which exists on the date of finalising this resolution plan. For determining the level of debt that can be serviced, the assessed free cash flow should be allocated to servicing each existing debt facility in the order in which its servicing falls due. **The level of debt so determined will be referred to as Part A**. The difference between the aggregate current outstanding debt, from all sources, and **Part A** will be referred to as **Part B**. The security position of lenders will, however, not be diluted and **Part A** portion of loan will continue to have at least the same amount of security cover as was available prior to this resolution.

The Resolution Plan

- The resolution plan should have the following features: **(a)** There should be no fresh moratorium granted on interest or principal repayment for servicing of **Part A, (b)** There should not be any extension of the repayment schedule or reduction in the interest rate for servicing of **Part A**, as compared to repayment schedule and interest rate prior to this resolution, **(c) Part B** should be converted into equity/redeemable cumulative optionally convertible preference shares. However, in cases where the resolution plan does not involve change in promoter, banks may, at their discretion, also convert a portion of **Part B** into optionally convertible debentures. All such instruments will continue to be referred to as **Part B** instruments.
- For the purpose of this scheme, the fair value for **Part B** instruments should be arrived at as per the following methodologies:

  Equity Shares The equity shares in the bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis. The equity shares for which current quotations are not available or where the shares are not listed on the stock exchanges, should be valued at the lowest value arrived using the following valuation methodologies:

  (i) ***Break-up value*** (without considering 'revaluation reserves', if any) which is to be ascertained from the company's latest audited balance sheet (which should not be more than one year prior to the date of valuation). In case the latest audited balance sheet is not available, the shares are to be valued at ₹1 per company. The independent TEV will assist in ascertaining the break-up value.

  (ii) ***Discounted Cash Flow Method*** where the discount factor is the actual interest rate charged to the borrower plus 3 per cent, subject to floor of 14 per cent. Further, cash flows [cash flow available from the current as well as immediately prospective (not more than 6 months) level of operations] occurring within 85 per cent of the useful economic life of the project only should be reckoned.

  Redeemable Cumulative Optionally Convertible Preference Shares/Optionally Convertible Debentures The valuation should be on discounted cash flow (DCF) basis. These should be valued with a discount rate of a minimum mark up of 1.5 per cent over the weighted average actual interest rate charged to the borrower for the various facilities. Where preference dividends are in arrears, no credit should be taken for accrued dividends and the value determined as above on DCF basis should be discounted further by at least 15 per cent if arrears are for one year, 25 per cent if arrears are for two years, so on and so forth (i.e., with 10 per cent increments).
- Where the resolution plan does not involve a change in promoter or where existing promoter is allowed to operate and manage the company as minority owner by lenders, the principle of proportionate loss sharing by the promoters should be met. In such cases, lenders should, therefore, require the existing promoters to dilute their shareholdings, by way of conversion of debt into equity/sale of some portion of promoter's equity to lenders, at least in the same proportion as that of **Part B** to total dues to lenders. The JLF/consortium/bank should also obtain promoters' personal guarantee in all such cases, for at least the amount of **Part A**.
- The upside for the lenders should be primarily through equity/quasi equity, if the borrowing entity turns around. The terms for exercise of option for the conversion of preference

shares/debentures to equity should be clearly spelt out. The existing promoter or the new promoter may have the right of first refusal in case the lenders decide to sell the share, at a price beyond some predetermined price. The lenders may also include appropriate covenants to cover the use of cash flows arising beyond the projected levels having regard to quasi-equity instruments held in **Part B**.

- The other important principles for this scheme are the following:
  (a) The JLF/consortium/bank should engage the services of credible professional agencies to conduct the TEV and prepare the resolution plan. While engaging professional agencies, they should ensure that the agency is reputed, truly independent/free from any conflict of interest, has proven expertise and will be in a position to safeguard the interest of lenders while preserving the economic value of the assets. Further, from a risk management perspective, lenders should avoid concentration of such assignments in any one particular professional agency.
  (b) The resolution plan should be agreed upon by a minimum of 75 per cent of lenders by value and 50 per cent of lenders by number in the JLF/consortium/bank.
  (c) At individual bank level, the bifurcation into **Part A** and **Part B** should be in the proportion of **Part A** to **Part B** at the aggregate level.

Overseeing Committee

An Overseeing Committee (OC), comprising of eminent persons, should be constituted by the Indian Bank Association (IBA) in consultation with RBI. The members of **OC** cannot be changed without the prior approval of RBI. The resolution plan should be submitted by the JLF/consortium/bank to the OC. The OC should review the processes involved in preparation of resolution plan, etc. for reasonableness and adherence to the provisions of these guidelines, and opine on it. The OC will be an advisory body.

Asset Classification and Provisioning

Where There is a Change of Promoter In case a change of promoter takes place, that is, a new promoter comes in, the asset classification and provisioning requirement will be as per the 'SDR' scheme or 'outside SDR' scheme as applicable.

Where There is no Change of Promoters The asset classification as on the date of lenders' decision to resolve the account under these guidelines (reference date) will continue for a period of 90 days from this date. This standstill clause is permitted to enable JLF/consortium/bank to formulate the resolution plan and implement the same within the said 90 day period. If the resolution is not implemented within this period, the asset classification will be as per the extant asset classification norms, assuming there was no such 'stand-still'.

In respect of an account that is **Standard** as on the reference date, the entire outstanding (both Part A and part B) will remain standard subject to provisions made upfront by the lenders being at least the higher of 40 per cent of the amount held in Part B or 20 per cent of the aggregate outstanding (**sum of Part A and Part B**). For this purpose, the provisions already held in the account can be reckoned.

In respect of an account that is classified as non-performing asset on the date of this resolution, the entire outstanding (**both Part A and part B**) would continue to be classified and provided for as a non-performing asset.

Lenders may upgrade Part A and Part B to standard category after one year of satisfactory performance of Part A loans. In case of any pre-existing moratorium in the account, the upgrade will be permitted one year after completion of the longest moratorium, subject to satisfactory performance of Part A debt. However, lenders would continue to mark to market Part B instruments as per the stated norms.

Any provisioning requirement on account of difference between the book value of Part B instruments and their fair value in excess of the minimum requirements should be made within 4 quarters commencing with the quarter in which the resolution plan is actually implemented in the lender's books, such that the MTM provision held is not less than 25 per cent of the required provision in the first quarter, not less than 50 per cent in the second quarter and so on. The provision already held in the account can also be reckoned.

If the provisions held by the bank in respect of an account prior to this resolution are more than the applicable cumulative provisioning requirement, the excess can be reversed only after one year from the date of implementation of resolution plan (that is, when it is reflected in the books of the lender referred to as **date of restructuring**), subject to satisfactory performance during this period.

The resolution plan and control rights should be structured in such a way so that the promoters are not in a position to sell the company/firm without the prior approval of lenders and without sharing the upside, if any, with the lenders towards loss in **Part B**.

If **Part A** subsequently slips into NPA category, the account will be classified with slippage in category with reference to the classification obtaining on the reference date and necessary provisions should be made immediately.

Where a bank/NBFC/AIFI chooses to make the prescribed provisions/write downs over more than one quarter and this results in the full provisioning/write down remaining to be made as on the close of a financial year, they should debit 'other reserves' [that is, reserves other than the one created in terms of Section 17(2) of the Banking Regulation Act 1949] by the amount remaining un-provided/not written down at the end of the financial year, by credit to specific provisions. However, they should proportionately reverse the debits to 'other reserves' and complete the provisioning/write down by debiting profit and loss account, in the subsequent quarters of the next financial year. The banks should make suitable disclosures in notes to accounts with regard to the quantum of provision made during the year under this scheme and the quantum of unamortised provisions debited to 'other reserves' as at the end of the year.

Fees and Charges

The IBA will collect a fee from the lenders as a prescribed percentage of the outstanding debt of the borrowal entity to the consortium/JLF/consortium/bank and create a corpus fund. This fund will be used to meet the expenses of the OC.

Mandatory Implementation

Once the resolution plan prepared/presented by the lenders is ratified by the OC, it will be binding on all lenders. They will, however, have the option to exit as per the extant guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP).

SECURITISATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTEREST (SRFAESI) ACT 2002

The main objective of SRFAESI Act is to regulate securitisation and reconstruction of financial assets and enforcement of security interest to provide for a central database of security interest created on property rights and connected matters. Its main features are discussed in this Section with reference to **(a)** regulation of securitisation and reconstruction of financial assets of banks and financial institutions(FIs), **(b)** enforcement of security interest **(c)** central registry, **(d)** registration by secured/other creditors, **(e)** offences and penalties and **(f)** power of Government to make rules.

Regulation of Securitisation and Reconstruction of Financial Assets of Banks and Financial Institutions

The scheme of regulation of securitisation and reconstruction of financial assets is discussed below.

Registration To commence (new company) or carry on (existing company) the business of securitisation/asset reconstruction, an asset reconstruction company (ARC) must **(1)** be registered with the RBI and **(2)** have a minimum owned fund of ₹2 crore or any amount specified by the RBI. However, the RBI may specify different amounts for different class(es) of such companies. **Securitisation** is defined as acquisition of financial assets by ARC from any originator (i.e. the owner of the financial asset) by raising of funds from the ARC/**qualified buyers** (i.e. a financial institution/insurance company/banks/state financial corporation/state industrial development corporation/trustee or asset management company of a mutual fund, ARC, or a SEBI-registered foreign institutional investor/any category of non-institutional investors specified by the RBI or any other body corporate specified by the SEBI) by issue of security receipts representing undivided interest in such financial asset or otherwise. A **security receipt** means a receipt/other security issued by a ARC to any qualified buyer (QB) pursuant to a scheme as an evidence of purchase/acquisition by its holder of an undivided right/title/interest in the financial asset involved in securitisation. A **financial asset** refers to debt/receivables including **(i)** a claim to any secured/unsecured debt/receivables, **(ii)** any debt/receivables secured by mortgage of, charge on immovable property, **(iii)** a mortgage/charge/hypothecation/pledge of movable property, **(iv)** any right/interest in the security underlying such debt/receivables, **(v)** any existing/future/accruing/ conditional/contingent beneficial interest in movable/unmovable property or in such debt/receivables and **(vi)** any beneficial right/title/interest in any tangible asset given on hire or financial lease/conditional sale or under any other contract which secures the obligation to pay unpaid portion of the purchase price of the asset or an obligation incurred/credit provided to enable the borrower to acquire the asset, **(vii)** any right/title/interest on any intangible asset/license/assignment which secures the obligation to pay any unpaid portion of its purchase price or an obligation incurred/credit extended to enable the borrower to acquire the asset or obtain license of the asset, **(viii)** any financial assistance. **Hypothecation** means a charge in/upon any existing/future movable property created by a borrower in favour of a secured creditor without delivery of possession of the property to the creditor as a security for financial assistance and includes a floating charge and crystallisation of such charge into fixed charge on movable property. Included in **secured creditors** are banks/FIs/consortium or group of banks/FIs/debenture trustees appointed by a bank/FI/an ARC/any other trustee holding securities on behalf of the bank/FI, in whose favour security interest is created for due repayment by any borrower of any financial assistance. **Security interest** is the right/title/interest of any kind upon property created in favour of any secured creditor, other than the following: **(1)** a lien on any goods/money/security given by, or under the, Indian Contract Act/Sales of Goods Act/any other law for the time being in force, **(2)** a pledge of movables in terms of Section 172 of the Indian Contract Act, **(3)** creation of any security interest in any aircraft under the Aircraft Act, **(4)** creation of security interest in any vessel under the Merchant Shipping Act, **(5)** any rights of the unpaid seller under the Sales of Goods Act, **(6)** any properties not liable to attachment under the Code of Civil Procedure, **(7)** any security interest for securing repayment of any financial asset not exceeding ₹ one lakh, **(8)** any security interest created in agricultural land and **(9)** any case in which the amount due is less than 20 per cent of the principal amount and interest thereon. It includes **(i)** any mortgage/charge/hypothecation/assignment/any right/title of any kind on tangible asset retained by the secured creditor as an owner of the property given on hire/financial lease/conditional sale/any other contract which secures the obligation to pay any unpaid portion of its purchase price or an obligation incurred/credit provided to enable the borrower to acquire the asset; **(ii)** right/title/interest in any intangible asset or assignment/license which secures the obligation to pay an unpaid portion of the purchase price of the asset or obligation incurred/credit provided to enable the borrower to acquire the asset or license of the asset.

Asset reconstruction refers to the acquisition by an ACR of any right/interest of any bank/FI in any **financial assistance** (i.e., loans/advance granted or debentures/bonds subscribed or guarantees given or letters of credit established or any other credit facility extended by a bank/FI) including funds provided for acquisition of any tangible asset on hire-purchase or financial lease/conditional sale/any other contract/obtaining assignment or license of any intangible asset or purchase of debt securities.

The application for registration to the RBI by any ARC should be in the specified form/manner. Before granting registration, the RBI would satisfy itself by inspection of records/books of the applicant - ARC or otherwise that the following condition are satisfied: **(a)** the ARC has not made any loss in any of the preceding three years, **(b)** it has made adequate arrangements for realisation of financial assets acquired for securitisation/reconstruction and would be able to pay periodical returns and redeem on respective due date on the investments made in the company by the QBs/other persons, **(c)** its directors have adequate professional experience in matters related to finance, securitisation and reconstruction, **(d)** any of its Directors has not been convicted of any offence involving moral turpitude, **(e)** the **sponsor** (i.e. any person holding atleast 10 per cent of the paid-up equity capital of the ARC) is a fit/proper person in terms of the RBI-specified of guidelines, **(f)** it has complied with/is in a position to comply with the prudential norms specified by the RBI, and **(g)** it has complied with the conditions specified in the RBI guidelines issued for this purpose. While granting the certificate of registration, RBI may impose such conditions as it may deem fit. Prior approval of the RBI would be necessary for **(i)** any substantial change in the management (i.e. the change in management by way transfer of shares or change affecting the sponsorship by way of transfer of shares or amalgamation or transfer of its business) or **(ii)** change of location of the registered office or **(iii)** change in the name of the SRC. The decision of the RBI that the change in management in substantial or not would be final.

Cancellation of Registration The registration of an ARC can be cancelled by the RBI if it **(a)** ceases to carry on business of a SRC, **(b)** ceases to receive/hold any investment from a QIB, **(c)** has failed to comply with any condition subject to which the certificate of registration had been granted, **(d)** at any time fails to fulfil any of the conditions which were taken into account while considering application for registration, **(e)** fails to **(i)** comply with any directions issued by the RBI under the provisions of the SRFAESI Act, **(ii)** maintain accounts in accordance with any law/directions/order issued by the RBI under the provisions of the SRFAESI Act, **(iii)** submit/offer for inspection its books of accounts/other relevant documents when demanded by the RBI and **(iv)** obtain prior approval of the RBI for substantial change in its management/ change of location of its registered office/change in its name. Any ARC aggrieved by the order of cancellation of registration may prefer an appeal within 30 days from the date of the order of communication to the Government.

Acquisition of Rights/Interest in Financial Assets Any ARC may acquire financial assets of any bank (i.e. bank/corresponding new bank/SBI and its Subsidiaries/multi-state cooperative bank/others specified by government)/FI [i.e. a public financial institution (PFI), any institution specified by Government under the provisions of the Recovery of Debts and Insolvency Bankruptcy (code) Act, the International Finance Corporation, any other financial institution or non-banking finance company (NBFC) which the Government may specify as a financial institution] **(a)** by issuing a debenture/bond/any other security in the nature of a bond for consideration and on terms and conditions mutually agreed upon and **(b)** by entering into an agreement with them for the transfer of such financial assets on terms and conditions mutually agreed upon. If the bank/FI is a lender in relation to any financial asset so acquired by it, the ARC would be deemed to be the lender and all rights would vest in the ARC in relation to such financial assets. The rights/titles/interest upon any tangible/intangible asset of the bank(s)/ FIs would vest in the ARC. All contracts, deeds, bonds, agreements, powers of attorneys, grants of legal representation, permissions, approvals, consents or no objections under any law or otherwise and other instruments of whatever nature which relate to the relevant financial asset, and which are subsisting or having effect immediately before its acquisition would be of as full force and effect against/in favour of the ARC as may be enforced/acted upon as fully and effectively as if the ARC had been a parity in place of the bank/FI or as if they had been issued in favour of the ARC. Similarly, if on the date of the acquisition of the financial asset, any suit, appeal or other proceedings of whatever nature relating to the relevant financial asset is pending by or against the bank/FI, the same would not abate or be discontinued or be in any way prejudicially affected by reason of its acquisition by the ARC. The suit/appeal/other proceedings may be continued, prosecuted and enforced by/against the ARC.

On acquisition of financial assets, the ARC may, with the consent of the originator, file an application before the DRT/AT or any court/authority for substitution of its name in any pending suit/appeal/other proceedings who will pass the necessary order.

Transfer of Pending Application to Debt Recovery Tribunal (DRT) If any financial asset of a borrower acquired by a ARC comprises of secured debt of more than one bank/FI for the recovery of which an application has been filed before two or more DRTs by the banks/FIs, the concerned ARC may file an application to the Appelate Tribunal (AT) having jurisdiction over any DRT for transfer of all pending applications to one of the DRTs. The order passed by the AT would be binding on the DRTs.

Notice to Obligor and Discharge of his Obligations An **obligor** means a person liable to the **originator** (i.e. the owner of the financial asset acquired by the ARC) under a contract or otherwise to pay financial asset/discharge any obligation in respect of a financial asset whether existing, future, conditional or contingent and includes the borrower. A **borrower** means any person who has **(i)** been granted financial assistance by a bank/FI or **(ii)** given any guarantee/ created any mortgage or pledge as security for the financial assistance from the bank/FI. It includes a person who becomes borrower of an ARC consequent upon acquisition by it of any rights/ interests of any bank/FI in relation to such financial assistance or who raised funds through issue of debt securities. The bank/FI may give a notice of acquisition of financial assets by any ARC to **(i)** the concerned obligor/any other concerned person, **(ii)** the concerned registering authority including Registrar of Companies in whose jurisdiction the mortgage/charge/hypothecation/ assignment or other interest created on the financial assets has been registered. On receipt of the notice, the obligor should make payment to the ARC and such payment in discharge of any obligation in relation to the specified financial assets would be a full discharge from all liability in respect of such payment. Where no notice for acquisition of financial asset is given by a bank/ FI, money/other properties subsequently received by them, should constitute money/properties held in trust for the benefit, and on behalf, of the ARC and immediately made over/delivered to the ARC or its duly authorised agent.

Issue of Security by Raising of Receipts/Funds After acquisition of financial assets, an ARC may offer security receipts to the QBs or other category of investors including non-institutional investors specified by the RBI in consultation with the SEBI for subscription in accordance with the provisions of the Companies Act, SEBI Act, and Securities Contracts (Regulation) Act. It may raise funds from them by formulating schemes for acquiring financial assets. It should keep/maintain separate/distinct accounts for each scheme for every financial asset acquired out of investments made by a QB, and ensure that realisations of the financial assets are held and applied towards redemption of investments and payment of returns assured on such investments under the relevant scheme(s). The scheme for offering recurity receipts may be in the nature of a trust managed by the ARC which would hold the acquired assets/ funds raised for acquiring assets in trust for the benefit of the QBs. In case of non-realisation of financial assets, the QBs holding at least 75 per cent of the total value of the security receipts issued under a scheme would be entitled to call a meeting of all the QB to pass any resolution which would be binding on the ARC.

Exemption from Registration of Security Receipt Any issue or transfer of security receipt issued by an ARC which do not create, declare, assign, limit or extinguish any right/title/interest to/in immovable property except to the extent it entitles the holders of security receipts to an undivided interest afforded by a registered instrument, would not required compulsory registration.

Measures for Assets Reconstruction Any ARC may, for the purposes of asset reconstruction, provide for any one or more of the following measures, namely: **(a)** the proper management of the business of the borrower, by change in, or take over of, the management of its business; **(b)** the sale or lease of a part or whole of the business of the borrower; **(c)** rescheduling of payment of debts payable by the borrower; **(d)** enforcement of security interest in accordance with the provisions of this Act; **(e)** settlement of dues payable by the borrower; **(f)** taking possession of secured assets in accordance with the provisions of this Act, and **(g)** convert any portion of debt into shares of a borrower company. Such conversion would be deemed always to have been valid as if this stipulation was in force at all material times. The RBI may determine the policy and issue directions including for regulation of management of the business of the borrower and fees to be charged and ARC would have to comply.

Other Functions of ARC Any SRC may **(a)** act as an agent for any bank/FI for the purpose of recovering their dues from the borrower on payment of such fees or charges as may be mutually agreed upon between the parties; **(b)** act as a manager [i.e. any person to manage the secured assets (i.e. the property on which security interest is created) the possession of which has been taken over by the secured creditor (i.e. any bank/FI or any consortium group of banks/FIs and includes debenture trustees appointed by a bank/FI, a SRC, any other trustee holding securities on behalf of a bank/FI, in whose favour security interest is created for due repayment by any borrower of any financial assistance)] on such fee as may be mutually agreed upon between the parties; and **(c)** act as receiver if appointed by any court or tribunal. However, it cannot act as a manager if acting as such gives rise to any pecuniary liability.

Any ARC (other than a subsidiary) which has been granted a certificate of registration can commence or carry on, with the prior approval of the RBI, any business other than that of securitisation or asset reconstruction.

Resolution of Disputes Any dispute relating to securitisation or reconstruction or non-payment of any amount due including interest arising amongst any of the parties, namely, the bank/FI/an ARC/QBs would be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act, 1996, as if the parties to the dispute have consented in writing for determination of such dispute by conciliation or arbitration and the provisions of that Act would apply accordingly.

Power of RBI to Determine Policy and Issue Directions If satisfied that in the public interest or to regulate financial system of the country to its advantage or to prevent the affairs of any ARC from being conducted in a manner determined to the interest of investors or in any manner prejudicial to the interest of the ARC, it is necessary or expedient so to do, the RBI may determine the policy and give directions to all or any ARC in matters relating to income recognition, accounting standards, making provisions for bad and doubtful debts, capital adequacy based on risk weights for assets and also relating to deployment of funds and the ARC would be bound to follow the policy and the directions issued.

The RBI may issue directions in particular as to **(a)** the type of financial assets of a bank/FI which can be acquired and procedure for acquisition of such assets and valuation thereof; and **(b)** the aggregate value of financial assets which may be acquired by any ARC; **(c)** fee/other charges for management of the acquired financial assets; **(d)** transfer of security receipts issued by the QBs. **Security receipt** means a receipt/other security issued by an ARC to a QB evidencing the purchase/acquisition of an undivided right/title/interest in the concerned financial asset.

The RBI may also direct a SC/RC to furnish within the specified time statement(s)/information relating to its business/affairs as it may consider necessary/expedient to obtain for the purpose of the SRFAESIA.

Audit and Inspection by RBI The RBI may carry out /caused to be carried out audit/inspection of an ARC which would be duty-bound to provide necessary assistance/cooperation.

On being satisfied that the business of the ARC is being conducted in a manner detrimental to public interest/interest of investors, the RBI, to secure proper management, may **(i)** remove the chairman/director or appoint additional directors, **(ii)** appoint an officer to observe the working of the Board of Directors of the ARC. Every director/other officer/employee of the ARC would be duty-bound to produce all the concerned books/accounts/other documents in his custody/control and provide the required statements/information within the specified time.

Enforcement of Security Interest

Any security interest created in favour of any secured creditor would be enforced, without the intervention of the courts/tribunal, by the concerned creditor according to the provisions discussed below.

If a borrower who is under a liability to a secured creditor under any **security agreement** (i.e. an agreement/instrument/any other document or arrangement under which security interest is created in favour of the secured creditor including the creation of mortgage by deposit of title deeds with the secured creditor), defaults in repayment of his secured debt/any instalment and his account is consequently classified as NPA, the secured creditor may require by a written notice giving details of the amount payable and the secured assets intended to be enforced in the event of non-payment to discharge in full his liabilities within 60 days from the date of the notice. A borrower who has raised funds through debt securities need not classify secured debt as NPA. A debenture trustee would be entitled to enforce security interest in accordance with the terms/conditions of security documents executed in his favour. **Default** means non-payment of any debt/other amount payable by the borrower **(i)** to any secured creditor consequent upon which the account is classified as NPA, **(ii)** with respect to debt securities after 90-day notice demanding payment of dues by the debenture trustee/other authority in whose favour security interest is created for the benefit of the holders of these securities. A **NPA** means an asset/account of a borrower classified by a bank/FI as bub-standard, doubtful/loss asset in accordance with the directions/guidelines issued by the RBI/authority or body administering/regulating the banks/FIs. **Secured creditors** mean **(i)** bank/FI, consortium of banks/FIs holding right/title/interest upon any tangible/intangible asset, **(ii)** debenture trustee appointed by the banks/FIs, **(iii)** an ARC, **(iv)** SEBI-registered debenture trustee appointed by a company for secured debt securities, **(v)** any other trustee holding securities on behalf of a bank/FI in whose favour security interest is created by any borrower for due payment of financial assistance. The notice should give details of the amount payable by the borrower and the secured assets (i.e. the property on which security interest is created) to be reinforced by the secured creditor for non-payment of **secured debts** (i.e. a debt secured by a security interest) by the borrower. The secured creditor should consider any representation/objection by the borrower relating to the notice and within 15 days communicate the reason for non-acceptance/untenability of the objection/representation. On the basis of the reasons or the likely action of the secured creditor at the stage of communication, the borrower is not entitled to prefer an application to the DRT/Court of District Judge. Where the management of the whole/part of the business of the borrowed is severable, the secured creditor should take over the management of business relatable to the security for the debt. In case of failure of the borrower, the secured creditor may take recourse to one/more of the following measures to recover his debt:

- Take possession/take over management of the secured assets of the borrower including the right to transfer by way of lease/assignment/sale for realising the assets;
- Takeover the management of the business of the borrower including the right to transfer by way of lease/assignment/sale for realising the secured assets if the substantial part of the business of the borrower is held as security for the debt.
- Appointment a manager to manage the concerned secured assets; and
- Require at any time by written notice any person, who has acquired any of the secured assets from the borrower and from whom any money is due/may become due to the borrower, to pay the secured creditor so much money as is sufficient to pay the secured debt. Any payment made by such a person would give him a valid discharge as if the payment is made to the borrower.

Where the sale of an immovable property with a reserve price has been postponed for want of a valid bid, an authorised officer would be lawfully intitled to bid on behalf of the secured creditor at any subsequent sale. If the secured creditor purchases the property at the subsequent sale, the purchase price would be adjusted towards the claim for which the auction of enforcement of security interest is taken by him. The provisions of Section 9 of the Banking Regulation Act would apply to the acquired property.

All rights in, or in relation to, the secured asset would be vested in the transferee as if the transfer had been made by the owner (borrower) of the secured asset. All costs/charges/exposures properly incurred by the secured creditor, or expenses incidental there to, would be recoverable from the borrower. The money received by the secured creditor would be held in trust to be applied, firstly, in payment of such costs/charges/expenses and, secondly, in discharge of the creditors' dues. The balance would be paid to the person entitled thereto according to his rights and interests. If the total dues of the secured creditor including all costs/charges/expense incurred is tendered to him at any time before the date of publication of the notice for public auction/inviting quotations/tenders from public or private party for transfer by way lease/assignment/sale of the secured assets, they would not be transferred by way of lease/assignment/sale. If any step has been taken by the secured creditor, no further action would be taken by him in this regard. In case of financing of a financial asset by more than one secured creditor/joint financing, a secured creditor would be entitled to exercise any/all rights conferred on him on failure of the borrower to discharge in full his liabilities only with the agreement of the secured creditors representing at least 60 per cent of the amount outstanding, that is, principal, interest, any other dues payable by the borrower in respect of the secured asset as per the books of accounts of the secured creditor, as on a **record date** (i.e. the date agreed upon by the secured creditors representing not less than 60 per cent of the amount outstanding on that date). However, **(i)** in case of a company in liquidation, the realisation from the sale of secured assets would be distributed according to the provisions of Section 529-A of the Companies Act; and **(ii)** in case of winding up of a company, the secured creditor who opts to realise his security instead of reliquinshing it and proving his debt under Section 529(1) of the Companies Act may retain the sale proceeds of his secured assets of the depositing workmen's dues with the liquidator under Section 529-A of the Companies Act.

Where dues of a secured creditor are not fully satisfied with the sale proceeds of the secured assets, he may file an application to the Debt Recovery Tribunals or a competent court for recovery of the balance from the borrower.

The secured creditors would be entitled to proceed against the guarantors/sell the pledged assets without first taking any of the measures specified above, namely, **(i)** taking possession of secured assets, **(ii)** taking over of management of the secured assets, **(iii)** appointment of a manager to manage the secured assets and **(iv)** requiring any person owing money to the borrower to pay it to the secured creditor.

For taking possession/control of any secured asset, a secured creditor can take the help of Chief Metropolitan/District Magistrate or an authorised subordinate officer who would take possession of the asset(s)/document(s) and forward them to the secured creditor. The application of the secured creditor should be accompanied by an affidavit duly affirmed by its authorised officer declaring that **(i)** the aggregate financial assistance granted and the total claim as on date; **(ii)** the borrower has **(a)** created security interest over various properties with their details and the bank/FI is holding a valid/subsisting security interest over them and the claim is within the limitation period, **(b)** committed default in repayment of the total specified amount; **(iii)** consquent upon non-payment, the borrower account has been classified as NPA; **(iv)** 60 days notice demanding payment has been served on the borrower; **(v)** the objection/representation in reply to the notice has been considered and reasons for their non-acceptance has been communicated to the borrower; **(vi)** the borrower has not made any repayment in spite of the notice and the authorised officer is entitled to possession of the secured assets; and **(vii)** the provisions of the SRFAESI Act/rules had been complied with. On receipt of the affidavit from the authorised office, the Chief Metropolitan/District Magistrate would, after being satisfied about its contents, pass suitable order for possession of the concerned asset within 30 days which may be extended to 60 days for reasons beyond his control. The Chief Metropolitan/District Magistrate would take steps or use such force as may be necessary for the purpose. Their act cannot be questioned in any court or before any authority.

Manner and Effect of Take Over of Management On taking over of the management of a borrower, the ARC secure borrower/secured creditor by publishing a notice in an English newspaper and a newspaper in an Indian language in circulation in a place where the principal office of the borrower is situated, may appoint director(s) in case of company-borrowers and administrator(s) in other cases. All persons holding office as directors of the company/holding any office and having power of superintendence, directions and control of the business of the borrower would be deemed to have vacated their respective offices. Any contract of management between the borrower and any director/manager would be deemed to be terminated. All the property and effects of the business of the borrower would be deemed to be in the custody of the director(s)/

administrator(s) appointed by the secured creditors from the date of the publication of the notice. They alone would be entitled to exercise all powers derived from the memorandum or articles of association of the company of the borrower or from any other source.

After the takeover of the management of the business of the borrower-company by the secured creditor, shareholders/any other person cannot lawfully appoint/nominate a director, unless approved by the secured creditor, any shareholders resolution cannot be implemented and proceedings for its winding up/appointment of a receiver would lie in any court only with his consent. On realistion of his debt in full, the secured creditor would restore the management of the business of the borrower to him. However, no managing director/director/ manager/ any person in charge of management of the business of the borrower would be entitled to any compensation for the loss of office/premature termination of any contract of management entered into by him with the borrower. But they can recover from the business of the borrower moneys recoverable otherwise than by way of compensation.

Application Against Measures to Recover Secured Debts Any person, including a borrower, aggrieved by any of the measures taken by the secured creditor/his authorised officer to enforce his security interest, when a borrower fails to discharge his liability in full, may make as application along with the prescribed fee to the DRT (Debt Recovery Tribunal) within 45 days from the date on which such measure had been taken. The application should be files before the DRT within the local limits of whose jurisdiction **(a)** cause of action arises, **(b)** where the concerned asset is located, **(c)** branch/any other office of a bank/FI is maintaining an account in which debt claimed is outstanding. The DRTs would consider whether any measure taken by the secured creditor for enforcement of security **(discussed earlier)**, namely, possession of secured assets, takeover of management, appointment of manager to manage the secured assets and issue of notice to any person who has acquired any of the secured assets of the borrower) is in conformity with the provisions of the SRFAESI Act/rules. If, after examination of the facts/circumstances of the case and evidence produced by the parties, any measure taken by the secured creditor is found to the violative of these, the DRT may declare the measure invalid and restore the possession/management of the secured assets to the borrower/any other person and pass any other appropriate/necessary direction in relation to any recourse taken by the secured creditor. The DRT would dispose of the application of the borrower within 60 days but in no case beyond 4 months, failing which the borrower can make application to the Appellate Tribunal (AT) for expeditions disposal of the pending application.

Any person aggrieved by an order of the DRT may prefer an appeal along with the prescribed fee to the AT within 30 days. The borrower must deposit with the AT atleast 50 per cent of the amount of debt due from him as claimed by the secured creditor or determined by the DRT whichever is less. For reasons recorded in writing, the AT can reduce the amount of deposit to 25 per cent.

Where an application/appeal is expected to be made or has been made, the secured creditor/ any person claiming a right to appear before the Tribunal/District Judge/Appelate Tribunal may lodge a caveat in respect of the hearing of the application/appeal. The caveat would remain in force for 90 days from the date on which it was lodged.

If the DRT/AT holds that the possession of secured assets by the secured creditor is not in accordance with the provision's of the SRFAESI Act/rules and directs it to return them to the concerned borrower, the borrower would be entitled to the payment of cost/compensation as may be determined by the DRT/AT.

Central Registry

The provisions relating to central registry are discussed below.

The Government may set up a Central Registry for registration of transaction of securitisation and reconstruction of financial assets and creation of security interest. The Government for providing a central database may integrate the registration records of the registration systems for recording rights over any property or creation/modification/satisfaction of any security interest of the concerned property with the records of the central registry. It may delegate its powers to the RBI. It may also appoint a Central Registrar for registration of transactions relating to securitisation, reconstruction of financial assets and security interest created over properties. A Central Register would be kept at the head office of the Central Registry for entering the particulars of transactions relating to **(1)** securitisation of financial assets, **(2)** their reconstruction and **(3)** creation of security interest. The particulars of all such transactions should be filed with the Central Registrar in the specified manner together with the prescribed fee.

The Government may require the registration of transactions relating to different types of security interest created on different kinds of property with the Central Registry. It may also prescribe the forms and fee charged for the registration. Whenever the terms/conditions/extent/operation of any security interest registered are modified, the ARC/secured creditor would be duty bound to send the particulars of the modifications to the Central Registrar. They would also have to give intimation to the Central Registrar of the payment or satisfaction in full of any security interest within 30 days on the basis of which a memorandum of satisfaction would be entered into the Central Register. On receipt of the intimation, the Central Registrar would order that a memorandum of satisfaction should be entered into the Central Register. If the concerned borrower gives an intimation for not recording the payment/satisfaction, the Central Registrar would send a show cause notice to the ARC secured creditor within 14 days as to why payment/satisfaction should not be recorded. If no cause is shown, a memorandum of satisfaction would be entered. If a cause is shown, the Central Registrar would inform the borrower.

The particulars of securitisation/reconstruction/security interest entered in the Central Register would be open for inspection by any person on payment of the prescribed fee.

The Government, on being satisfied that **(a)** the omission to file with the Registrar the particulars of any transaction of securitisation/asset reconstruction/security interest or its modification/satisfaction or the omission/mis-statement of any particular to such transaction/modification/satisfaction or any other entry was accidental/inadvertent or due to some other sufficient cause or is not of a prejudicial nature to the position of creditors, **(b)** on other grounds, it is just/equitable, may direct that the time for filing of the particulars of the transaction for registration/modification/satisfaction should be extended or the omission/mis-statement should be rectified. However, the extension of time would not prejudice any rights acquired in respect of the property/financial asset concerned before the actual registration of the transaction.

Registration by Secured/Other Creditors

The Government may extend the provisions relating to Central Registry to all creditors other than secured creditors for creation/modification/satisfaction of any security interest over any property of a barrower for securing due payment of any financial assistance granted by them. But they would not be entitled to exercise any right of enforcement of securities. They may file particulars of attachments, of any property of any person liable to pay tax/Government dues by any authority/officer of Government/local authority entrusted with the function of their recovery, with the Central Registry with particulars of the assesse and details of tax/other Government dues in the prescribed manner and as payment of the prescribed fee. The registration of transaction/filing of attachment orders would be deemed to be a public notice. The claims of such creditors would have priority over any subsequent security interest.

A secured creditor would be entitled to exercise the enforcement of securities only if the security interest created in its favour by the borrower has been registered with the Central Registry. After the registration of security interest, the debts due to any secured creditor would be paid in priority over all other debts/revenues/taxes/cesses/other rates payable to Government/local authority.

In cases where insolvency/bankruptcy proceedings are pending in respect of secured assets of the borrower, priority to secured creditors would be subject to the Insolvency and Bankruptcy (IB) Code **(discussed in the next section of this chapter)**.

Offences and Penalties

Any default made **(a)** in filing the particulars of every transaction of securitisation/ asset reconstruction/security interest created by a ARC/secured creditor, **(b)** in sending the particulars of the modifications of security interest registered and **(c)** in giving intimation of payment/satisfaction in full, would be punishable with fine up to ₹5,000 for every day of default. The penalty for non-compliance of the RBI directions on questions of polity as well furnishing of statement/information by any SRC would be fine up to ₹5 lakh, with an additional fine of ₹10,000 for every day during which the default continues. Offences involving contravention/attempts to contravention/abetment of contravention of the provisions of the SRFAESI Act/rules would be punishable with imprisonment for a term up to one year or with fine or with both.

No court would take cognizance of any offence in relation to any non-compliance of any provisions of the SRFAESI Act except upon a written complaint by a generally/specially authorised officer of the Central Registry/RBI. Only a court of a Metropolitan/Judicial Magistrate of the first class can try any offence punishable under the SRFAESI Act.

On failure to comply with any RBI direction by ARC/any person, the adjudicating authority (i.e. officer/committee of officers designated by the RBI) may impose a penalty of the higher of **(i)** ₹1 crore, **(ii)** twice the amount involved in the failure. For continuing failure, a further penalty up to ₹1 lakh for every day during which it continues may be imposed. The penalty must be paid within 30 days failing which the registration of the ARC may be cancelled. An aggrieved person may within 30 days file an appeal to the Appellate Authority (AA). The penalty would be recovered as a **recoverable** sum payable within 30 days by the person in default failing which the RBI would **(i)** debit the current account/liquidate the securities held in its books, **(ii)** issue notice to **persons** (e.g. post offices/banks/insurance companies etc.) from whom amount is due to the concerned person to deduct the concerned amount and pay to the RBI. A person discharging any liability to any person in default after the receipt of the notice would be personally liable to the RBI the lesser of the extent of **(i)** his own liability to the defaulter, **(ii)** recoverable sum payable to the RBI. On failure to make payment in pursuance of the notice, he would be deemed to be the person in default and action/proceedings may be taken/instituted against him for the realisation of the amount in the specified manner. The RBI may enforce recovery of the recoverable sum through the appropriate civil court as if the notice was a decree of a court. An application for the enforcement of the recovery should be made to the principal court by an authorised officer of the RBI certifying the concerned person has failed to pay the recoverable sum.

Where an offence is committed by a company (i.e. a body corporate including a firm/other association of individuals), every person who, when the offence was committed, was in charge of, and was responsible to the company for the conduct of its business as well as the company would be deemed to be guilty of the offences and liable to punishment. However, if he proves that the offence was committed without his knowledge/he had exercised due diligence to prevent the commission of such offence, such a person would not be liable. Where it is proved that the offence was committed by a company with the consent/convenience of, or is attributable to, any neglect on the part of any director/partner in a firm, manager, secretary, other officer, he would be deemed to be guilty of the offence. A civil court would neither have jurisdiction to entertain any suit/proceedings in respect of any matter, which a DRT/AT is empowered to determine nor grant any injunctions against any action taken/to be taken in pursuance of any power conferred by the SRFAESI Act or the Recovery of the Debts and Insolvency Bankruptcy Act.

Exemptions

The Government, in public interest, may direct that any of the specified provisions of the SRFAESI Act would **(i)** not apply a bank(s)/FI(s), (ii) apply with exceptions/modifications/adaptations.

Powers of Government to Make Rules

The Government may make rules for carrying out the provisions of the SRFAFSI Act, in particulars to provide, *inter-alia*, for the following matters:

- The form and manner in which an application may be filed to the DRTs for recovery of balance amount,
- The manner in which the rights of a secured creditor may be exercised by his officer(s),
- The fee for making an application to the DRTs/preferring an appeal to the AT and the form of making an application to the AT,
- The manner of integration of records of various registration systems with the records of the Central Registry,
- The safeguards subject to which records may be kept in the Central Register,
- The manner in which the particulars of every transaction of securitisation would be filed with the Central Registrar and fee for filing such transaction,
- The forms for registration of different types of security interests and fee,
- The fee for inspecting particulars of transactions entered in the Central Register,
- The fee for inspecting the Central Register maintained in electronic form,
- The form and manner of filing (i) particulars of transactions (ii) attachment orders with the Central Registry and the date/fee,
- Any other matter requiring to be prescribed as per rules.

RBI Guidelines and Direction

Under the SRFAESI Act, 2002, the RBI has to grant certificate of registration to SRCs to commence/carry on business and suggest conditions and eligibility criteria. It is empowered **(a)** to frame guidelines to enable such companies to take necessary measures for the purpose of asset reconstruction, namely, management of the business of a borrower, sale/lease of a business of the borrower, rescheduling of debt repayment, enforcement of security, settlement of dues, taking possessions of secured assets and so on, **(b)** to prescribe appropriate prudential norms relating to income recognition, accounting standards, provisioning, capital adequacy and deployment of funds for such companies, and **(c)** to issue directions either generally or to a particular class of companies or to a company or companies regarding deployment of funds, acquisition of any type of financial assets, their valuations and aggregate value of financial assets that can be acquired.

The RBI directions/guidelines for the SRCs relate to the following: **(1)** The SRCs (RBI Guidelines and Directions) 2003, **(2)** Guidance Notes for SRCs, 2003 **(3)** Guidelines on Sale of Financial Assets for SRCs, 2003, **(4)** Fair Practice Code on Lenders Liability, 2003, **(5)** Guidelines on Securitisation of Standard Assets, 2006, **(6)** Guidelines on Change in or Takeover of Management of Business of Borrowers, 2011, and **(7)** Guidelines on Transfer of Assets Through Securitisation and Direct Assignment of Cash Flows, 2012..

RBI's SRCs Guidelines and Directions, 2003 The RBI, having considered it necessary in the public interest and being satisfied that for the purpose of enabling it to regulate the financial system to the advantage of the country and to prevent the affairs of any SRC from being conducted in a manner detrimental to the interest of the investors or in any manner prejudicial to the interest of the SRC, it is necessary to issue guidelines and directions relating to registration, measures of asset reconstruction, functions of the SRC, prudential norms, acquisition of financial assets and related matters thereto, has issued the SRCs (RBI) Guidelines and Directions, the main elements of which are discussed below.

Registration Every SRC having a minimum of owned funds of ₹2 crore should obtain a certificate of registration from the RBI. However, a SC/RC seeking registration with the RBI or carrying on business on March 29, 2004, should have a minimum owned fund of 15 per cent of the total financial assets acquired/to be acquired by it on an aggregate basis or ₹100 crore whichever is less. In no case, the minimum owned fund would be less than ₹2 crore. The amount should continue to be held by the SC/RC until realisation of assets and redemption of security receipts against them. In addition to other modes of deployment of funds (**discussed later**), the SC/RCs should invest in the security receipts issued by the trust set up for the purpose of securitisation an amount not less than 5 per cent under each scheme. It can undertake both securitisation and reconstruction activities. Any entity not registered with the RBI may conduct the business of securitisation/asset reconstruction outside the purview of the SARFASI Act. **Owned funds** mean the aggregate of paid-up equity capital, paid-up preference capital to the extent it is compulsorily convertible into equity capital, free reserves (excluding revaluation reserve), credit balance in profit and loss account as reduced by the debit balance on the profit and loss account and miscellaneous expenditure (to the extent not written-off/adjusted), book value of intangible assets and under/short provisions against NPAs/diminution in the value of investments and over-recognition of income if any; and further reduced by the book value of the shares aquired in a SRC and other deductions required on account of the items qualified by the auditors in their reports on the financial statements. A **NPA** means an asset in respect of which **(a)** interest/principal overdue (i.e. remains unpaid beyond the due date) 180 days or more) from the date of acquisition (i.e. the date on which the ownership of the financial assets has been acquired by the SRC) or the due date as per contract between the borrower and the originator whichever is latter, **(b)** from the date fixed for receipt in the plan formulated for realisation of the assets (which is discussed later under asset reconstruction), **(c)** is overdue on expiry of the planning period [i.e. a period not exceeding 12 months allowed for formulating a plan for realisation of NPAs (in the books of the originator) acquired for the purpose of reconstruction] where no plan is formulated for realisation of the assets (as discussed later under asset reconstruction) and **(d)** any other receivables if overdue for 180 days or more in the books of the SRC. However, the Board of Directors of the SRC may classify a borrower in default as NPA even earlier than 180 days for facilitating enforcement as provided in Section 13 of the SRFAESI Act.

Permissible Business Any SRC can undertake only securitisation and asset reconstruction activities as well as the functions provided for in Section 10 of the SRFAESI Act (**discussed earlier**). It is not permitted to raise money by way of deposit.

Asset Reconstruction The elements of the directions/guidelines relating to asset reconstruction by the SRCs are: **(i)** acquisition of financial assets, **(ii)** change/take over of management/sale or lease of business of the borrower, **(iii)** rescheduling of debts, **(iv)** enforcement of security interest, **(v)** settlement of dues payable by the borrower and **(vi)** plan for realistion.

Acquisition of Financial Assets Every SRC should frame with the approval of its Board of Directors, a Financial Asset Acquisition Policy, within 90 days of the grant of certificate of registration, clearly laying down the policies and guidelines covering, *inter alia*, **(a)** norms and procedure for acquisition either on its own books or directly in the books of the trust, **(b)** types and the desirable profile of the assets; **(c)** valuation procedure ensuring that the assets acquired have realisable value which is capable of being reasonably estimated and independently valued; **(d)** in the case of financial assets acquired for asset reconstruction, the broad parameters for formulation of plans for their realisation. The Board of Directors may delegate powers to a committee comprising any director and/or any functionaries of the company for taking decisions on proposals for the acquisition of financial assets. Any deviation from the policy should be made only with the approval of the Board of Directors. The SRCs are permitted to acquire debts from other SRCs on the following conditions: **(i)** The acquisition is for debt aggregation for the enforcement of the security interest and the acquiring SRC's (i.e. aggregating SRC) existing debt are below 60 per cent and the proposed acquisition would result in its holding more than 60 per cent of the total secured debt; **(ii)** The transaction is settled on cash basis; **(iii)** The proceeds would be utilised by the selling SRC for redeeming the underlying security receipts; **(iv)** The acquisition would not **(a)** result in extension of the data of redemption of the security receipts of the aggregating SRC form the acquired assets, **(b)** extend the period of realisation of assets beyond 8 years from the date of acquisition of the asset by the aggregating SRC from the concerned bank/FIs.

Change/Take Over of Management/Sale or Lease of Business of the Borrower The SRCs would take these measures under the RBI guidelines (**discussed later in this Section**).

Rescheduling of Debts Every SRC should frame a policy, duly approved by the Board of Directors, laying down the broad parameters for rescheduling of debts due from borrowers. All proposals should be in line with and supported by an acceptable business plan, projected earnings and cash flows of the borrower. They should not materially affect the asset liability management of the SRC or the commitments given to the investors. The Board of Directors may delegate powers to a committee comprising any director and/or any functionaries of the company for taking decisions on proposals for reschedulement of debts. Any deviation from the policy should be made only with the approval of the Board of Directors.

Enforcement of Security Interest The SRCs have to obtain the consent of 60 per cent of the secured creditors for enforcement of security interest. While taking recourse to the sale of secured assets in terms of Section 13(4) of the SRFAESI Act, a SRC may itself acquire the secured assets, either for its own use or for resale, only if the sale is conducted through a public auction.

Settlement of Dues Payable by the Borrower The SRCs should frame a policy duly approved by the Board of Directors laying down the broad parameters for settlement of debts due from borrowers. The policy may, *inter alia* cover aspects such as cut-off date, formula for computation of realisable amount and settlement of account, payment terms and conditions, and borrower's capability to pay the amount settled. Where the settlement does not envisage payment of the entire amount agreed upon in one instalment, the proposals should be in line with and supported by an acceptable business plan, projected earnings and cash flows of the borrower. The proposal should not materially affect the asset liability management of the SRC or the commitments given to investors. The Board of Directors may delegate powers to a committee comprising any director and/or any functionaries of the company for taking decisions on proposals for settlement of dues. Any deviation from the policy should be made only with the approval of the Board of Directors. Promoters of the defaulting company/borrowers/guarantors are allowed to buy-back their assets subject to the specified conditions.

Every SRC should frame a Board-approved policy, laying down the broad parameters for conversion of debt into shares of the borrower-company. In case of the financial assets which have turned around potential after restructuring but normally with huge default and unsustainable level of debt, it should be necessary to arrive at a sustainable level of debt, on the basis of evaluation of detailed business plan with the projected level of operations, which can be serviced by the company. A part of the residual unsustainable debt may be converted into equity for an optimal debt equity structure. While the SRCs are permitted to have a significant influence/say in decisions surrounding the borrower's turnaround through conversion of debt into equity, they should not be seen to be running the companies. Their shareholding should not exceed 26 per cent of post-converted equity of the company under reconstruction.

Plan for Realisation The SRCs may, within the planning period, [i.e. a period upto 12 months allowed for formulating a plan for realisation of NPAs (in thebooks of the originator) acquired for the purpose of reconstruction] formulate a plan for realisation of assets, which may provide for one or more of the following measures:

- **(a)** Rescheduling of payment of debts payable by the borrower;
- **(b)** Enforcement of security interest in accordance with the provisions of the SRFAESI Act;
- **(c)** Settlement of dues payable by the borrower;
- **(d)** Change or take over of the management, or sale or lease of the whole or part of business of the borrower after formulation of necessary guidelines in this behalf by the RBI (**discussed later in this Section**).
- **(e)** Conversion of any portion of debt into shares of a borrower company.

The SCs/RCs should formulate the policy for realisation of financial assets within five years from the date of its acquisition (i.e. the date on which the ownership is acquired either on its own books or directly in the books of the trust). This period may be increased by their Board of Directors to eight years who should also specify the steps to be taken to realise the financial assets. The QIBs would be entitled to invoke the provisions relating to the rescheduling of debts only at the end of the extended period (i.e. 8 years).

Securitisation Included in the guidelines/directions are the following.

Issue of Security Receipts A SRC should give effect to the provisions of Section 7(1) and (2) of the SRFAESI Act through one or more trusts set up exclusively for the purpose. It should transfer the assets to them at the price at which those were acquired from the originator if the assets are not acquired directly on the books of the trust. The trusts should issue security receipts only to qualified institutional buyers, and hold and administer the financial assets for their benefit. The trusteeship of the trusts should vest with the SRC. Prior to such an issue, the SRC should formulate a policy, duly approved by the Board of Directors, providing for issue of security receipts under each scheme formulated by the trust. The SRCs can invest upto 15 per cent of the security receipts of each class issued by them under each scheme till the redemption of all the security receipts. The policy should provide that the security receipts issued would be transferable/assignable only in favour of other qualified institutional buyers.

Restructuring Support Finance A SRC can utilise a part of funds raised under a scheme from the QBs for restructuring of financial assets acquired under the relative scheme if it has acquired assets in excess of ₹500 crore. Nor more than 25 per cent of the funds can be utilised for the scheme which should be disclosed upfront in the scheme. They should be separately accounted for. The SRCs should frame a policy approved aby its Board of Directors laying down the broad parameters for utilisation of funds raised from the QBs under the scheme.

Disclosures Every SRC intending to issue security receipts should make disclosures as mentioned below:

(1) Disclosure in Offer Document

(A) Relating to the Issuer of Security Receipts

(i) Name, place of registered office, date of incorporation, date of commencement of business of the SRC;
(ii) Particulars of sponsors, shareholders, and a brief profile of the Directors on the Board of the SRC with their qualifications and experience;
(iii) Summary of financial information of the company for the last three years or since commencement of business of the company, whichever is shorter;
(iv) Details of securitisation/asset reconstruction activities handled, if any, in the last three years or since commencement of business, whichever is shorter.

(B) Terms of offer

(i) Objects of offer;
(ii) Description of the instrument giving particulars relating to its form, denomination, issue price, etc. together with an averment that the transferability of security receipts is restricted to the qualified institutional buyers;
(iii) Arrangements made for management of assets and extent of management fee charged by SRC;
(iv) Interest rate/probable yield;
(v) Terms of payment of principal/interest, date of maturity/redemption;
(vi) Servicing and administration arrangement;
(vii) Details of credit rating, if any, and a summary of the rationale for the rating;
(viii) Description of assets being securitised;

(ix) Geographical distribution of asset pool;
(x) Residual maturity, interest rates, outstanding principal of the asset pool;
(xi) Nature and value of underlying security, expected cash flows, their quantum and timing, credit enhancement measures;
(xii) Policy for acquisition of assets from banks/financial institutions;
(xiii) Terms of acquisition of asses and the valuation methodology adopted;(xiv) Details of performance record with the originators;
(xv) Terms of replacement of assets, if any, to the asset pool;
(xvi) Statement of risk factors, particularly relating to future cash flows and steps taken to mitigate the same;
(xvii) Arrangements, if any, for implementing asset reconstruction measures in case of default;
(xviii) Duties of the trustee;
(xix) Specific asset reconstruction measures, if any, on which approvals would be sought from investors;
(xx) Dispute redressal mechanism

(2) Disclosures on Quarterly Basis

(i) Defaults, prepayments, losses, if any, during the quarter;
(ii) Change in credit rating, if any;
(iii) Change in profile of the assets by way of accretion to or realisation of assets from the existing pool;
(iv) Collection summary for the current and previous quarter;
(v) Any other material information, which has a bearing on the earning prospects affecting the qualified institutional buyers.

Requirement as to Capital Adequacy The SRC should maintain, on an ongoing basis, a capital adequacy ratio of not less than 15 per cent of its total risk-weighted assets. The risk-weighted should be calculated as the weighted aggregate of on-balance sheet and off-balance sheet items as detailed below.

	Percentage risk weight
On-Balance Sheet Items	
(a) Cash and deposits with scheduled commercial banks	0
(b) Investments in Government securities	0
(c) Other assets	100
Off-Balance Sheet Items	
All contingent liabilities	50

Shares held in other SRCs would not attract any risk weight.

Deployment of Funds The SRC, may as a sponsor and for the purpose of establishing a joint venture, invest in the equity share capital of a SRC formed out of the purpose of asset reconstruction. It may deploy any surplus available with it only in Government securities and deposits with scheduled commercial banks, SIDBI, NABARD, and other entities specified by the RBI. It should not invest in land and buildings except for its own use up to 10 per cent of its owned funds or acquired in satisfaction of claims in ordinary course of business of reconstruction of assets according to the SARFAESI Act. They should be disposed within five years/extended period by the RBI in the interest of realisation.

Accounting Year Every SRC should prepare its balance sheet and profit and loss account as on March 31 every year.

Asset Classification The stipulations are as follows.

Classification After taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, the SRCs should classify the assets held in own books into the following categories, namely: **(a)** standard assets and **(b)** non-performing assets. The non-performing assets should be classified further as **(a)** 'sub-standard assets' for a period not exceeding twelve months from the date it was classified as non-performing assets; **(b)** 'doubtful asset' if the asset remains a sub-standard asset for a period exceeding twelve months; **(c)** 'loss assets' if the asset is **(A)** non-performing for a period exceeding 36 months; **(B)** adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security; **(C)** been identified as loss asset by the SRC or its internal or external auditor; or **(D)** the financial asset including security receipts is not realised within the specified time frame and the SRC/trust continue to hold them.

Asset Reconstruction **Renegotiated/Rescheduled Assets** Where the terms of agreement regarding interest and/or principal relating to standard asset have been renegotiated or rescheduled by a SRC, (otherwise than during planning period) the asset concerned should be classified as sub-standard asset with effect from the date of renegotiation/reschedulement or continue to remain as a doubtful asset as the case may be. The asset may be upgraded as a standard asset only after satisfactory performance for a period of twelve months as per the renegotiated/reschedulement terms.

Provisioning Requirements Every SRC should make provisions against NPAs, as under:

Asset Category	*Provision required*
Sub-standard assets	A general provision of 10 per cent of the outstanding
Doubtful assets	**(i)** 100 per cent provision to the extent the asset is not covered by the estimated realisable value of security; **(ii)** In addition to item **(i)** above, 50 per cent of the remaining outstanding
Loss assets	The entire asset should be written-off. (If, for any reason, the asset is retained in the books, 100 per cent thereof should be provided for).

Investments Investments in security receipts where the underlying cashflows are dependent on realisation from NPAs should be classified as available for sale (**AS**). They may be aggregated for arriving at net depreciation/appreciation of investments. Net depreciation should be provided. Net appreciation should be ignored. All investments should be valued at the lower of cost or realisable value. Where market rates are available, the market value would be presumed to be the realisable value and in cases where market rates are not available, the realisable value should be the fair value (i.e. the mean of the earning value and the breakup value). However, investments in other registered SRCs should be treated as long-term investments and valued in accordance with the Accounting Standards and Guidance Notice issued by the Institute of Chartered Accountants of India.

Income Recognition The yields on security receipts (SRs) should be recognised only after the full redemption of the entire principal. Upside income should be recognised only after full redemption of the SRs. Management fee before the availability of NAVs of the SRs should be reckoned as a percentage of its actual outstanding value. It should be calculated/charged as percentage of the NAV at the lower end of the range specified by the credit rating agency but it should not exceed the acquisition value of the underlying asset. It may be recognised on accrual basis and must be realised with 180 days from the date of expiry of the planning period/recognition and unrealised fee should be reversed. It should be reversed if before the prescribed time for realisation, the NAV of the SRs falls below 50 per cent of the face value. The income recognition on all other items should be based on recognised accounting principles. All the Accounting and Guidance Notes issued by the Institute of Chartered Accountants of India should be followed in so far as they are not inconsistent with the guidelines and directions contained here. Interest and any other charges in respect of all the NPAs should be recognised only when they are actually realised. Any such unrealised income recognised by a SRC before the asset became non-performing and remaining unrealised should be derecognised.

Disclosure in the Balance Sheet Every SRC should, in addition to the requirements of Schedule VI of the Companies Act, prepare the following schedules and annex them to its balance sheet:

(i) The names and addresses of the banks/financial institutions from whom financial assets were required and the value at which such assets were acquired from each of them;

(ii) Dispersion of various financial assets industry-wise and sponsor-wise (dispersion is to be indicated as a percentage to the total assets);

(iii) Details of related parties as per Accounting Standard and guidance notes issued by the Institute of Chartered Accountants of India and the amounts due to and from them; and

(iv) A statement clearly charting therein the migration of financial assets from standard to non-performing.

(v) Value of financial assets **(1)** acquired during the year on its books/books of the trust, **(2)** realised/outstanding during the year.

(vi) Value of security receipts **(1)** redeemed partially/fully during the year, **(2)** pending for redemption at the end of the year, and **(3)** which could not be redeemed as a result of non-realisation of the financial assets.

(vii) Value of land/building acquired in normal course of business of reconstruction of assets year-wise.

(viii) Basis of valuation of assets if the acquisition value of the asset exceeds the book value.

(ix) Details of the assets disposed of (by write-off or realisation) during the year at a discount exceeding 20 per cent of valuation as on the previous year and reasons.

(x) Details of assets where the value of the SRs has declined more than 20 per cent below the acquisition value.

The accounting policies adopted in the preparation and presentation of the financial statements should be in conformity with the applicable prudential norms prescribed by the RBI. Where any of the accounting policies is not in conformity with these directions, the particulars of departures should be disclosed together with the reasons and the financial impact on account. Where such an effect is not ascertainable, the fact should be so disclosed citing the reasons thereof.

An inappropriate treatment of an item in balance sheet or profit and loss account cannot be deemed to have been rectified either by disclosure of accounting policies used or by disclosure in notes to balance sheet and profit and loss account.

Internal Audit The SRCs should put in place an effective internal control system providing for periodical checks and review of the asset acquisition procedures and asset reconstruction measures followed by the company and matters related thereto.

Exemptions The RBI may, if it considers necessary for avoiding any hardship to any SRC, or for any other just and sufficient reason, exempt all or a particular or class of SRC(s), from all or any of the provisions of these guidelines and directions either generally, or for any specified period, subject to such conditions and it may impose.

Prior Approval The RBI's prior approval would be required for transfers of shares resulting in **substantial change** in **management** in case of transfer by which **(i)** the transferee becomes/ transferor ceases to be a sponsor, **(ii)** an aggregate transfer of atleast 10 per cent of the paid-up share capital of the SRC by a sponsor during five years commencing from the date of CoR.

Guidance Notes for SRCs Since the asset reconstruction activity mainly centres around non-performing loan assets, the whole process of asset reconstruction and matters related thereto has to be initiated with due diligence and care, warranting the existence of a set of clear instructions which should be complied with by all the SRCs so that the process of asset reconstruction proceeds on smooth and sound lines. In addition, there is a need for specific guidance to these companies on certain matters. The need for some healthy and uniform guidelines has been further necessitated by the fact that there is no prior experience as to the functioning of these companies. Accordingly, the RBI has framed a set of guidance notes listed below in certain matters which are recommendatory in nature. They relate to: **(a)** acquisition of financial assets, **(b)** engagement of outside agency and **(c)** sales committee.

Acquisition of Financial Assets The stipulations relating to the acquisition of financial assets by the SRCs are as follows:

- The asset acquisition policy should provide that the transactions take place in a transparent manner and at a true price in a well-informed market, and the transactions are executed at arm's length in exercise of due diligence;
- The share of financial assets to be acquired from the bank/FI should be appropriately and objectively worked out, keeping in view the provisions in the SRFAESI Act requiring consent of secured creditors holding not less than 75 per cent of the amount outstanding to a borrower for the purpose of the enforcement of the security interest;
- For easy and faster realisability, all financial assets due from a single debtor to various banks/FIs may be considered for acquisition. Similarly, financial assets having linkages to the same collateral may be considered for acquisition to ensure relatively faster and easy realisation. However, a balanced approach taking into account the risk in such acquisition may be adopted while deciding on the asset for acquisition;
- Both fund and non-fund based financial assets may be included in the list of assets for acquisition. The standard assets in the books of the originator likely to face distress prospectively may also be acquired;
- Acquisition of funded assets should not include take over of outstanding commitments, if any, of bank/FI to lend further. The terms of acquisition of security interest in non-fund transactions, should provide for the relative commitments to continue with bank/FI, till demand for funding arises;
- Loans not backed by proper documentation should be avoided;

- As far as possible, the valuation process should be uniform for assets of the same profile and a standard valuation method should be adopted to ensure that the valuation of the financial assets is done in scientific and objective manner. The valuation may be done internally and/or by engaging an independent agency, depending upon the value of the assets. Ideally, valuation may be entrusted to committee authorised to approve acquisition of assets, which should carry out the task in line with an asset acquisition policy laid down by the Board of Directors in this regard;
- A record indicating therein the details of deviations made from the prescriptions of the Board of Directors in the matter of asset acquisition, pricing, and so on, and their reasons should be maintained;
- To ensure functioning of the SRCs on healthy lines, their operations and activities may be subjected to periodic audit and checks by internal/external agencies.

Issue of Security Receipts The parties in question may finalise the price at which financial assets would be sold and security receipts would be issued as per the mutually agreed terms and on assessment of the risk involved. The issuer may consider obtaining credit rating of the security receipt from any of the recognised credit rating agencies. The matters relating to charging of 'management fee' and expenses by the SRCs, for managing schemes floated by them, may be as per the mutually agreed terms.

Committee of the Board of Directors For approving the proposal relating to asset reconstruction contained in the RBI guidelines and directions, the Board of Directors may constitute a committee(s).

Guidelines on Sale of Financial Assets to SRCs and Related Issues The SRFAESI Act provides, among others, sale of financial assets by banks/FIs to the SRCs. Since the Act focuses on asset reconstruction activity, which mainly centers around impaired assets, the whole process of asset reconstruction and related matters has to be initiated with due diligence and care, warranting the existence of a set of clear instructions to be complied with by all banks/FIs, so that the process proceeds on smooth and sound lines. The need for some healthy and uniform guidelines has been further necessitated by the fact that there is no prior experience in this area. Accordingly, a set of guidelines to be followed by banks/FIs has been formulated by the RBI. The prudential guidelines while selling their financial assets to the SRCs and investing in bonds/debentures/ security receipts offered by the SRCs fall into four groups:

- Financial assets which can be sold;
- Procedure for sale of financial assets by banks/FIs to SRCs including valuation and pricing taspects;
- Prudential norms relating to **(a)** provisioning/valuation; **(b)** capital adequacy and **(c)** exposure for banks/FIs for sale of their financial assets to SRCs and for investing in bonds/ debentures/security receipts and any other securities offered by the SRCs as compensation consequent upon sale of financial assets;
- Disclosure requirements.

Financial Assets Which Can Be Sold A bank/FI may sell to a SRC an asset which is **(i)** a NPA including bonds/debentures and **(ii)** a standard asset if **(a)** it is under consortium/multiple banking arrangement, **(b)** at least 75 per cent of its value is classified as NPA in the books of other banks/FIs and **(c)** at least 75 per cent of the banks/FIs who are under consortium/multiple banking arrangements agree to the sale.

Procedure for Sale The SRFAESI Act allows acquisition of financial assets by the SRCs from banks/FIs on mutually agreed terms and conditions. This provides for sale on without recourse basis, that is, the entire credit risk being transferred to the SRC as well as on with recourse basis, that is, subject to the unrealised part of the asset reverting to the seller bank/FI. However, banks/FIs have to ensure that the effect of the sale should be such that the asset is taken off of their books and after the sale there should be no known liability devolving on them. The seller bank/FI should ensure that the sale is conducted in a prudent manner in accordance with a policy approved by its Board of Directors which should lay down policies/guidelines covering, *inter alia*, **(i)** financial assets to be sold; **(ii)** norms and procedure for sale of such financial assets; **(iii)** valuation procedure to be followed to ensure that the realisable value of financial assets is reasonably estimated; **(iv)** delegation of powers of various functionaries for taking decision on the sale of the financial assets; and so on. The banks/FIs should ensure that subsequent to sale of the financial assets to SCR, they do not assume any operational, legal or any other type of risks relating to the financial assets sold. Each of them should make its own assessment of the value offered by the SRC for the financial asset, and decide whether to accept or rejects the offer. In the case of consortium/multiple banking arrangements, if 75 per cent (by value) of the banks/FIs decide to accept the offer, the remaining banks/FIs would be obligated to do the same. Under no circumstances can a transfer to the SCR be made at a contingent price whereby in the event of shortfall in the realisation by the SRC, the banks/FIs would have to bear a part of the shortfall. They may receive cash/bonds/ debentures as sale consideration for the financial assets sold to the SRC. The bonds/debentures received by them as sale consideration would be classified as investments in their books. They may also invest in security receipts, pass-through certificates (PTC), other bonds/debentures issued by the SRC. These securities would also be classified as investments. In cases of specific financial assets, where it is considered necessary, banks/FIs may enter into agreement with the SRC to share, in an agreed proportion, any surplus realised by the SRC on the eventual realisation of the concerned asset. In such cases, the terms of sale should provide for a report from the SRC to the bank/FI on the value realised from the asset. No credit for the expected profit would be taken by them until the profit materialise on the actual sale.

Prudential Norms The prudential norms for banks/FIs for the sale transaction relate to **(A)** Provisioning, **(B)** Capital adequacy and exposure.

Provisioning/Valuation Norms When a bank/FI sells its financial assets to any SRC, the same should be removed from its books on transfer. If the sale to the SRC is at a price below the net book value (NBV) that is, book value less provisions held, the shortfall should be debited to the profit and loss account of that year. If the sale is for a value higher than the NBV, the excess provision should not be reversed but utilised to meet the shortfall/loss on account of sale of other financial assets to the SRCs. When banks/FIs invest in the security receipts/pass-through certificates issued by the SRC in respect of the financial assets sold by them, the sale should be recognised in their books at the lower of **(i)** the redemption value of the security receipts/pass-through certificates; and **(ii)** the NBV of the financial assets. The above investment should be carried in the books of the bank/FI at the price as determined above until its sale or realisation, and on such sale or realisation, the loss or gain must be dealt within the same manner as mentioned above.

The securities (bonds and debentures) offered by the SRCs should satisfy the following conditions. They must **(i)** Not have a term in excess of six years; **(ii)** Carry a rate of interest not lower than 1.5 per cent above the bank rate in force at the time of the issue; **(iii)** Be secured by an appropriate charge on the asset transferred; **(iv)** Provide for part or full prepayment in the event the SRC sells the asset securing the security before the maturity date of the security. The commitment of the SRC to redeem the securities must be unconditional and not linked to the realisation of the assets. Whenever the security is transferred to any other party, notice of transfer should be issued by the SRC.

All instruments received by banks/FIs from the SRCs, as sale consideration for financial assets sold to them and also other instruments issued by them in which the banks/FIs invest (i.e. debentures/bonds/security receipts/pass-through certificates) would be in the nature of non-SLR securities. Accordingly, the valuation, classification and other norms applicable to investment in non-SLR instruments prescribed by the RBI from time to time (discussed in an earlier Section of this Chapter) would be applicable to such investments also. However, if any of the above instruments is limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme, the bank/FI should reckon the Net Asset Value (NAV), obtained from the SRC from time to time, for valuation of such investments.

Capital Adequacy The banks/FIs should assign risk weights to the investments in debentures/bonds/security receipts/pass through certificates of the SRCs as under: **(i)** for credit risk: 100 per cent, and **(ii)** for market risk: 2.5 per cent. The applicable risk weight would be equal to **(i)** + **(ii)**.

Exposure Norms Such investment of banks/FIs would constitute an exposure on the SRC. Such exposure may go beyond the prudential exposure ceiling as only a few SRCs are being set up now. The bank/FIs are allowed in the initial years to exceed prudential exposure ceiling on a case-to-case basis.

Disclosure Requirements The banks/FIs selling their financial assets to any SRC should make the undermentioned disclosures relating to the details of the financial assets sold for reconstruction in the Notes on Accounts to their balance sheet: **(a)** number of accounts, **(b)** aggregate value (net of provisions) of accounts sold, **(c)** aggregate consideration, **(d)** additional consideration realised in respect of accounts transferred in earlier years and **(e)** aggregate gain/loss over net book value.

Related Issues Normally, the SRCs should not take over financial assets which cannot be revived and would, therefore, have to be disposed of on an realisation basis, but act as agent for recovery and charge a fee. Such assets, if taken over, would be removed from the books of the banks/FIs but realisations should be credited to the asset account. The provisioning for the asset should continue to be made in the normal course.

Fair Practices Code on Lenders Liability While piloting the SRFAESI Act in Parliament, the Finance Minister, by way of moderating the possible misuse of the powers under the Act by banks/FIs, gave an assurance to bring out a Code of Fair Practices defining lenders liability to the borrowers in respect of loans and advances extended by them. As a follow-up, the RBI has prepared the broad guidelines to be adopted by banks/FIs for framing the Fair Practices Code with the approval of their Board of Directors. The main elements of the guidelines on fair practices code are discussed below: **(a)** Application for loans and their processing, **(b)** Loan appraisal and terms/conditions, **(c)** Disbursement of loans including change in terms and conditions, **(d)** Post-disbursement, supervision and **(e)** General.

Applications for Loans and their Processing

(a) Loan application forms in respect of priority sector advances up to ₹2 lakh should be comprehensive. It should include information about the fees/charges, if any, payable for processing, the amount of such fees refundable in case of non acceptance of application, pre-payment options and any other matter which affects the interest of the borrower, so that a meaningful comparison with that of other banks can be made and informed decision can be taken by the borrower.

(b) Banks should devise a system of giving acknowledgement for receipt of all loan applications. This timeframe within which loan applications up to ₹2 lakh would be disposed of should also be indicated in acknowledgement of such applications.

(c) They should verify the loan applications within a reasonable period of time. If additional details/documents are required, they should intimate the borrowers immediately.

(d) In the case of small borrowers seeking loans up to ₹2 lakh, the lenders should convey in writing, the main reasons/reasons which, in the opinion of the bank after due consideration, have led to rejection of the loan applications within the stipulated time.

Loan Appraisal and Terms/Conditions

(a) Lenders should ensure that there is proper assessment of credit application by borrowers. They should not use margin and security stipulation as a substitute for due diligence on credit worthiness of the borrower.

(b) The lender should convey to the borrower the credit limit along with the terms and conditions thereof and keep the borrower's acceptance of these terms and conditions given with his full knowledge on record.

(c) Terms and conditions and other caveats governing credit facilities given by banks/arrived at after negotiation by lending institution and the borrower should be reduced in writing and duly certified by the authorised official. A copy of the loan agreement with a copy each of the enclosures quoted in the loan agreement should be furnished to the borrower.

(d) As far as possible, the loan agreement should clearly stipulate credit facilities that are solely at the direction of lenders. These may include approval or disallowance of facilities, such as, drawings beyond the sanctioned limits, honouring cheques issued for the purpose other than specifically agreed to in the credit sanction, and disallowing drawing on a borrowal account of non-compliance with the terms of sanction. It may also be specifically stated that the lender does not have an obligation to meet further requirements of the borrowers on account of growth in business and so on without proper review of credit limits.

(e) In the case of lending under consortium arrangement, the participating lenders should evolve procedures to complete appraisal of proposals in the time bound manner to the extent feasible, and communicate their decisions on financing or otherwise within a reasonable time.

Disbursement of Loans Including Changes in Terms and Conditions Lenders should ensure timely disbursement of loans sanctioned in conformity with the terms and conditions governing such sanction. They should give notice of any change in the terms and conditions including interest rates, service charges and so on. They should also ensure that changes in interest rates and charges are effected only prospectively.

Post-disbursement Supervision

(a) Post-disbursement supervision by lenders, particularly in respect of loans up to ₹2 lakh, should be constructive with a view to taking care of any 'lender-related' genuine difficulty that the borrower may face.

(b) Before taking a decision to recall/accelerate payment or performance under the agreement or seeking additional securities, lenders should give notice to borrowers, as specified in the loan agreement or a reasonable period, if no such condition exist in the loan agreement.

(c) Lenders should release all securities on receiving payment of loan or realisation of loan subject to any legitimate right or lien for any other claim lenders may have against borrowers. If such right of set off is to be exercised, borrowers should be given notice about the same with full particulars about the remaining claims and the documents under which lenders are entitled to retain the securities till the relevant claim is settled/paid.

General

(a) Lenders should restrain from interference in the affairs of the borrowers except for what is provided in the terms and conditions of the loan sanction documents (unless new information, not earlier disclosed by the borrower, has come to the notice of the lender).

(b) They must not discriminate on grounds of sex, caste and religion in the matter of lending. However, this does not preclude lenders from participating in credit-linked schemes framed for weaker sections of the society.

(c) In the matter of recovery of loans, the lenders should not resort to under harassment, that is, persistently bothering the borrowers at odd hours, use of muscle power for recovery of loans, and so on.

(d) In case of receipt of request for transfer of borrowal account, either from the borrower or from a bank, which proposes to take-over the account, the consent or otherwise, that is, objection of the lender, if any, should be conveyed within 21 days from the date of receipt of request.

The Fair Practices Code based on the guidelines outlined above should be put in place in respect of all lending prospectively, but not later than August 1, 2003. Banks would have the freedom of drafting the Fair Practices Code, enhancing the scope of the guidelines but in no way sacrificing the spirit underlying the above guidelines. For this purpose, the Boards of Directors of banks should lay down a clear policy.

The Board of Directors should also lay down the appropriate grievance redressal mechanism within the organisation to resolve disputes arising in this regard. Such a mechanism should ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. They should also provide for periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of controlling offices. A consolidated report of such reviews may be submitted to the Board of Directors at regular intervals, as may be prescribed by it.

RBI Guidelines on Securitisation of Standard Assets, 2006 Securitisation is a process by which performing asset(s) are sold to a bankruptcy remote special purpose vehicle (SPV) and transferred from the balance sheet of the originator to the SPV in return for an immediate cash payment. **Bankruptcy remote** means the unlikelihood of an entity being subjected to voluntary/involuntary bankruptcy proceedings including by the originator or its creditors. **Originator** refers to a bank/FI/NBFC that transfers from its balance sheet a single/pool of asset(s) to an SPV as part of a securitisation transaction. An **SPV** means a company/trust/other entity constituted/established for a specific purpose: **(a)** activities limited to those for accomplishing the purpose and **(b)** structured in a manner intended to isolate it from the credit risk of an originator to make it bankruptcy remote. Securitisation follows a two-stage process: First, sale of a performing asset(s) to a 'bankruptcy remote' SPV in return for an immediate cash payment; Two, repackaging and selling the security interests representing claims on incoming cash flows from the asset(s) to third party investors by issuance of tradeable debt securities.

Exposures of banks/FIs/NBFCs to a securitisation transaction (i.e. securitisation exposure) include, *inter-alia*, exposures to **(i)** securities issued by the SPV, **(ii)** credit enhancement facility [provided to an SPV to cover the losses associated with the asset(s); the rating given to the securities issued by the SPV, that is, pass-through-certificates (PTCs) by a rating agency reflecting the level of enhancement], liquidity facility [enabling the SPV to ensure investors of timely payment, this includes smoothening of timing differences between payment of interest/principal on asse(s) and payments due to investors], underwriting facility (i.e. the arrangement under which a bank/FI/NBFC agrees, before issue, to buy a specified quantity of securities in a new issue on a given date/at a given price if no other purchaser has come forward), interest rate/currency swaps and cash collateral accounts. The main features of the RBI guidelines issued in January 2006 are discussed below.

True Sale An essential prerequisite for removing from the balance sheet of the 'originator' in a securitisation structure the transferred assets is **true sale**, that is, the isolation of assets so that the originator would not have to maintain any capital against the value of the transferred assets from the date of transfer. If the transferred asset does not meet the '**true-sale**' criteria, it would be deemed to be on the balance sheet of the originator who would be constrained to maintain capital for them. The elements of an true sale criteria, *inter-alia,* are:

- The sale should result in immediate legal separation of the originator from the assets sold to the SPV. After its transfer, the asset should be completely isolated in that it should be beyond the reach of the originator as well as their creditors even in the event of bankruptcy of the originator.
- All risk/rewards and rights/obligations pertaining to the asset should be effectively transferred and the originator should have no beneficial interests in it after sale to the SPV. The SPV should have the unfettered right to pledge/sell/transfer/exchange/otherwise dispose of the asset free of any restraining condition. However, the originator may be entitled to any surplus income on the securitised asset at the end of the life of the securities issued by the SPV.
- While the originator would not have any economic interest in the asset after sale, the SPV would have recourse to the originator only for specifically permitted exposures/losses.

- The originator would not be obliged to repurchase/fund the repayment of the asset held by the SPV except in case of breach of warranty or representation at the time of sale.
- The originator can retain the option to repurchase fully performing asset(s) at the end of the securitisation scheme where their residual value is less than 10 per cent of the original amount sold to the SPV (i.e. **clean up calls**).
- The originator should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the scheme/investors.
- Sale should be on cash basis; sale consideration should be market-based and arrived at in a transparent manner on an arms' length basis.
- Provision of certain services such as credit enhancement, liquidity facility, underwriting, asset-servicing and so on and assumption of consequent risks/obligations by the originators would not detract from the true sale nature of the transaction, if such service obligations do not entail any residual credit risk on the securitised asset(s) or any additional liability for them beyond the contractual performance obligation in respect of such services.
- An opinion from the legal counsel of the originating bank to the effect that **(i)** all rights/titles/interests/benefits in the asset(s) have been transferred to the SPV, **(ii)** originator is not liable to investors in any way and **(iii)** creditors of the originator have no right in regard to these assets even in case of his bankruptcy should be kept on record.
- Any reschedulement, restructuring/renegotiation of the terms of the underlying agreement(s) effected after the transfer of assets to the SPV would be binding on the SPV but not on the originator and should be done only with the express consent of the investors, providers of credit enhancement and other **service providers** [i.e. banks that carry out on behalf of the SPV **(a)** administrative function relating to the cash flows of the underlying exposure of securitisation, **(b)** funds management and **(c)** servicing the investors]. This should be expressly provided in the sale transaction documents.
- Transfer of assets from the originator should not contravene the terms/conditions of any underlying agreement governing them and all necessary consents from obligors (including from third parties, if necessary) should be obtained.
- In case the originator also agrees to provide servicing of assets after securitisation and payments/repayments from borrowers are routed through it, it would be under an obligation to remit funds to the SPV only when these are actually received.
- The originator would have no obligation to purchase/subscribe to the securities issued by the
- SPV. However, it can purchase at the market price only senior securities of at least "**investment grade**" upto a maximum of 10 per cent inclusive devolvement on account of underwriting commitments of the original amount of the issue.
- The originator should not indulge in market-making/dealing in securities issued by the SPV.
- The securities issued by the SPV should not have any **put option**; they may have **call option** to address the pre-payment risk on the underlying assets.

Criteria To Be Met By SPV The beneficial interest in the securitised assets are sold/transferred to the SPV on a without recourse basis. The SPV may be a partnership firm/trust/company. It should meet the following criteria to enable the originator to treat the assets transferred by it to the SPV as a true sale and apply the prudential guidelines on capital adequacy/other aspects with regard to the securitisation exposure assumed by it:

(i) Transaction(s) between the originator and the SPV should **(a)** be strictly on a arm's length basis and **(b)** not intentially provide for absorbing any future losses;

(ii) The SPVs and the trustees should not resemble in name/imply any connection/ relationship with the originator in its title/name;

(iii) The SPV should be entirely independent of the originator. The originator should not have any ownership, proprietary or beneficial interest and hold any share capital in the SPV.

(iv) The originator should **(a)** have only one representative, without veto power, on the Board of the SPV provided it has at least four members and independent directors are in a majority and **(b)** not exercise control, directly or indirectly, over the SPV and the trustees, and settle the trust deed.

(v) The SPV should be bankruptcy remote and non-discretionary.

(vi) The trust deed should lay down, in detail, the functions to be performed by the trustee, their rights and obligations as well as the rights and obligations of the investors in relation to the securitised assets. It should not provide for any discretion to the trustee as to the manner of disposal and management or application of the trust property. In order to protect their interests, investors should be empowered in the trust deed to change the trustee at any point of time.

(vii) The trustee should only perform trusteeship functions and not undertake any other business with the SPV.

(viii) The originator should not support the losses of the SPV except under the facilities explicitly permitted under these guidelines and also not be liable to meet the recurring expenses of the SPV.

(ix) The securities issued by the SPV should compulsorily be rated by a rating agency registered with the SEBI and such rating at any time should not be more than 6 months old. The credit rating should be publicly available. For the purpose of rating and subsequent updation, the SPV should supply the necessary information to the rating agency in a timely manner. Commonality and conflict of interest, if any, between the SPV and the rating agency should also be disclosed.

(x) The SPV should inform the investors in the securities issued by it that these securities are not insured and that they do not represent deposit liabilities of the originator, servicer or trustee.

(xi) A copy of the trust deed and the accounts and statement of affairs of the SPV should be made available to the RBI, if required.

Special Features: Representation and Warranties An originator that sells assets to SPV may make representations and warranties concerning those assets. Where the following conditions are met, the originator would not be required to hold capital against such representation and warranties:

The representation or warranty is provided only by way of a formal written agreement. The originator undertakes appropriate due diligence before providing or accepting any representation or warranty which refers to an existing state of facts that is capable of being verified by the originator at the time the assets are sold. It is not open-ended and, in particular, does not relate to the future creditworthiness of the assets, the performance of the SPV and/or the securities the SPV issues. The exercise of a representation or warranty, requiring an originator to replace assets sold to a SPV, must be **(1)** undertaken within 120 days of the transfer of assets to the SPV; and **(2)** conducted on the same terms and conditions as the original sale. An originator can pay damages for breach of representation or warranty can do so provided the agreement to pay damages meet the following conditions: **(1)** the onus of proof remains at all times with the party so alleging; **(2)** the party alleging the breach serves a written notice of claim on the originator, specifying the basis for the claim; and **(3)** damages are limited to losses directly incurred as a result of the breach. An originator should notify the RBI of all instances where it has agreed to replace assets sold to SPV or pay damages arising out of any representation or warranty.

Repurchase of Assets from SPVs An option to repurchase fully performing asset(s) at the end of the securitisation scheme where residual value of such assets has, in aggregate, fallen to less than 10 per cent, of the original amount sold to the SPV (**'clean up calls'**) could be retained by the originator and would not be construed to constitute 'effective control', provided: **(i)** the purchase is conducted at arm's length, on market terms and conditions (including price/fee) and is subject to the originator's normal credit approval and review processes; and **(ii)** the exercise of the clean-up call is at its discretion.

Policy on Provision of Credit Enhancement Facilities Credit enhancement facilities include all arrangements provided to the SPV that could result in a bank absorbing losses of the SPV or its investors. Such facilities may be provided by both originators and third parties. A bank should hold capital against the credit risk assumed when it provides credit enhancement, either explicitly or implicitly. The entity providing credit enhancement facilities should ensure that the following conditions are fulfilled:

- **(i)** Provision of the facility should be structured in a manner to keep it distinct and documented separately from any other facility provided by the bank. The nature, purpose, extent of the facility and all required standards of performance should be clearly specified in a written agreement to be executed at the time of originating the transaction and disclosed in the offer document.
- **(ii)** The facility is provided on an 'arm's length basis' on market terms and conditions, and subjected to the facility provider's normal credit approval and review process. It is limited to a specified amount and duration. Its duration is limited to the earlier of the dates on which: **(a)** the underlying assets are redeemed; **(b)** all claims connected with the securities issued by the SPV are paid out; or **(c)** the bank's obligations are otherwise terminated.
- **(iii)** Payment of any fee or other income for the facility is not subordinated or subject to deferral or waiver.
- **(iv)** There should be no recourse to the facility provided beyond the fixed contractual obligations. In particular, the facility should not bear any recurring expenses of the securitisation.
- **(v)** The facility provider has written opinions from its legal advisors that the terms of agreement protect it from any liability to the investors in the securitisation or to the SPV/trustee, except in relation to its contractual obligations pursuant to the agreement governing provision of the facility.
- **(vi)** The SPV and/or investors in the securities issued by the SPV have the clear right to select an alternative party to provide the facility.
- **(vii)** Credit enhancement facility should be provided only at the initiation of the securitisation transaction.

(viii) The amount of credit enhancement should be **(i)** available to the SPV during the entire life of the securities issued by the SPV, **(ii)** reduced only to the extent of drawdowns to meet the contingencies arising out of losses accruing to the SPV or its investors. No portion should be released to the provider during the life of the securities issued by the SPV.

(ix) Any utilisation/drawdown of the credit enhancement should be immediately written-off by debit to the profit and loss account.

(x) When a first loss facility does not provide substantial cover, a second loss facility might carry a disproportionate share of risk. In order to limit this possibility, a credit enhancement facility would be deemed to be a second loss facility only where it: **(1)** enjoys protection given by a substantial first loss facility; **(2)** it can be drawn only after the first loss facility has been completely exhausted; **(3)** it covers only losses beyond those covered by the first loss facility; and **(4)** the provider of the first loss facility continues to meet its obligations. If the second loss facility does not meet the above criteria, it would be treated as a first loss facility. **A first loss facility** represents the first level of financial support to a SPV as part of the process in bringing the securities issued by the SPV to investment grade. The provider of the facility bears the bulk/all of the risks associated with the asset held by the SPV. A **second loss facility** represents a credit enhancement providing a second/subsequent tier of protection to a SPV against potential losses.

(xi) The first-loss facility would be considered substantial where it covers some multiple of historic losses or worst case losses estimated by simulation or other techniques. The second loss facility provider should assess adequacy of first loss facility on the arm's length basis and review it periodically at least once six months. The following factors may be reckoned while conducting the assessment as well as review: **(a)** the class and quality of assets held by the SPV; **(b)** the history of default rates on the assets; **(c)** the output of any statistical models used by banks to assess expected default rates on the assets; **(d)** the type of activity in which the SPV is engaging in or is permitted to engage in; **(e)** the quality of the parties providing the first loss facility; and **(f)** the opinions or rating letters provided by reputable rating agencies regarding the adequacy of first loss protection.

Where any of the above conditions is not satisfied, the bank providing credit enhancement facility should hold capital against the full value of the securitised assets as if they were held on its balance sheet.

Treatment of Credit Enhancement Provided by an Originator *Treatment of First Loss Facility* The first loss credit enhancement provided by the originator should be reduced from capital funds and the deduction capped at the amount of capital that the bank would have been required to hold for the full value of the assets, had they not been secutritised. The deduction should be made 50 per cent from Tier-1 and 50 from Tier-2 capital.

Treatment of Second Loss Facility The second loss credit enhancement provided by the originator should be reduced from capital funds to the full extent: 50 per cent from Tier-1 and 50 per cent from Tier-2 capital each.

Treatment of Credit Enhancement Provided by Third Party *Treatment of First Loss Facility* The first loss credit enhancement provided by third party service providers should be reduced from capital to the full extent: 50 per cent from Tier-1 and Tier-2 capitals each.

Treatment of Second Loss Facility The second loss credit enhancement should be treated as a direct credit substitute with a 100 per cent credit conversion factor and a 100 per cent risk weight covering the amount of the facility.

Policy on Provision of Liquidity Facilities A liquidity facility is provided to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to investors. It should meet the following conditions to guard against the possibility of the facility functioning as a form of credit enhancement and/or credit support.

- All conditions specified in relation to provisions of credit enhancement facilities (discussed earlier) specified in **(i) to (vii)**.
- The securitised assets are covered by a substantial first loss credit enhancement. The documentation must clearly define the circumstances under which the facility may or may not be drawn on. It should be capable of being drawn only where there is a sufficient level of non-defaulted assets or cover drawings, or the full amount of assets that may turn non-performing are covered by a substantial credit enhancement. It should not be drawn for the purpose of **(a)** providing credit enhancement; **(b)** covering losses of the SPV; **(c)** serving as a permanent revolving funding; and **(d)** covering any losses incurred in the underlying pool of exposures prior to a drawdown.
- The liquidity facility should not be available for **(a)** meeting recurring expenses of securitisation; **(b)** funding acquisition of additional assets by the SPV; **(c)** funding the final scheduled repayment of investors and **(d)** funding breach of warranties. Funding should be provided to SPV and not directly to the investors. When the liquidity facility has been drawn, the facility provider would have a priority of claim over the future cash flows from the underlying assets, which would be senior to the claims of the seniormost investor.
- When the originator is providing the liquidity facility, an independent third party, other than the originator's group entities, should co-provide at least 25 per cent of the liquidity facility that would be drawn and repaid on a *pro rata* basis. The originator must not be liable to meet any shortfall in liquidity support provided by the independent party. During the initial phase, a bank may provide the full amount of a liquidity facility on the basis that it will find within 3 months an independent party to participate in the facility.

In case the facility fails to meet any of these conditions, it would be regarded as serving the economic purpose of credit enhancement and the liquidity facility provided by a third party and the originator would be treated as a first loss facility and as a second loss facility respectively.

Treatment of Liquidity Facility The commitment to provide liquidity facility, to the extent not drawn, would be an off-balance sheet item and attract 100 per cent credit conversion factor as well as 100 per cent risk weight. The extent to which the commitment becomes a funded facility, it would attract 100 per cent risk weight.

Since the liquidity facility is meant to smoothen temporary cash flow mismatches, it would remain drawn only for short periods. If the drawings under the facility are outstanding for more than 90 days, it should be classified as NPA and fully provided for.

Policy on Provisions of Underwriting Facilities An originator or a third-party service provider may act as an underwriter for the issue of securities by an SPV and treat the facility as an underwriting facility for capital adequacy purposes subject to the following conditions. **(i)** All conditions specified **(i)** to **(vii)** pertaining to credit enhancement facility (discussed earlier); **(ii)** The underwriting is exercisable only when the SPV cannot issue securities into the market at a price equal to, or above, the benchmark predetermined in the underwriting agreement; **(iii)** The bank has the ability to withhold payment and terminate the facility, if necessary, upon the occurrence of specified events (e.g. material adverse changes or defaults on assets above a specified level); and **(iv)** There is a market for the type of securities underwritten.

In case any of the above conditions is not satisfied, the facility would be considered as a credit enhancement and treated as a first loss facility when provided by a third party and a second loss facility when provided by an originator.

Underwriting by an Originator/Third Party Service Provider An originator/third party service provider may underwrite only investment grade senior securities issued by the SPV. The holdings of securities devolved through underwriting should be sold to third parties within three months following the acquisition. During this period, the total outstanding amount of devolved securities would be subjected to a risk weight of 100 per cent. In case of failure to off-load within this period, any holding in excess of 10 per cent of the original amount of issue, including secondary market purchases, should be deducted 50 per cent from Tier-1 capital and 50 per cent from Tier-2 capital.

Policy on Provision of Services A servicing bank administers or services the securitised assets. Hence, it should not have any reputational obligation to support any losses incurred by the SPV and should be able to demonstrate this to the investors. A bank performing the role of a service provider for a proprietary or a third-party securitisation transaction should ensure that the following conditions are fulfilled:

- All conditions specified **(i)** to **(vii)** relating to credit enhancement (discussed earlier).
- The service provider should be under no obligation to remit funds to the SPV or investors until it has received funds generated from the underlying assets except where it is the provider of an eligible liquidity facility. He should hold in trust, on behalf of the investors, the cash flows arising from the underlying and should avoid co-mingling of these cash flows with their own cash flows.

Where these conditions are not met, the service provider may be deemed as providing liquidity facility to the SPV or investors and treated accordingly for capital adequacy purpose.

Prudential Norms for Investments in the Securities Issued by SPV As the securities issued by the SPVs would be in the nature of non-SLR securities, banks' investments in these securities would attract all prudential norms applicable to non-SLR investments prescribed by RBI from time to time (discussed in an earlier Section of this Chapter).

Limits on Investment in Securities by the Originator The aggregate investment by the originator in securities issued by the SPV together with devolvement on account of underwriting commitments should not exceed 10 per cent of the original amount of issue.

Exposure Norms For Investments in the PTCs (Pass Through Certificates) The counterparty for the investor in the securities would not be the SPV but the underlying assets in respect of which the cashflows are expected from the obligors/borrowers. These should be taken into consideration when reckoning overall exposures to any particular borrower/borrower group, industry or geographic area for the purpose of managing concentration risks and compliance with the prudential exposure norms, wherever the obligors in the pool constitute 5 per cent or more of the receivables in the pool or ₹5 crore whichever is lower.

Income Recognition and Provisioning Norms for Investors in the PTCs As the securities are expected to be limited-tenor, interest-bearing debt instruments, the income on the securities may normally be recognised on accrual basis. However, if the income (or even the redemption amount) on securities remains in arrears for more than 90 days, any future income should be recognised only on realisation and any realised income recognised on accrual basis should be reversed. In case of pendancy of dues on the securities, provisions appropriate for the diminution in value of the securities on account of such overdues should also be made, as already envisaged in the RBI norms for classification and valuation of investment by the banks (discussed in an earlier Section of this Chapter).

Accounting Treatment of the Securitisation Transactions *Accounting in the Books of the Originator* Banks can sell assets to an SPV only on cash basis and the sale consideration should be received not later than the transfer of the asset to the SPV. Hence, any loss arising on account of the sale should be accounted accordingly and reflected in the profit and loss account for the period during which the sale is affected and any profit/premium arising on account of sale should be amortised over the life of the securities issued or to be issued by the SPV: **(i)** In case the securitised assets qualify for derecognition from the books of the originator, the entire expenses incurred on the transaction, say, legal fees, and so on, should be expensed at the time of the transaction an should not be deferred; **(ii)** Where the securitised assets do not qualify for derecognition, the sale consideration received should be treated as a borrowing.

The accounting treatment of the securitisation transactions in the books of originators, SPV and investors in securities should be as per the Guidance Note issued by the ICAI (Institute of Chartered Accountants of India) with reference to those aspects not specifically covered in these guidelines.

Disclosures to be Made by the SPV/Trustee **(i)** SPV/trustee should make available/provide to the RBI or other regulators, as and when required, a copy of the trust deed, the financial accounts and statement of affairs, its constitution, ownership, capital structure, size of issue, terms of offer including interest payments/yield on instruments, details of underlying asset pool and its performance history, information about originator, transaction structure, service arrangement, credit enhancement details, risk factors and so on.

The investors should be informed in writing that: **(a)** their investment do not represent deposit or other liabilities of the originator, servicer, SPV or the trustee, and they are not insured; **(b)** the trustee/originator/servicer/SPV does not guarantee the capital value of securities and/or performance of the securities issued, or collectability of receivables pool; and **(c)** their investments can be subject to investment risk, including prepayment risk, interest rate risk, credit risk, possible delays in repayment and loss of income and principal invested.

The SPV/trustee should provide continuing disclosures by way of a disclosure memorandum, signed and certified for correctness of information jointly by the servicer and the trustee, and addressed to each securities holder individually through registered post/email/courier/fax at periodic intervals (maximum 6 months or more frequent). In case the securities holders are more than 100 in number, the memorandum may also be published in a national financial daily newspaper. In addition, data may be made available on websites of the SPV/trustee. The contents of the memorandum would be: **(a)** collection summary of previous collection period; **(b)** asset pool behaviour – delinquencies, losses, prepayment and so on with details; **(c)** drawals from credit enhancements; **(d)** distribution summary: **(i)** in respect of principal and interest to each class of securityholders; **(ii)** in respect of servicing and administration fee, trusteeship fee etc; **(e)** payment in arrears; **(f)** current rating of the securities and any migration of rating during the period; and **(g)** any other material/information relevant to the performance of the pool.

The SPV/trustee should publish a periodical report on any reschedulement, restructuring or re-negotiation of the terms of the agreement, effected after the transfer of assets to the SPV, as apart of disclosures to all the participants at quarterly/half-yearly intervals. The authorisation of investors to this effect may be obtained at the time of issuance of securitised paper.

The SPV should obtain signed acknowledgement from investors indicating that they have read and understood the required disclosures.

Disclosures to be Made by the Originator The originator should make the following disclosures, as notes to accounts, presenting a comparative position for two years: **(i)** total number and book value of loan assets securitised; **(ii)** sale consideration received for the securitised assets and gain/loss on sale on account of securitisation; and **(iii)** form and quantum (outstanding value) of services provided by way of credit enhancement, liquidity support, post-securitisation asset servicing, and so on.

In addition to the above balance sheet disclosures, originating banks of the securitisation transactions should provide disclosures to the Audit sub-committee of their Board, on quarterly basis, as per the format prescribed in the Annexure below.

Annexure **Format of Quarterly Reporting to the Audit Sub-Committee of the Board by Originating Banks of the Securitisation Transactions**

1. Name of the originator;
2. Name and nature of SPV and details of relationship with originator and service providers (including constitution and shareholding pattern of SPV);
3. Description and nature of asset transferred;
4. Carrying cost of assets transferred and percentage of such assets to total assets before transfer;
5. Method of transfer of assets;
6. Amount and nature of consideration received;
7. Objects of the securitisation offer;
8. Amount and nature of credit enhancement and other facilities provided by the originator (give details each facility provided for example, nature, amount, duration, terms and conditions);
9. Information regarding third party service providers (e.g. credit enhancement, liquidity support, servicing of assets, etc.) giving the details, facility-wise, namely, name and address of the provider, amount, duration and terms and conditions of the facility;
10. *CRAR of transferor:*

CRAR of transferor:	*Before transfer*	*After transfer*
Tier-1		
Tier-2		

11. Type and classes of securities issued by SPV with ratings, if any, of each class of security, assigned by a rating agency;
12. Name and address of holders of 5 per cent or more of securities (if available);
13. Investment by the originator in the securitised paper, issuer-wise;

Name of the issuer	*Class of security*	*No. of securities held*	*Total amount*

14. Details of hedging arrangements (IRS/FRAs), if any, giving amount/maturity date, name of counter parties, etc.;
15. Brief description (including diagrammatic representation of the structure) of the scheme denoting cash and process flows;
16. Date and method of termination of the scheme including mopping up of remaining assets.

RBI Guidelines on Changes in or Takeover of Management of Business of the Borrower by SCs/RCs, 2010 The objective of these guidelines is to ensure transparency, non-discrimination/arbitrariness in the action of SCs/RCs and to build a system of checks and balances while effecting changes in or takeover of management of the business of the borrower. **Change in management** means effecting changes by the borrower at the instance of the SC/RC in the person(s) who has responsibility for the whole/substantially whole of the management of business of the borrower and/or other relevant personnel. **Takeover of management** means taking over of the responsibility for the management of the business of the borrower with/without effecting change in management personnel of the borrower by the SC/RC. The main elements of the guidelines are: **(i)** power of SCs/RCs and scope of guidelines, **(ii)** eligibility conditions to exercise power, **(iii)** grounds for effecting change, **(iv)** policy regarding change in or takeover of management, **(v)** procedure, and **(vi)** reporting.

Powers of SC/RCs They may resort to change in or takeover of the management of the business of a borrower for realisation of its dues from the borrower. On realistion of the dues, it should fully restore the management of the business to the borrower in terms of the requirements of the SARFAESI Act in this regard.

Eligibility Conditions A SC/RC may effect change in or takeover the management of the borrower where **(i)** the due amount is at least 25 per cent of the total assets as disclosed in the balance sheet immediately preceding the date of taking action of the borrowers, and **(ii)** at least 75 per cent of the outstanding security receipts agree to such action in case the borrower is financed by several secured creditors including the SC/RC.

Grounds for Effecting Change in or Takeover of Management The SCs/RC would be entitled to effect change in management or takeover the management of business of the borrower on any of the following grounds:

(a) The borrower makes a willful default in repayment of the amount due under the relevant loan agreement(s). **Willful default** in repayment of amount due, includes: **(a)** non-payment of dues despite adequate cash flow and availability of other resources, or **(b)** routing of transactions through banks which are not lenders/consortium members' so as to avoid payment of dues, or **(c)** siphoning off funds to the detriment of the defaulting unit, or misrepresentation/falsification of records pertaining to the transactions with the SC/RC. The decision as to whether the borrower is a wilful defaulter or not, should be made by the SC/RC keeping in view the track record of the borrower and not on the basis of an isolated transaction/incident which is not material. The default to be categorised as wilful must be intentional, deliberate and calculated.

(b) The SC/RC is satisfied that the management **(i)** is acting in a manner adversely affecting their interest/failing to take necessary action to avoid any events which would adversely affect their interest; **(ii)** is not competent to run the business resulting in losses/non-repayment of dues or there is a lack of professional management or the key managerial personnel have not been appointed for more than one year from the date of such vacancy which would adversely affect the financial health of the business of the borrower or the interests of the SC/RC as a secured creditor;

(c) The borrower has without the prior approval of the SC/RC sold, disposed of, charged, encumbered or alienated 10 per cent or more (in aggregate) of its assets secured to the SC/RC;

(d) There are reasonable grounds to believe that the borrower would be unable to pay its debts as per terms of repayment accepted by him;

(e) The borrower has **(i)** entered into any arrangement or compromise with creditors without the consent of the SC/RC which adversely affects its interest or **(ii)** committed any act of insolvency, **(iii)** discontinues/threatens to discontinue any of its business consisting of 10 per cent or more of its turnover;

(f) All/significant part of the assets of the borrower required/essential for its business/operations are damaged due to his actions;

(g) The general nature/scope of the business, operations, management, control/ownership of the business of the borrower are altered to an extent, which in the opinion of the SC/RC, materially affects his ability to repay the loan;

(h) The SC/RC is satisfied that serious dispute(s) have arisen among the promoters/directors/partners of the business of the borrower, which would materially affect his ability to repay the loan;

(i) Failure of the borrower to acquire the assets for which the loan has been availed and utilisation of the funds borrowed for other than stated purposes or disposal of the financed assets and misuse or misappropriation of the proceeds; and

(j) Fraudulent transactions by the borrower in respect of the assets secured to the creditor(s).

Policy Regarding Change in or Takeover of Management Every SC/RC should frame policy guidelines regarding change in or takeover of the management of the business of the borrower, with the approval of its Board of Directors and the borrower should made aware of such policy. Such policy should generally provide the following:

(i) The change in or takeover of the management of the business of the borrower should be done only after the proposal is examined by an independent advisory committee to be appointed by the SC/RC consisting of professionals having technical/finance/legal background who, after assessment of the financial position of the borrower, time frame available for recovery of the debt from him, future prospects of the business, and other relevant aspects, should recommend to the SC/RC that it may resort to change in or takeover of the management of the business of the borrower and that such action would be necessary for effective running of the business leading to recovery of its dues.

(ii) The Board of Directors, including at least two independent directors of the SC/RC, should deliberate on the recommendations of the independent advisory committee and consider the various options available for the recovery of dues before deciding whether, under the existing circumstances, the change in or takeover of the management of the business of the borrower is necessary and the decision should be specifically included in the minutes.

(iii) The SC/RC should carry out due diligence, exercise and record the details of the exercise, including the findings on the circumstances which had led to default in repayment of the dues by the borrower and why the decision under consideration has become necessary.

(iv) The SC/RC should identify suitable personnel/agencies, who can takeover by formulating a plan for operating and managing the business of the borrower effectively, so that its dues may be realised within the time frame.

(v) Such plan will also include procedure to be adopted by the SC/RC at the time of restoration of the management of the business to the borrower, his rights and liabilities at the time of change/restoration of management back to the borrower, rights and liabilities of the new management taking over management of the business of the borrower at the behest of SC/RC. It should be clarified to the new management by the SC/RC that the scope of their role is limited to the recovery of dues of the SC/RC by managing the affairs of the business of the borrower in prudent manner.

To ensure independence of members of independent advisory committee (IAC), they should not be connected with the affairs of the SC/RC in any manner and should not receive any pecuniary benefit from the SC/RC except for services rendered for acting as member of IAC.

Procedure The SC/RC should give a notice of 60 days to the borrower indicating its intention to effect the proposed change and calling for objections, if any. The objections submitted by the borrower should be initially considered by the IAC and, thereafter, the objections along with the recommendations of the IAC should be submitted to the Board of Directors who should pass a reasoned order within a period of 30 days from the date of expiry of the notice period, indicating the decision of the SC/RC regarding the change in or takeover of the management of the business of the borrower, which should be communicated to the borrower.

Reporting The SC/RCs should report to the RBI all cases where they have taken action to cause change in or takeover the management of the business of the borrower for realisation of its dues from the borrower.

Guidelines on Transfer of Assets Through Securitisation and Direct Assignment of Cash Flows 2012 Securitisation involves pooling of homogeneous assets and the subsequent sale of the cash flows from these asset pools to investors. The securitisation market is primarily intended to redistribute the credit risk away from the originators to a wide spectrum of investors who can bear the risk, thus, aiding financial stability and provide an additional source of funding. The recent crisis in the credit markets has called into question the desirability of certain aspects of securitisation activity as well as of many elements of the '**originate to distribute**' business model, because of their possible influence on originators' incentives and the potential misalignment of interests of the originators and investors. While the securitisation framework in India has been reasonably prudent, certain imprudent practices have reportedly developed like origination of loans with the sole intention of immediate securitisation and securitisation of tranches of project loans even before the total disbursement is complete, thereby passing on the project implementation risk to investors. With a view to developing an orderly and healthy securitisation market, to ensure greater alignment of the interests of the originators and the investors as also to encourage the development of the securitisation activity in a manner consistent with the aforesaid objectives, several proposals for post-crisis reform are being considered internationally. Central to this is the idea that originators should retain a portion of each securitisation originated, as a mechanism to better align incentives and ensure more effective screening of loans. In addition, a minimum period of retention of loans prior to securitisation is also considered desirable, to give comfort to the investors regarding the due diligence exercised by the originators. Keeping in view the above objectives and the international work on these accounts, guidelines have been formulated regarding the minimum holding period (MHP) and minimum retention requirement (MRR). They are organised in three sections. While Section A contains the provisions relating to securitisation of assets, Section B contains stipulations regarding transfer of standard assets through direct assignment of cash flows.

Guidelines on Securitisation of Standard Assets They relate to the requirements to be met by **(i)** originating banks and **(ii)** banks other than originators having securitisation exposure.

Requirements to be Met by the Originating Banks The main requirements, namely, **(i)** eligible assets, **(ii)** minimum holding period, **(iii)** minimum retention requirement, **(iv)** limit on total retained exposures, **(v)** booking of profit upfront, **(vi)** disclosures, **(vii)** loan origination standards and **(viii)** treatment of securitised assets not meeting the requirements **(i)** to **(vii)** are discussed below.

Assets Eligible for Securitisation In a single securitisation transaction, the underlying assets should represent the debt obligations of a homogeneous pool of obligors. Since the single asset securitisations do not involve any credit tranching and redistribution of risk, they are inconsistent with the economic objectives of securitisation. All on-balance sheet standard assets in terms of loans, advances and bonds in the nature of advances, except the following, are eligible for securitisation by the originators: **(i)** revolving credit facilities (e.g. cash credit accounts, credit card receivables etc.), **(ii)** assets purchased from other entities, **(iii)** securitisation exposures (e.g. mortgage/asset-backed securities), **(iv)** loans with bullet repayment of both principal and interest. However, loans with tenor upto 24 months extended to individuals for agricultural activities where both interest and principal are due only on maturity and trade receivables with tenor up to 12 months discounted/purchased by banks from their borrowers will be eligible for securitisation where a borrower (in case of agricultural loans) /a drawee of the bill (in case of trade receivables) has fully repaid the entire amount of last two loans/receivables (one loan, in case of agricultural loans with maturity extending beyond one year) within 90 days of the due date.

Minimum Holding Period (MHP) Loans can be securitised only after being held by for a minimum period in the books of the banks. The criteria governing determination of MHP for assets listed below reflect the need to ensure that: **(a)** the project implementation risk is not passed on to the investors, and **(b)** a minimum recovery performance is demonstrated prior to securitisation to ensure better underwriting standards. The originating banks can securitise loans only after MHP counted from the date of full disbursement of **(i)** loans for an activity/purpose, **(ii)** acquisition of assets such as car, residential house by the borrower or **(iii)** the date of completion of a project. The MHP defined with reference to the number of instalments to be paid prior to securitisation would be applicable to various loans depending upon the tenor and repayment frequency given below.

Minimum Holding Period

	Minimum number of instalments to be paid before securitisation			
	Repayment frequency			
	Weekly	*Fortnightly*	*Monthly*	*Quarterly*
Loans with original maturity up to 2 years	12	6	3	2
Loans with original maturity of more than 2 y ears and up to 5 years	18	9	6	3
Loans with original maturity of more than 5 years	—	—	12	4

Where the repayment is at more than quarterly intervals, loans can be securitised after repayment of atleast two instalments. The MHP would be applicable to individual loans in the pool of securitised loans and not to loans with bullet repayment of both principal and interest.

Minimum Retention Requirement (MRR) The MRR is primarily designed to ensure that the originating banks have a continuing stake in the performance of the securitised assets so as to ensure that they carry out their proper due diligence. In the case of long term loans, the MRR may also include a vertical tranche of securitised paper in addition to the equity/subordinate tranche, to ensure stake in their performance for the entire life of the securitisation process. The originating banks should adhere to the MRR detailed below while securitising loans. The minimum retention requirements at the time of securitisation are related to the type of loan, namely, with original maturity **(a)** upto 24 months, **(b)** more than 24 months and **(c)** bullet repayment loans/receivables. The MRR should be 5 per cent in case of type **(a)** and 10 per cent in case of type **(b)** and **(c)** loans.

Limit on Total Retained Exposures At present, total investment by the originators in the securities issued by the SPV through underwriting or otherwise is limited to 20 per cent of the total securitised instruments issued. Credit enhancement, liquidity support and counterparty credit exposures in the case of interest rate/currency swaps with the SPV are outside this limit. However, under the Basel II requirements, a significant credit risk associated with the securitised exposures should be transferred to the third parties for recognition of risk transfer. In view of this, the total exposure of banks to the loans securitised in the following forms should not exceed 20 per cent of the total securitised instruments issued: **(a)** investments in equity/subordinate/senior tranches of securities issued by the SPV including through underwriting commitments, **(b)** credit enhancements including cash and other forms of collaterals including over-collateralisation, but excluding the credit enhancing interest only strip, and **(c)** liquidity support. If a bank exceeds the above limit, the excess amount would be risk weighted at 11.11 per cent. Credit exposure on account of interest rate/currency swaps entered into with the SPV should be excluded from this limit as this would not be within the control of the bank. The 20 per cent limit on exposures would not be deemed to have been breached if it is exceeded due to amortisation of securitisation instruments issued.

Booking of Profit Upfront In terms of the present stipulations, any profit/premium arising on account of securitisation of loans should be amortised over the life of the securities issued/to be issued by the SPV to discourage '**originate-to-distribute**' model. Since these concerns are sought to be addressed to some extent by measures such as MRR and MHP, higher recognition of cash profits are allowed during a year based on amortisation of principal and losses incurred as well as specific provision requirements on the securitisation exposures as explained below. The amount of profit received in cash may be held under an accounting head styled as ***Cash Profit on Loan Transfer Transactions Pending Recognition*** maintained on individual transaction basis. The amortisation of cash profit arising out of **securitisation transaction would be done at the end of every financial year and calculated as under**:

Profit to be amortised = Max{L, [(X × (Y/Z))], [(X/n)]}

X = amount of unamortised cash profit lying in the account 'Cash Profit on Loan Transfer Transactions Pending Recognition' at the beginning of the year

Y = amount of principal amortised during the year

Z = amount of unamortised principal at the beginning of the year

L = Loss (marked to market losses incurred on the portfolio + specific provisions, if any, made against the exposures to the particular securitisation transaction + direct write-off) excluding loss incurred on credit enhancing interest only strip.

n = residual maturity of the securitisation transaction

At times, the originating banks retain contractual right to receive some of the interest amount due on the transferred assets. This receivable interest represents a liability of the SPV and its present value is capitalised as an interest only strip (**I/O Strip**), which is an on-balance sheet asset. Normally, a bank would recognise an unrealised gain in its profit and loss account on capitalisation of future interest receivable by way of I/O Strip. However, banks should not recognise the unrealised gains. Instead, they should hold the unrealised profit under an accounting head styled as ***Unrealised Gain on Loan Transfer Transactions***. The balance in this account may be treated as a provision against potential losses incurred on the I/O Strip due to its serving as credit enhancement for the securitisation transaction. The profit may be recognised only when it is redeemed in cash. As banks would not be booking gain on sale represented by I/O Strip upfront, it should be deducted from Tier-I capital. This method of accounting of I/O Strip can be applied to outstanding securitisation transactions as well.

Disclosures by the Originating Banks They include disclosures in **(i)** servicer/investor/trustee report and **(ii)** notes to annual accounts.

- The originating banks should disclose to the investors the weighted average holding period of the assets securitised and the level of their MRR in the securitisation. They should ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures. The disclosure by an originator of its fulfilment of the MHP and MRR should be made available publicly and appropriately documented. For instance, a reference to the retention commitment in the prospectus for securities issued under the securitisation programme would be considered appropriate. The disclosure should be made at the origination of the transaction, and confirmed thereafter at a minimum half-yearly (end-September and March), and at any point when the requirement is breached. These periodical disclosures should be made in the specified format separately for each securitisation transaction, throughout its life, in the servicer/investor/trustee report/any similar published document.
- The notes to annual accounts of the originating banks should indicate the outstanding amount of securitised assets as per the books of the SPVs sponsored, and total amount of exposures retained, by the bank as on the date of balance sheet to comply with the MRR. They should be based on the information duly certified by the SPV's auditors obtained by the originating bank from the SPV and disclosed in the specified format.

Loan Origination Standards The originating banks should apply the same sound and well-defined criteria for credit underwriting to exposures to be securitised as they apply to exposures to be held on their book. The same processes for approving/amending/renewing and monitoring of credits should also be applied by them.

Treatment of Securitised Assets not Meeting the Requirements Stipulated Above If an originating bank fails to meet the requirement laid down above, it will have to maintain capital for the securitised assets as if these were not securitised. This would be in addition to the capital which it is required to maintain on its other existing exposures to the securitisation transaction.

Requirements to Be Met by Banks Other Than Originators Having Securitisation Exposures They include: **(i)** due diligence, **(ii)** stress testing, **(iii)** credit monitoring and **(iv)** exposures not meeting stipulated requirements.

Standards for Due Diligence Banks can invest in, or assume exposure to, a securitisation position only if the originator (i.e. other banks/FIs/NBFCs) has explicitly disclosed that it has adhered to the stipulated MHP and MRR and would adhere to them on an ongoing basis. The overseas branches of Indian banks can invest in such instruments in the jurisdictions where the MRR has been prescribed, though it may be different from that prescribed in India.

Banks should be able to demonstrate for each of their individual securitisation positions that they have a comprehensive and thorough understanding of risk profile of their proposed/existing investments in securitised positions. They would also have to demonstrate that they have implemented formal policies and procedures appropriate to banking book and trading book for analysing and recording the following:

(a) information disclosed by the originators regarding the MRR in the securitisation on at least half-yearly basis;

(b) the risk characteristics of the individual securitisation position including all the structural features of the securitisation that can materially impact the performance of the investing bank's **securitisation position** [i.e., the seniority of the tranche, thickness of the subordinate tranches, its sensitivity to pre-payment risk and credit enhancement resets, structure of repayment water-falls, waterfall related triggers, the position of the tranche in sequential repayment of tranches (time-tranching), liquidity enhancements, availability of credit enhancements in the case of liquidity facilities, deal-specific definition of default, etc.];

(c) the risk characteristics of the exposures underlying the securitisation position [i.e., the credit quality, extent of diversification and homogeneity of the pool of loans, sensitivity of the repayment behavior of individual borrowers to factors other than their sources of income, volatility of the market values of the collaterals supporting the loans, cyclicality of the economic activities in which the underlying borrowers are engaged, etc.];

(d) the reputation of the originators in terms of **(i)** observance of credit appraisal/monitoring standards, **(ii)** adherence to MRR and MHP standards in earlier securitisations, and **(iii)** fairness in selecting exposures for securitisation;

(e) loss experience in earlier securitisations of the originators in the relevant exposure classes underlying the securitisation position, incidence of any frauds committed by the underlying borrowers, truthfulness of the representations and warranties made by the originator;

(f) the statements and disclosures made by the originators/their agents/advisors, about their due diligence on the securitised exposures and on the quality of the collateral supporting the securitised exposures; and

(g) the methodologies and concepts on which the valuation of collateral supporting the securitised exposures is based and the policies adopted by the originator to ensure the independence of the valuer.

When the securitised instruments are subsequently purchased in the secondary market by a bank, it should ensure that the originator has explicitly disclosed that it will retain a position that meets the MRR.

Stress Testing Banks should regularly perform their own stress tests appropriate to their securitisation positions. Factors which may be considered would, ***inter alia***, include, rise in **(i)** default rates in the underlying portfolios in a situation of economic downturn/**(ii)** pre-payment rates due to fall in rate of interest/**(iii)** income levels of the borrowers leading to early redemption of exposures, fall in rating of the credit enhancers resulting in fall in market value of asset/mortgage backed securities, and drying of liquidity of the securities resulting in higher prudent valuation adjustments. The results of stress test should be taken into account in Pillar II exercise under Basel II framework and additional capital be held to support any higher risk.

Credit Monitoring Banks should monitor on an ongoing basis and in a timely manner, performance information on the exposures underlying their securitisation positions and take appropriate action including modification to **(i)** exposure ceilings to certain type of asset class underlying securitisation transaction, **(ii)** ceilings applicable to originators. They should establish formal procedures appropriate to their banking and trading books and commensurate with the risk profile of their exposures in securitised positions including the exposure type, percentage of loans more than 30, 60 and 90 days **past** due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with bandwidths that facilitate adequate sensitivity analysis. They may, ***inter alia***, make use of the disclosures made by the originators in the specified form to monitor the securitisation exposures.

Treatment of Exposures not Meeting the Requirements Stipulated Above The investing banks should assign a risk weight of 11.11 per cent to the securitisation exposures where the above requirements are not met. While banks should make serious efforts to comply with these guidelines, the higher risk weight of 11.11 per cent would be applicable, and necessary systems and procedures to implement the requirements should be put in place.

Transactions Involving Transfer of Assets Through Direct Assignment of Cash Flows and the Underlying Securities The main elements of the RBI guidelines are requirements to be met by **(i)** originating, **(ii)** purchasing banks.

Requirements to be Met by the Originating Banks are: **(i)** assets eligible for transfer, **(ii)** minimum holding period (MHP), **(iii)** minimum retention requirement (MRR), **(iv)** booking of profit upfront, **(v)** disclosures, **(vi)** loan origination standards, and **(vii)** treatment of assets sold not meeting the stipulated requirements.

Assets Eligible for Transfer Transfer is defined to mean transfer of assets through direct sale, assignment and any other form of transfer of assets. The generic term used for transfers would be sale and purchase. Banks can transfer a single standard asset/a part or portfolio of such assets to financial entities through an assignment deed with the exception of the following: **(i)** revolving credit facilities, **(ii)** assets purchased from other entities, and **(iii)** assets with bullet repayment of both principal and interest. However, these guidelines do not apply to: **(i)** transfer of loan accounts of borrowers by a bank to other bank/FIs/NBFCs and *vice versa*, at the request/instance of borrower, **(ii)** inter-bank participations, **(iii)** trading in bonds, **(iv)** sale of entire portfolio of assets consequent upon a decision to exit the line of business completely. Such a decision should have the approval of Board of Directors of the bank, **(v)** consortium and syndication arrangements and arrangement under Corporate Debt Restructuring mechanism, **(vi)** any other arrangement/transactions, specifically exempted by the RBI.

Minimum Holding Period (MHP) Same as applicable to originating banks in relation to securitisation of standard assets (**discussed earlier**).

Minimum Retention Requirement (MRR) The originating banks should adhere to the MRR specified below while transferring assets to other financial entities: asset with original maturity **(a)** upto 24 months and **(b)** more than 24 months, and assets with bullet repayment, retention of right to receive 5 per cent and 10 per cent respectively of the cash flows on *pari passu* basis.

In the case of partial sale of assets, if the portion retained by the seller is more than the MRR required above, the portion equivalent to 5 pr cent or 10 per cent of the portion sold, would be treated as MRR. However, all exposures retained by the selling bank including MRR should rank *pari-passu* with the sold portion of the asset.

Banks should not **(i)** offer credit enhancements in any form and liquidity facilities in the case of loan transfers through direct assignment of cash flows, as the investors in such cases are generally the institutional investors who should have the necessary expertise to appraise and assume the exposure after carrying out the required due diligence, **(ii)** retain any exposures through investment in the I/O Strip representing the excess interest spread/future margin income from the loans transferred. However, they will have to satisfy the MRR requirements stipulated above. The retention of partial interest in the loans transferred to comply with the required MRR should be supported by a legally valid documentation. At a minimum, a legal opinion regarding the following should also be kept on record by the originator: **(a)** legal validity of amount of interest retained by the originator, **(b)** such arrangement not interfering with assignee's rights and rewards associated with the loans to the extent transferred to it, and **(c)** the originator not retaining any risk and rewards associated with the loans to the extent transferred to the assignee.

The MRR will have to be maintained by the entity which sells the loans. In other words, it cannot be maintained by other entities which are treated as '**originator**' in terms of guidelines on securitisation of standard assets (**discussed in earlier Section of the Chapter**).

The level of commitment by originators, that is, the MRR should not be reduced either through hedging of credit risk or selling the retained interest. As a percentage of unamortised principal, it should be maintained on an ongoing basis except for reduction of retained exposure due to proportionate repayment or through the absorption of losses. The form of MRR should not change during the life of transaction. For complying with the required MRR, banks should ensure that proper documentation in accordance with law is made.

Booking of Profit Upfront The amount of profit in cash on direct sale of loans and amortisation of cash profit arising out of loan assignment transaction should be done at the end of every financial year and calculated as in case of securitisation of standard assets (**discussed earlier**).

The asset classification and provisioning rules in respect of the exposure representing the MRR should be as under:

(a) The originating bank may maintain a consolidated account of the amount representing MRR if the transferred loans are retail loans. Alternatively, it may continue to maintain borrower-wise accounts for the proportionate amounts retained in respect of those accounts.

(b) In the case of transfer of a pool of loans other than retail loans, the originator should maintain borrower-wise accounts for the proportionate amounts retained in respect of each loan.

(c) If the originating bank acts as a servicing agent of the assignee bank for the loans transferred, it would know the overdue status of loans transferred which should form the basis of classification of the entire MRR/individual loans representing MRR as NPA in the books of the originating bank, depending upon the method of accounting followed as explained in paras **(a)** and **(b)** above.

Disclosures by the Originating Banks Same as in case of securitisation of standard assets.

Loan Originating Standards Same as in case of securitisation of standard assets.

Treatment of Assets Sold Not Meeting the Requirements Stipulated Above If an originating bank fails to meet the requirement laid down above, it will have to maintain capital for the assets sold as if these were still on its books.

Requirements to be Met by the Purchasing Banks The main requirements are: **(i)** restrictions on purchase of loan, **(ii)** standards for due diligence, **(iii)** stress testing, **(iv)** credit monitoring, **(v)** true sales criteria, **(vi)** representations/warranties, **(vii)** repurchase of assets, **(viii)** capital adequacy and other prudential norms, and **(ix)** treatment of exposures not meeting the stipulated requirement.

Restrictions on Purchase of Loans Banks can purchase loans from other banks/FIs/NBFCs in India only if the seller has explicitly disclosed to them that it will adhere to the required MRR on an ongoing basis. In addition, for domestic transactions, they should also ensure that the originating institution has strictly adhered to the prescribed MHP criteria in respect of loans purchased by them. The overseas branches of Indian banks may purchase loans in accordance with the regulations laid down in those jurisdictions.

Standards for Due Diligence Banks should have the necessary expertise and resources in terms of skilled manpower and systems to carry out the due diligence of the loans/portfolios of loans. They should adhere to the following guidelines: **(a)** with the approval of their Board of Directors, they should formulate policies regarding the process of due diligence which needs to be exercised by their own officers to satisfy about the Know Your Customer (**KYC**) requirements and credit quality of the underlying assets. Such policies should, *inter alia,* lay down the methodology to evaluate credit quality of underlying loans, the information requirements and so on; **(b)** the due diligence of the purchased loans cannot be outsourced by them and should be carried out by their own officers with the same rigour as would have been applied while sanctioning new loans by them; **(c)** if a bank wishes to outsource certain activities like collection of information and documents, this should be subject to the RBI guidelines on outsourcing of non-core activities by banks, which would, *inter alia,* imply that they would continue to retain full responsibility in regard to selection of loans for purchase and compliance with **KYC** requirements.

Moreover, they should be able to demonstrate that they have a comprehensive and thorough understanding of, and have implemented formal policies and procedures commensurate with, the risk profile of the loans purchased, analysing and recording:

(a) Information disclosed by the originators regarding the MRR on an ongoing basis;

(b) The risk characteristics of the exposures constituting the portfolio purchased (i.e., credit quality, extent of diversification and homogeneity of the pool of loans, sensitivity of the repayment behaviour of individual borrowers to factors other than their sources of income, volatility of the market values of the collaterals supporting the loans, cyclicality of the economic activities in which the underlying borrowers are engaged, and so on);

(c) The reputation of the originators in terms of observance of credit appraisal and credit monitoring standards, adherence to MRR and MHP standards in earlier transfer of portfolios and fairness in selecting exposures for transfer;

(d) Loss experience in earlier transfer of loans/portfolios by the originators in the relevant exposure classes underlying and incidence of any frauds committed by the underlying borrowers, truthfulness of the representations and warranties made by the originator;

(e) The statements and disclosures made by the originators/their agents/advisors, about their due diligence on the assigned exposures and, on the quality of the collateral supporting the loans transferred; and

(f) The methodologies and concepts on which the valuation of loans transferred is based and the policies adopted by the originator to ensure the independence of the valuer.

Stress Testing The stress testing by banks should be similar to the securitisation of standard assets.

Credit Monitoring The credit monitoring should be similar to securitisation of standard assets. In addition, depending upon the size of the portfolio, credit monitoring procedures may include verification of the information submitted by the bank's concurrent and internal auditors. The servicing agreement should provide for such verifications by the auditors of the purchasing bank. All relevant information and audit reports should be available for verification by the inspecting officials of the RBI during their annual financial inspections.

True Sale Criteria The term **sale** is defined to include direct sale, assignment and any other form of transfer of asset, but excluding loan participation through inter-bank participation certificates, bills rediscounted, outright transfer of loan accounts to other financial entities at the instance of the borrower and sale of bonds other than those in the nature of advance should result in immediate legal separation of the **selling bank** (including other financial entities selling loans to banks) defined to include direct selling/assigning bank and the bank transferring assets through any other mode, from the assets which are sold. In case of sale of a part of an asset, true sale criteria will apply to the part of the asset sold. The assets should stand completely isolated from the selling bank, after its transfer to the buyer, that is, put beyond the selling bank's as well as its creditors' reach, even in the event of bankruptcy of the selling/assigning/transferring bank.

The selling bank should effectively transfer all risks/rewards and rights/obligations pertaining to the asset and not hold any beneficial interest after its sale except those specifically permitted under these guidelines. The buyer should have the unfettered right to pledge, sell, transfer or exchange or otherwise dispose of the assets free of any restraining conditions. The selling bank should not have any economic interest in the assets after its sale and the buyer should have no recourse to the selling bank for any expenses or losses except those specifically permitted under these guidelines.

There should be no obligation on the selling bank to re-purchase or fund the re-payment of the asset or any part of it or substitute assets held by the buyer or provide additional assets to the buyer at anytime except those arising out of breach of warranties or representations made at the time of sale. It should be able to demonstrate that a notice to this effect has been given to the buyer and that the buyer has acknowledged the absence of such obligation. It should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the buyer.

The sale should be only on cash basis and the consideration received not later than at the time of transfer of assets. The sale consideration should be market-based and arrived at in a transparent manner on an arm's length basis.

If the seller acts as the servicing agent for the loans, it would not detract from the 'true sale' nature of the transaction, provided such service obligations do not entail any residual credit risk on the sold assets or any additional liability for them beyond the contractual performance obligations in respect of such services.

An opinion from the selling bank's legal counsel should be kept on record signifying that: **(i)** all rights, titles, interests and benefits in the assets have been transferred to the buyer; **(ii)** the selling bank is not liable to the buyer in any way with regard to these assets other than the servicing obligations above; and **(iii)** its creditors do not have any right in any way with regard to these assets even in case of its bankruptcy.

Any re-schedulement/restructuring/re-negotiation of the terms of the underlying agreement(s) effected after the transfer of assets to the buyer would be binding on the buyer and not on the selling bank except to the extent of the MRR.

The transfer of assets from selling bank must not contravene the terms and conditions of any underlying agreement governing them and all necessary consents from obligors (including from third parties) should have been obtained.

In case the selling bank also provides servicing of assets after the sale under a separate servicing agreement for fee, and the payments/repayments from the borrowers are routed through it, it would be under no obligation to remit funds to the buyer unless and until these are received from the borrowers.

Representations and Warranties An originator that sells assets to other financial entities may make representations/warranties concerning them. Where the following conditions are met, the seller would not be required to hold capital against such representations/warranties:

(a) It is provided only by way of a formal written agreement,
(b) The seller undertakes appropriate due diligence before providing/accepting it,
(c) It **(i)** refers to an existing state of facts that is capable of being verified by the seller at the time the assets are sold, **(ii)** is not open-ended and, in particular, does not relate to the future creditworthiness of the loans/underlying borrowers.
(d) Its exercise, requiring an originator to replace assets sold, on grounds covered in them must be: **(i)** undertaken within 120 days of the transfer of the assets; and **(ii)** conducted on the same terms and conditions as the original sale.
(e) A seller that is required to pay damages for breach of representation/warranty can do so provided the agreement to pay damages meets the following conditions: **(i)** the onus of proof for breach remains at all times with the party so alleging which serves a written notice of claim on the seller, specifying the basis for the claim, and **(ii)** damages are limited to losses directly incurred as a result of the breach.
(f) A seller should notify the RBI of all instance where it has agreed to replace assets sold to another financial entity or pay damages arising out of any representation/warranty.

Repurchase of Assets In order to limit the extent of effective control of transferred assets by the seller in the case of direct assignment transactions, banks should not have any re-purchase agreement including through "**clean-up calls**" on the transferred assets.

Capital Adequacy and Other Prudential Norms The capital adequacy treatment for direct purchase of **(i)** corporate, **(ii)** retail loans, should be as per the rules applicable to corporate loans and retail portfolios directly originated by banks except in cases where the individual accounts have been classified as NPA, in which case usual capital adequacy norms as applicable to retail NPAs should apply. No benefit in terms of reduced risk weights will be available to purchased retail loans portfolios based on rating because this is not envisaged under the Basel II standardised approach for credit risk. Investment in tranches of securitised loans will attract capital adequacy and other prudential norms as applicable to securitisation transactions. However, banks may have the pools of loans rated so as to have a third party view of the credit quality of the pool in addition to their own due diligence. However, such rating cannot substitute for the due diligence that the purchasing bank is required to perform.

In purchase of pools of both retail and non-retail loans, income recognition, asset classification, provisioning and exposure norms for the purchasing bank will be applicable on individual obligors and not on portfolio. It should not apply such norms at portfolio level, as such treatment is likely to weaken the credit supervision due to its inability to detect and address weaknesses in individual accounts in a timely manner. If it is not maintaining the individual obligor-wise accounts for the portfolio of loans purchased, it should have an alternative mechanism to ensure application of prudential norms on individual obligor basis, especially the classification of the amounts corresponding to the obligors which need to be treated as NPAs as per existing prudential norms. One such mechanism could be to seek monthly statements containing account-wise details from the servicing agent to facilitate classification of the portfolio into different asset classification categories. Such details should be certified by the authorised officials of the servicing agent. The concurrent/internal/statutory auditors of the bank should also conduct checks of these portfolios with reference to the basic records maintained by the servicing agent. The servicing agreement should provide for such verifications. All relevant information and audit reports should be available for verification by the inspecting officials of the RBI during their annual financial inspections.

The purchased loans should be carried at acquisition cost unless it is more than the face value, in which case the premium paid should be amortised based on straight line method or effective interest rate method. The outstanding/unamortised premium need not be deducted from capital. The discount/premium on the purchased loans can be accounted for on portfolio basis or allocated to individual exposures proportionately.

INSOLVENCY AND BANKRUPTCY (IB CODE) 2016

A serious lacunae of the NPA management mechanism in India was the absence of ease of exit of enterprises from unsustainable businesses. The cost of impeded exit in terms of non-recovery of debt for investors/creditors/banks/financial institutions was enormous necessitating a framework for easy exit. The SARFAESI Act was an adhoc approach in the absence of a market-led mechanism for resolution of insolvency. The object of the IB Code is to consolidate the laws relating to reorganisation and insolvency resolution of corporate persons/firms/individuals in a time-bound manner for maximisation of value of their assets, promote availability of credit and balance the interest of all the stakeholders including alteration in the order of priority of payment of Government dues. **We focus in this Section on the framework applicable to corporate persons** where the minimum and maximum amount of default is ₹1,00,000 and ₹1 crore. The main elements of the IB Code are: **(a)** corporate insolvency resolution and liquidation, **(b)** regulation of insolvency professionals/agencies and information utilities and **(c)** miscellaneous provisions.

To ensure effective speedy enforcement of the IB code, the RBI has recently been empowered by the Government to issue directions to banks for its implementation.

Corporate Insolvency Resolution and Liquidation

The main elements of the corporate insolvency resolution and liquidation are: **(i)** corporate insolvency resolution process, **(ii)** liquidation process, **(iii)** fast track resolution process, **(iv)** voluntary liquidation, **(v)** adjudicating authority and **(vi)** offences and penalties.

Corporate Insolvency Resolution Process Where any **corporate debtor** (i.e. a corporate person who owes debt to any person including an individual/HUF/company/trust/partnership/LLP/any other entity established under a statute and includes a non-resident) commits a default, a financial/operational creditor/corporate debtor itself may initiate corporate insolvency resolution process. A **corporate person** means a company/LLP/any person incorporated with limited liability but excludes a **financial service provider** (i.e. a person engaged in providing financial service in terms of authorisation issued/registration granted by a **financial sector regulator** including the RBI/SEBI/IRDA/PFRA). **Default** means non-payment of a due/payable debt. **Debt** means a liability/obligation respect of a claim due from any person and includes financial/operational debt. **Claim** means a right to payment/remedy for breach of contract giving right to payment. **Financial service** include **(i)** accepting deposits; **(ii)** safeguarding/administering assets consisting of financial products of another person or agreeing to do so. **Financial product** means securities/contracts of insurance/deposits/credit arrangements including loans/advances by banks and financial institutions (i.e. banks/public financial institutions/others notified by Government), retirement benefit plans/small savings instruments/foreign currency contracts/other prescribed instruments; **(iii)** offering/managing assets consisting of financial products of another person; **(iv)** effecting insurance contracts; **(v)** rendering/agreeing to render advice or/soliciting for **(1)** buying/selling/subscribing to a financial products, **(2)** availing of a financial service, **(3)** exercise any right associated with a financial product/service; **(vi)** establishing/operating an investment scheme; **(vii)** maintaining/transferring records of ownership of financial products; **(viii)** underwriting the issuance/subscription of financial products; **(ix)** selling/providing/issuing stored value or payment instruments or providing payment services. **Creditor** means any person to whom a debt is owed and includes a financial/operational, secured/unsecured creditor and a decree holder. **Financial creditor** means any person to whom a financial debt is owed. **Operational** creditor means a person to whom an **operational debt** (i.e. a claim in respect of provision of goods/services including employment or a debt in respect of repayment of dues payable to the Government) is owed and includes any person to whom it has been legally assigned/transferred. **Financial debt** means a debt along with interest disbursed against the consideration for time value of money and includes: **(a)** money borrowed against the payment of interest, **(b)** amount raised by/under acceptance credit facility or its demat equivalent, **(c)** amount raised pursuant to note, purchase facility/issue of bonds, notes debentures, loan stock, similar instruments, **(d)** amount of any liability in respect of lease/hire-purchase contract deemed as finance/capital lease, **(e)** non-recourse receivables sold/discounted, **(f)** amount raised under any transaction having commercial effect of borrowing, **(g)** derivative transaction in terms of market value in connection with protection against/benefit from fluctuation in any rate/price, **(h)** counter-indemnity obligation in respect of guarantee/indemnity/ bond/documentary letter of credit/any other instrument issued by a bank/financial institution, and **(i)** amount of liability in respect of guarantee/indemnity for any item(s) covered in **(a)** to **(h)** items.

The main elements of the insolvency resolution process are: **(i)** initiation by financial creditor, **(ii)** initiation by operational creditor, **(iii)** initiation by corporate applicant, **(iv)** appointment of interim resolution professional, and **(vi)** appointment of resolution professional.

Initiation of Corporate Insolvency Resolution by Financial Creditor A financial creditor either by itself or jointly with other financial creditors may file an application for initiating corporate insolvency resolution process against a corporate debtor before the adjudicating authority (**AA** i.e. National

Company Law Tribunal) when a default has occurred in the prescribed form and manner and accompanied with the prescribed fee. It should, along with the application, furnish **(a)** record of the default recorded with the information utility registered with the Insolvency and Bankruptcy Board of India (IBBI) or other specified record/evidence of default, **(b)** the name of the IBBI-registered resolution professional proposed to act as an interim resolution professional and **(c)** any other information specified by the IBBI. Within fourteen days, the **AA**/National Company Law Tribunal (NCLT) would ascertain the existence of a default from the records of an information utility or on the basis of other evidence furnished by the financial creditor. On being satisfied that **(a)** a default has occurred and the application is complete, and there is no disciplinary proceedings pending against the proposed resolution professional admit the application; **(b)** default has not occurred/the application is incomplete/any disciplinary proceeding is pending against the proposed resolution professional, reject the application. A **resolution professional** means an insolvency professional appointed to conduct the corporate insolvency resolution process. The insolvency resolution process would commence from the date of admission of the application.

Insolvency Resolution by Operational Creditor An operational creditor may, on the occurrence of a default, deliver a **demand notice** (i.e. a notice demanding repayment of debt in respect of which default has occurred) of unpaid operational debtor copy of an invoice demanding payment of the amount involved in the default to the corporate debtor in the prescribed form and manner. Within ten days of the receipt of the demand notice/copy of the invoice, the corporate debtor should bring to the notice of the operational creditor **(a)** existence of a dispute and record of the pendency of the suit or arbitration proceedings filed before the receipt of the notice/invoice, **(b)** the repayment of unpaid operational debt by sending an attested copy of the record **(i)** of electronic transfer of the unpaid amount from its bank account, **(ii)** the operational creditor has encashed a cheque issued by it.

After the expiry of ten days from the date of delivery of the notice or invoice demanding payment, if the operational creditor does not receive payment from the corporate debtor or notice of the dispute, it may file an application before the National Company Law Tribunal (NCET) for initiating an insolvency resolution process in the prescribed form and manner and accompanied with the prescribed fee. Along with the application, it should furnish **(a)** a copy of the invoice demanding payment/demand notice; **(b)** an affidavit to the effect that there is no notice given by the corporate debtor relating to a dispute of the unpaid operational debt; **(c)** a copy of the certificate from the financial institutions maintaining accounts of the operational creditor confirming that there is no payment of an unpaid operational debt; and **(d)** other specified information. Within 14 days of the receipt of the application, the NCLT would by an order **(i)** admit the application and communicate if **(a)** the application is complete, **(b)** there is no repayment of the unpaid debt, **(c)** the invoice/notice for payment has been delivered, **(d)** no notice of dispute has been received/there is no record of dispute in the information utility, and **(e)** there is no disciplinary proceeding pending against any resolution professional proposed; **(ii)** reject the application, if **(a)** the application is incomplete, **(b)** there has been repayment of the unpaid debt; **(c)** the creditor has not delivered the invoice or notice for payment to the corporate debtor, **(d)** notice of dispute has been received/there is a record of dispute in the information utility, or **(e)** any disciplinary processing is pending against any proposed resolution professional. The corporate insolvency resolution process would commence from the date of admission of the application.

Initiation of Resolution Process by Corporate Applicant Where a **corporate debtor** (i.e. a corporate person who owes a debt) has committed a default, a corporate applicant may file an application for initiating the process with **AA/NCLT**. The application should be filed in the prescribed form, containing the prescribed particulars and in the prescribed manner and accompanied with prescribed fee. It should furnish the information relating to **(a)** its books of account and other documentation relating the specified period, **(b)** the resolution professional proposed to be appointed as an interim resolution professional. Within 14 days, the **AA** would **(a)** admit, if complete, or **(b)** reject, if incomplete. The corporate insolvency resolution process would commence from the date of admission of the application.

Person Not Entitled to Make Application The following persons would not be entitled to make an application to initiate insolvency resolution process: **(a)** a corporate debtor including corporate applicant **(i)** undergoing insolvency resolution process, having completed the process 12 months preceding the date of the application, **(ii)** creditor who has violated any of the terms of the resolution plan approved 12 months before the date of the application, **(iii)** in respect of whom a liquidation order has been made.

Time-limit for Completion of Insolvency Resolution Process The process should be completed within 180 days from the date of admission of the application. If the **AA/NCLT** is satisfied, it may extend the duration of the process upto 90 days.

Declaration of Moratorium and Public Announcement The **AA/NCLT**, after admission of the application, should by an order **(a)** declare a moratorium (**discussed below**), **(b)** cause a public announcement of the initiation of the resolution process and call for the submission of claims and **(c)** appoint an interim resolution professional in the specified manner. The public announcement should be made immediately after his appointment.

Moratorium On the **insolvency commencement date** (i.e. date of admission of application for initiating corporate insolvency resolution process), the **AA/NCLT** should declare a moratorium for prohibiting, **(a)** institution/continuation of pending suits or proceedings against the corporate debtor including execution of any judgment/decree/order in any court of law/tribunal/arbitration panel/other authority, **(b)** transferring/encumbering/alienating/disposing of by the corporate debtor any of its assets/any legal right or beneficial interest, **(c)** any action to foreclose/recover/enforce any security interest created by the corporate debtor in respect of its **property** (i.e. money/gods/actionable claims/land and every description of **(i)** property in/outside India, **(ii)** present/future, vested/contingent interest arising out of, incidental to property) including any action under SRFAESI Act, **(d)** the recovery of any property by an owner or where such property is occupied by or in the possession of the corporate debtor. The supply of specified essential goods or services to the corporate debtor would not be terminated/suspended/interrupted during moratorium. The provisions would not apply to transactions notified by the Central Government in consultation with any financial sector regulator. The order of moratorium would have effect from the date of the order till the completion of the insolvency resolution process.

Public Announcement of Corporate Insolvency Resolution Process The public announcement of the insolvency resolution process under the order of the **AA/NCLT** should contain, **(a)** name and address of the corporate debtor, **(b)** name of the authority with which it is incorporated/registered; **(c)** the last date for submission of claims, **(d)** details of the interim resolution professional vested with its management and responsible for receiving claims, **(e)** penalties for false/misleading claims, and **(f)** the date on which the process would close, that is, 180 days from the date of the admission of the application. The public announcement should be made in the specified manner.

Appointment and Tenure of Interim Resolution Professional The **AA/NCLT** would appoint an interim resolution professional within 14 days from the insolvency commencement date. Where the application is made by a financial creditor/the corporate debtor, the resolution professional would be appointed as the interim resolution professional if no disciplinary proceedings are pending against him. Where the application for corporate insolvency resolution process is made by an operational creditor and **(a)** no proposal for an interim resolution professional is made, the **AA/LNCT** should refer to the IBBI for the recommendation of an insolvency professional to act as an interim resolution professional; **(b)** a proposal for an interim resolution professional is made, he would be appointed as the interim resolution professional, if no disciplinary proceedings are pending against him. The IBBI should, within 10 days of the receipt of a reference from the **AA/NCLT** recommend the name of an insolvency professional. The term of the interim resolution professional would not exceed 30 days.

Management of Affairs of Corporate Debtor by Interim Resolution Professional From the date of appointment of the interim resolution professional **(a)** the management of the affairs of the corporate debtor would vest in him, **(b)** the powers of the Board of Directors/partners of the corporate debtor would stand suspended and exercised by him; **(c)** the officers and managers of the corporate debtor would report to him and provide access to the documents and records required by him, **(d)** the financial institutions maintaining its accounts would act on his instructions and furnish all information available with them to him.

The interim resolution professional should **(a)** act and execute in the name and on behalf of the corporate debtor all deeds, receipts, and other documents, **(b)** take actions in the matter and subject to restrictions specified by the IBBI, **(c)** have the authority to access its electronic records from information utility/books of account, records and other relevant documents available with government authorities, statutory auditors, accountants and other specified persons.

Duties of Interim Resolution Professional would perform the following duties: **(a)** collect all information relating to the assets, finances and operations of the corporate debtor for determining its financial position, including information relating to **(i)** business operations/financial and operational payments for the previous two years; **(ii)** list of assets and liabilities on the initiation date; and **(iii)** other specified matters; **(b)** receive and collate all the claims submitted by creditors to him, pursuant to the public announcement, **(c)** constitute a committee of creditors; **(d)** monitor its assets and manage its operations until a resolution professional is appointed; **(e)** file information collected with the information utility; and **(f)** take control/custody of asset(s) over which the corporate debtor has ownership rights recorded in its balance sheet or with information utility/depository of securities/other registry that records the ownership of assets including **(i)** assets over which it has ownership rights located in a foreign country; **(ii)** assets that may or may not be in its possession; **(iii)** movable or immovable tangible assets; **(iv)** intangible assets including intellectual property; **(v)** securities including shares held in its subsidiary, financial instruments, insurance policies; **(vi)** assets subject to the determination of ownership by a court or authority; **(g)** perform other IBBI-specified duties. The term **assets** would not include assets **(a)** owned by a third party in its possession held under trust or under contractual arrangements including bailment; **(b)** of any Indian/foreign subsidiary; and **(c)** other,s specified/notified by the Central Government in consultation with any financial sector regulator.

Personnel to Extend Cooperation to Interim Resolution Professional The personnel of the corporate debtor, its promoters/other associated persons should extend all required assistance and cooperation to him in managing its affairs. In case of non-cooperation, he may make an application to the **AA/NCLT** for necessary directions to them to comply with his instructions and cooperate with him.

Management of Operations of Corporate Debtor as Going Concern The interim resolution professional should make every endeavour to protect and preserve the value of its property and manage its operations as a going concern. He would have the authority to **(a)** appoint necessary accountants/legal/other professionals, **(b)** enter into contracts on its behalf, amend/modify them/transactions entered into before the commencement of corporate insolvency resolution process, **(c)** raise interim finance provided that no security interest would be created over any encumbered property of the corporate debtor without the prior consent of the creditors whose debt is secured over the encumbered property. Where, however, the value of the property is not less than twice the amount of the debt, no prior consent would be required, **(d)** issue necessary instructions to personnel for keeping it as a going concern, and **(e)** to take all necessary actions to keep it as a going concern.

Committee of Creditors The interim resolution professional should, after collation of all claims received against the corporate debtor and determination of its financial position, constitute a committee of all the financial creditors. However, a **related** party to whom it owes a financial debt, would not have any right of representation, participation or voting in its meetings. Where the corporate debtor owes financial debts to two or more financial creditors as part of a consortium or agreement, each would be part of the committee of creditors and their voting share would be determined on the basis of the financial debts owed to them. Where any person is a financial creditor as well as an operational creditor, he would be **(i)** a financial creditor to the extent of the financial debt, and included in the committee of creditors with proportionate voting share; **(ii)** be considered to be an operational creditor to the extent of the operational debt owed. Where an operational creditor has assigned or legally transferred any operational debt to a financial creditor, the assignee or transferee would be considered as an operational creditor to the extent of the assignment/legal transfer. Where the terms of the financial debt extended as part of a consortium arrangement or syndicated facility or issued as securities provide for a single trustee or agent to act for all financial creditors, each financial creditor may **(a)** authorise the trustee/ agent to act on his behalf; **(b)** represent himself; **(c)** appoint an insolvency professional (other than the resolution professional) at his own cost to represent himself in the committee of creditors to the extent of his voting share; or **(d)** exercise his right to vote to the extent of his voting share with one or more financial creditors jointly or severally. All decisions of the committee of creditors should be taken by a vote of not less than 75 per cent of voting share of the financial creditors. However, where a corporate debtor does not have any financial creditors, the committee of creditors would be constituted and comprise of the IBBI-specified persons to exercise the specified functions in the specified manner. The committee would have the right to require the resolution professional to furnish any financial information in relation to the corporate debtor at any time during the corporate insolvency resolution process. The resolution professional should make available any financial information required by the committee of creditors within 7 days of the requisition.

A **related party**, in relation to a corporate debtor, means **(a)** **(i)** director/partner **(ii)** key managerial personnel or their relatives, **(b)** limited liability partnership/partnership firm in which a director/partner/manager or his relative is partner, **(c)** private/public company in which a director/partner/manager is a director and holds along with relatives more than 2 per cent of share capital, **(d)** body corporate/limited liability partnership/partnership whose Board of Directors, Managing Director, manager/partners, employees in the ordinary course of business act on the advice, directions/instructions of its director/partner/manager, **(e)** any person on whose advise/directions/instructions, a director/partner/manager is accustomed to act, **(f)** body corporate which is its holding/subsidiary/associate or a subsidiary of a holding company to which it is a subsidiary, **(g)** a person **(i)** who controls more than 20 per cent of voting rights on account of ownership/voting agreement, **(ii)** in whom it controls 20 per cent of voting rights, **(iii)** who can control the composition of its Board of Directors/governing body, **(iv)** who is associated on account of **(1)** participation in policy making process, **(2)** having more than two directors in common, **(3)** inter-change of managerial personnel, and **(4)** provision of essential technical information.

Appointment of Resolution Professional The first meeting of the committee of creditors should be held within 7 days of its constitution and by a majority of at least 75 per cent of the **voting share** (i.e. share of the voting rights of a single financial creditor based on the proportion of the financial debt owed to him in relation to the total debt owed) of the financial creditors, either to resolve to appoint the interim resolution professional as a resolution professional or to replace him by another. The **AA/NCLT** would forward the name of the resolution professional to the IBBI for its confirmation and make the appointment after confirmation.

Resolution Professional to Conduct Corporate Insolvency Resolution Process The resolution professional should conduct the entire insolvency resolution process and manage the operations of the corporate debtor during the **insolvency resolution process period** (i.e. 180 days from the beginning of the commencement date). He should exercise powers and perform duties as are vested/conferred on the interim resolution professional.

Meeting of Committee of Creditors The members of the committee of creditors may meet in person or by specified electronic means. All meetings would be conducted by the resolution professional, who would give notice of each meeting to **(a)** members of committee of creditors; **(b)** members of the suspended Board of Directors/partners of the corporate persons; **(c)** operational creditors/their representatives if the amount of their aggregate dues is at least 10 per cent of the debt. The directors/partners/one representative of operational creditors may attend the meetings of creditors, but would not have any right to vote. Any member may appoint an insolvency professional other than the resolution professional to represent him in a meeting. Each creditor should vote in accordance with the voting share him based on the financial debts owed to him. The resolution professional would determine the voting share of to each creditor in the IBBI-specified manner. The meetings should be conducted in the specified manner.

Duties of Resolution Professional The duty of the resolution professional is to preserve and protect the assets of the corporate debtor, including its continued business operations. He should **(a)** take immediate custody and control of all the assets including the business records, **(b)** represent and act on its behalf with third parties, exercise rights for its benefit in judicial/quasi-judicial/arbitration proceedings, **(c)** raise **interim finances** (i.e. financial debt during the resolution process) subject to the approval of the committee of creditors, **(d)** appoint accountants/legal/other professionals in the IBBI-specified manner, **(e)** maintain an updated list of claims, **(f)** convene and attend all meetings of the committee of creditors, **(g)** prepare the specified information memorandum (**discussed later**), **(h)** invite prospective lenders/investors/other persons to put forward resolution plans, **(i)** present all resolution plans at the meetings of the committee of creditors, **(j)** file application for avoidance of specified transactions and **(k)** other IBBI-specified actions.

Replacement of a Resolution Professional by Committee of Creditors The committee of creditors may replace him with another resolution professional at a meeting, by a vote of 75 per cent of the voting shares. The name of the proposed insolvency professional should be sent by them to the **AA/NCLT** to forward it to the IBBI for its confirmation.

Approval of Committee of Creditors for Certain Actions The resolution professional would not take any of the following actions without the prior approval of the committee of creditors: **(a)** raise any interim finance in excess of the amount decided by it in their meeting, **(b)** create any **security interest** (i.e. right/title/interest/claim to property created in favour of/provided for a secured creditor by a transaction which secures payment/performance of an obligation including mortage/charge/hypothecation/assignment and encumbrance or any other agreement/arrangement securing payment/performance of any obligation) over the assets, **(c)** change its capital structure, including by way of issuance of additional securities, creating a new class of securities or buying back or redemption of issued securities, **(d)** record any change in its ownership interest, **(e)** give instructions to financial institutions maintaining its accounts for a debit transaction in excess of the amount decided by the committee of creditors in their meeting, **(f)** undertake any related party transaction, **(g)** amend any **constitutional documents** (i.e. articles/memorandum of association of a company and incorporation document of a limited liability partnership), **(h)** delegate its authority to any other person, **(i)** dispose of or permit the disposal of shares of any shareholder or their nominees to third parties, **(j)** make any change in the its management or its subsidiary, **(k)** transfer rights or financial/operational debts under material contracts otherwise than in the ordinary course of business, **(l)** make changes in the appointment or terms of contract of the **personnel** (i.e. directors/managers/key managerial personnel/designated partners/employees) specified by the committee of creditors, **(m)** make changes in the appointment/terms of contract of statutory internal auditors. He should seek the vote of the creditors prior to taking any of the above actions. The committee should approved it by a vote of 75 per cent of the voting shares. Any action taken by the resolution professional without seeking the approval of the committee of creditors be void. The committee of creditors may report the actions of the resolution professional to the IBBI for necessary actions against him under the IB Code.

Preparation of Information Memorandum The resolution professional should prepare an information memorandum in IBBI-specified form and manner containing the specified relevant information for formulating a resolution plan. He should provide to the **resolution applicant** (i.e. a person who submits a resolution plans to him) access to all relevant information in physical and electronic form provided it undertakes to **(a)** comply with provisions of law relating to confidentiality and insider trading, **(b)** protect any intellectual property it may have access to and **(c)** not share relevant information with third parties unless clauses **(a)** and **(b)** above are complied with. The **relevant information** means the information required by the resolution applicant to make the resolution plan, including the financial position, all information related to disputes by or against it any other specified matter.

Submission of Resolution Plan The resolution applicant may submit a resolution plan to the resolution professional prepared on the basis of the information memorandum. He would examine each resolution plan to confirm that it **(a)** provides for the payment of **insolvency resolution process costs** in the IBBI-specified manner in priority to the repayment of other debts, **(b)** provides for the repayment of the debts of operational creditors in the IBBI-specified manner which should not be less than the amount to be paid to them in the event of a liquidation (**discussed**

later), **(c)** provides for the management of its affairs after approval of the resolution plan, **(d)** the implementation and supervision of the resolution plan, **(e)** does not contravene any of the provisions of the law, **(f)** conforms to other IBBI-specified requirements. He should present to the committee of creditors for its approval the resolution plans which confirming the above conditions and submit it to **AA/NCLT**. The **insolvency resolution process costs** mean **(i)** cost incurred in raising interim finance, **(ii)** payable fee to an acting resolution professional, **(iii)** cost incurred in running the business as a going concern, **(iv)** cost incurred at the expense of the Government to facilitate the process and **(v)** any other IBBI-specified cost.

Approval of Resolution Plan If the **AA/NCLT** is satisfied that the resolution plan as approved by the committee of creditors meets the specified requirements, it would approve the resolution plan which would be binding on the corporate debtor and its employees, members, creditors, guarantors and other involved stakeholders. Where it is satisfied that the resolution plan does not confirm to the requirements, it may reject it. After the order of approval **(a)** the moratorium order passed by the **AA/NCLT** cease to have effect; and **(b)** the resolution professional would forward all records relating to the conduct of the corporate insolvency resolution process and the resolution plan to the IBBI to be recorded on its database.

Liquidation Process The main elements of the liquidation process are: **(i)** initiation of liquidation process, **(ii)** appointment of liquidator, **(iii)** powers/duties of liquidators, **(iv)** liquidation estate, **(v)** powers of liquidator to access information, **(vi)** consolidation of claims, **(vii)** verification of claims, **(viii)** preferential transactions and relevant time, **(ix)** avoidance of undervalued transaction, **(x)** transactions defrauding creditors, **(xi)** extortionate credit transaction, **(xii)** secured creditors in liquidation proceedings, and **(xiii)** dissolution of corporate debtor.

Initiation of Liquidation Where the **AA/NCLT (a)** before the expiry of the insolvency resolution process period/maximum period of **(i)** 180 days permitted for its completion, **(ii)** 90 days for fast track process (**discussed later**) does not receive a resolution, (b) rejects the resolution plan for the non-compliance of the specified requirements, it would **(i)** pass an order requiring the corporate debtor to be liquidated in the laid-down manner **(discussed below), (ii)** issue a public announcement stating that it is in liquidation and **(iii)** require the order to be sent to the authority with which the corporate debtor is registered. On intimation from the resolution professional during the resolution process but before confirmation of the resolution plan to the **AA/NCLT** of the decision of the committee of creditors to liquidate the corporate debtor, it should pass a liquidation order. Where the resolution plan approved by it is contravened by the concerned corporate debtor, any person prejudicially affected by it, may make an application to the **AA/NCLT** for a liquidation order. On receipt of the application if the **AA** determines contravention, it would pass a liquidation order after which, no suit or other legal proceeding would be instituted by/against the corporate debtor. However, a suit/other legal proceeding may be instituted by the liquidator, on behalf of the corporate debtor, with the prior approval of the **AA**. This provision would, however, not apply to legal proceedings in relation to transactions notified by the Central Government in consultation with any financial sector regulator. The order for liquidation would be deemed to be a notice of discharge to the officers/employees/workmen of the corporate debtor, except when its business is continued during the liquidation process by the liquidator.

Appointment of Liquidator and Fee to be Paid Where the **AA** passes liquidation order, the resolution professional insolvency would act as the liquidator. All powers of the Board of Directors, key managerial personnel and the partners of the corporate debtor would be vested in the liquidator. The **AA** should replace the resolution professional if **(a)** the resolution plan submitted by him was rejected for failure to meet the specified requirements, **(b)** the IBBI recommends his replacement for reasons to be recorded in writing. The liquidator should charge the IBBI-specified fee for the conduct of the liquidation proceedings and in proportion to the value of the liquidation estate assets to be paid from its proceeds (**discussed below**).

Powers and Duties of Liquidator Subject to the directions of the **AA**, the liquidator would have the powers and duties to: **(a)** verify claims of all the creditors, **(b)** take into his custody/control all its assets, property, effects and actionable claims, **(c)** evaluate its assets and property in the IBBI-specified manner and prepare a report, **(d)** take measures to protect and preserve its assets and properties as considered necessary, **(e)** carry on its business for its beneficial liquidation as considered necessary, **(f)** sell its immovable and movable property and actionable claims by public auction/private contract, with power to **transfer** it (including creation of charge) to any person/body corporate, or sell it in parcels in the specified manner, **(g)** draw, accept, make and endorse any negotiable instruments including bill of exchange, hundi or promissory note in its name and on its behalf, with the same effect with respect to the liability as if they were drawn/accepted/made/endorsed by or on its behalf in the ordinary course of its business, **(h)** take out, in his official name, letter of administration to any deceased contributory and do in his official name any other act necessary for obtaining payment of any money due and payable from a contributory/his estate which cannot be ordinarily done in the name of the corporate debtor, and the money due and payable would be deemed to be due to the liquidator himself, **(i)** obtain any professional assistance from any person/appoint any professional, in discharge of his duties, obligations and responsibilities, **(j)** invite and settle claims of creditors and claimants and distribute proceeds in accordance with the provisions of this IB Code, **(k)** institute/defend any suit, prosecution/other civil, criminal, legal proceedings, in the name/on behalf of the corporate debtor, **(l)** investigate its financial affairs to determine undervalued/preferential transactions, **(m)** take all necessary actions, steps, or to sign, execute and verify any paper, deed, receipt document, application, petition, affidavit, bond or instrument and use the common seal for liquidation, distribution of assets and in discharge of his duties and obligations and functions as liquidator, **(n)** apply to the **AA** for necessary orders/directions for its liquidation and to report the progress of the liquidation process in a the IBBI-specified manner, and **(o)** to perform other IBBI-specified functions. The liquidator would have the power to consult any stakeholders entitled to a distribution of proceeds (**discussed later**).

Liquidation Estate The liquidator should form an estate of the assets (**liquidation estate**) in relation to the corporate debtor and hold it as a fiduciary for the benefit of all the creditors. The liquidation estate would comprise all liquidation estate including **(a)** any assets over which the corporate debtor has ownership rights, including all rights and interests as evidenced in his balance sheet/an information utility or records in the registry or any depository recording its securities or by any other IBBI-specified means, including shares held in any subsidiary, **(b)** assets that may or may not be in its possession including but not limited to encumbered assets, **(c)** movable or immovable tangible assets, **(d)** intangible assets including but not limited to intellectual property, securities (including shares held in a subsidiary) and financial instruments, insurance policies, contractual rights, **(e)** assets subject to the determination of ownership by the court or authority, **(f)** any assets or their value recovered through proceedings for avoidance of transactions (**discussed later**), **(g)** any asset in respect of which a secured creditor has relinquished security interest, **(h)** any other property belonging to or vested in it at the insolvency commencement date, and **(i)** all proceeds of liquidation as and when realised.

The following would not be included in the liquidation estate assets of the corporate borrower and cannot be used for recovery in the liquidation: **(a)** assets owned by a third party in its possession, including **(i)** assets held in trust, **(ii)** bailment contracts, **(iii)** all sums due to any workman or employee from the provident/pension/gratuity fund, **(iv)** other contractual arrangements which do not stipulate transfer of title but only use of the assets, and **(v)** other assets be notified by the Central Government in consultation with any financial sector regulator, **(b)** assets in security collateral held by financial services providers and subject to netting and set-off in multi-lateral trading/clearing transactions, **(c)** personal assets of any shareholder/partner of a corporate debtor be provided not held on account of avoidance transactions (**discussed later**) that may be avoided, **(d)** assets of any Indian/foreign subsidiary, or **(e)** any other IBBI-specified assets including those which could be subject to set-off on account of mutual dealings between it and any creditor.

Powers of Liquidator to Access Information The liquidator would have the power to access any information systems for admission and proof of claims and identification of the liquidation estate assets relating to the corporate debtor from the following sources: **(a)** an information utility, **(b)** credit information systems regulated under any law, **(c)** any agency of the central, state or local Government including registration authorities, **(d)** information systems for regulated financial/non-financial liabilities/securities and assets posted as security interest regulated under any law, **(e)** any database maintained by the IBBI; and **(f)** any other IBBI-specified source. He should provide the above information to the creditors within 7 days or provide reasons for not providing it.

Consolidation of Claims The liquidator would receive/collect the claims of creditors within 30 days from the date of the commencement of the liquidation process. A financial creditor may submit a claim by providing its record of claim with an information utility. An operational creditor may submit a claim in the IBBI-specified form/manner and along with the specified supporting documents to prove the claim. A creditor who is partly a financial creditor and partly an operational creditor should submit claims to the extent of his financial and operational debts and separately. A creditor may withdraw/vary his claim within 14 days.

Verification of Claims The liquidator should verify the submitted claims within the time specified by the IBBI. He may require any creditor or the corporate debtor or any other person to produce any other necessary document/evidence for verifying the whole/part of the claim. After verification of claims he may admit/reject the claim, in whole or in part and communicate his decision within 7 days. He should determine the value of claims in a manner specified by the IBBI. A creditor may appeal to the **AA** against his decision within 14 days.

Preferential Transactions and Relevant Time Where the liquidator/resolution professional is of the opinion that the corporate debtor has at a relevant time given a preference to any person(s), he should apply to the **AA** for avoidance of preferential transactions and for orders. A corporate debtor would be deemed to have **given a preference**, if **(a)** there is a transfer of its property/an interest for the benefit of a creditor/surety/a guarantor for, or on account of, an antecedent financial/operational debt/other liabilities owed by it, and **(b)** the transfer has the effect of putting them in a beneficial position than it would have been in the event of a distribution of assets in the specified manner (**discussed later**). A preference would not include the following transfers: **(a)** made in the ordinary course of the business/financial affairs of the corporate debtor/transferee, **(b)** creating a security interest in property acquired by it to the extent that **(i)** the security interest secures **new value** and was given at the time of or after the signing of a security agreement containing their description and was used to acquire the property, and **(ii)** registered with an information utility on or before 30 days after the corporate debtor receives its possession. Any transfer made in pursuance of the order of a court would not preclude a transfer to be deemed as giving of preference by the corporate debtor. **New value** means money or its worth in goods, services, or new credit, or release by the transferee of property previously transferred to the transferee in a transaction that is neither void nor voidable by the liquidator or the resolution professional under the IB Code, including proceeds of the property, but does not include a financial/operational debt substituted for existing financial/operational debt. A **preference** would be deemed to be given at a relevant time, if it is given to a **(a)** related party (other than by reason only of being an employee), during two years **(b)** person other than a related party during one year preceding the insolvency commencement date.

Order in Case of Preferential Transactions The **AA**, on an application made by the resolution professional/liquidator may **(a)** require any property **(i)** transferred in connection with the giving of the preference to be vested in the corporate debtor, **(ii)** to be vested if it represents the application of the proceeds of sale of transferred property/money, **(b)** release or discharge of any security interest created by it, **(c)** require any person to pay in respect of benefits received by him from it, sums as the **AA** may direct to the liquidator/resolution professional, **(d)** direct any guarantor, whose financial/operational debts owed to any person were released/discharged by the giving of the preference, to be under new/revived financial/operational debts to him as the **AA** deems appropriate, **(e)** direct for providing **(i)** security or **charge** (i.e. an interest/lien created on asset/property on any person/its undertakings or both as security including mortgage) on any property for the discharge of any financial/operational debt under the order which would have the same priority as a security/charge released/discharged by the giving of the preference, **(ii)** the extent to which any such persons are to be proved in the liquidation/insolvency resolution process for financial/operational debts which arose from, or were released or discharged wholly or in part by the giving of the preference. The order would not **(a)** affect any interest **(i)** in property acquired from a person other than the corporate debtor, **(ii)** derived in good faith and for value, **(b)** require a person, who received a benefit from the preferential transaction in good faith and for value to pay a sum to the liquidator/resolution professional. However, if he **(i)** had sufficient information of the initiation/commencement of the insolvency resolution process, **(ii)** is a related party, it would be presumed that the interest was acquired/benefit was received otherwise than in good faith unless the contrary is shown. A person would be deemed to have sufficient information/opportunity to avail such information if a public announcement regarding the insolvency resolution process has been made.

Avoidance of Undervalued Transactions If the liquidator/resolution professional determines that certain transactions made during the relevant period were undervalued, he should make an application to the **AA** to declare them as void and reverse their effect. A **transaction would be considered undervalued** where the corporate debtor **(a)** makes a gift to a person, **(b)** enters into a transaction with a person involving the transfer of asset(s) for a consideration the value of which is significantly less than the value of the consideration provided by it and has not taken place in the ordinary course of business.

Relevant Period for Avoidable Transactions In an application for avoiding a transaction at undervalue, the liquidator/resolution professional should demonstrate that it was made with **(i)** any person within one year, **(ii)** a related party within two years preceding the insolvency commencement date.

Application by Creditor in Cases of Undervalued Transactions If an undervalued transaction has not been reported, a creditor, member/partner of the corporate debtor may make an application to the **AA** to declare them void and reverse their effect. On being satisfied that **(a)** undervalued transactions had occurred and **(b)** the liquidator resolution professional did not report, the **AA** would pass an order **(i)** restoring the position as it existed before the transactions and reversing its effects in the specified manner, **(ii)** requiring the IBBI to initiate disciplinary proceedings. The order of the **AA** may provide for the following: **(a)** require the transferred property to be vested in the corporate debtor, **(b)** release/discharge any security interest granted by the corporate debtor, **(c)** require any person to pay sums, in respect of benefits received by him, to the liquidator/resolution professional directed by it or determined by an independent expert.

Transactions Defrauding Creditors Where the corporate debtor has, and the **AA** is satisfied that the undervalued transaction was deliberately entered into **(a)** for keeping its assets beyond the reach of any person entitled to make a claim against him, **(b)** in order to adversely affect his interests in relation to the claim, the **AA** would make an order **(i)** restoring the position as it existed before the transaction as if the transaction had not been entered into, and **(ii)** protecting the interests of victims of such transactions. However, an order would not affect any interest **(i)** in property acquired from a person other than the corporate debtor and acquired in good faith, for value and without notice of the relevant circumstances, **(ii)** deriving from such an interest, and **(b)** require such a person to pay any sum unless he was a party to the transaction.

Extortionate Credit Transactions Where the corporate debtor has been a party to an extortionate credit transaction involving the receipt of financial/operational debt within two years preceding the insolvency commencement date, the liquidator/resolution professional may make an application for its avoidance to the **AA** if its terms required exorbitant payments by it. The IBBI may specify the circumstances in which a transactions would be covered. Any debt extended by any person providing financial services in compliance with any law would in no event be considered as an extortionate credit transaction.

Orders of Adjusting Authority in Respect of Extortionate Credit Transactions On being satisfied that the terms of a credit transaction required exorbitant payments, the **AA** would **(a)** restore the prior position, **(b)** set aside the whole/part of the debt created, **(c)** modify the terms of the transaction, **(d)** require him to repay any amount received by such person, **(e)** require any security interest created as part of the extortionate credit transaction to be relinquished in favour of the liquidator/resolution professional.

Secured Creditor in Liquidation Proceedings A **secured creditor** (i.e. a creditor in favour of whom security interest is created) in the liquidation proceedings may **(a)** relinquish its security interest to the liquidation estate and receive proceeds from the sale of assets by the liquidator in the specified manner (**discussed later**), **(b)** realise its security interest in the specified manner. Where he realises the security interest, he should inform the liquidator and identify the asset to be realised. Before any security interest is realised by him, the liquidator should verify and permit it to realise only security interest, the existence of which may be proved either **(a)** by the records of maintained by an information utility, or **(b)** by other IBBI-specified means. A secured creditor may enforce, realise, settle, compromise or deal with the secured assets in accordance with applicable law and apply the proceeds to recover the debts due to it. If he faces resistance from the corporate debtor/any connected person in taking possession of selling/otherwise disposing off the security, he may make an application to the **AA** to facilitate him to realise the security interest. Where the enforcement of the security interest yields an amount by way of proceeds is in excess of the debts to him, he would **(a)** account to and **(b)** tender the surplus funds to the liquidator. The insolvency resolution process costs would be deducted from the proceeds of the realisation by them and should be transferred to the liquidator to be included in the liquidation estate. Where the proceeds of the realisation of the secured assets are not adequate to repay the debts owed to them, their unpaid debts would be paid by the liquidator in the specified manner. The proceeds from the sale of the liquidation assets would be distributed in the following order of priority, within the specified period and in the specified manner: **(a)** insolvency resolution process costs and the liquidation costs paid in full, **(b)** the following debts would rank equally between and among the following: **(i)** workmen's dues for 24 months preceding the liquidation commencement date, and **(ii)** debts owed to a secured creditor who has relinquished the security in the prescribed manner, **(c)** wages and any unpaid dues owed to employees other than workmen for 12 months preceding the liquidation commencement date, **(d)** financial debts owed to unsecured creditors, **(e)** the following dues would rank equally between and among the following: **(i)** any amount due to the Government for two years preceding the liquidation commencement date, **(ii)** debts owed to a secured creditor for unpaid amount following the enforcement of security interest, **(f)** any remaining debts and dues, **(g)** preference shareholders, and **(h)** equity shareholders/partners. Any contractual arrangements between the above recipients with equal ranking disrupting the order of priority would be disregarded by the liquidator. The fees payable to the liquidator would be deducted proportionately from the proceeds payable to each class of recipients and their proceeds would be distributed after the deduction. At each stage of the distribution of proceeds in respect of a class of recipients that rank equally, each debt will either be paid in full or in equal proportion within the same class of recipients, if the proceeds are insufficient to meet the debts in full.

Dissolution of Corporate Debtor Where the assets of the corporate debtor have been completely liquidated, the liquidator would make an application to the **AA** for its dissolution. The **AA** under would order its dissolution from the date of the order and the corporate debtor would be dissolved accordingly. A copy of the order should be forwarded to the authority with which the corporate debtor is registered.

Fast Tract Corporate Insolvency Resolution Process An application for fast track corporate insolvency resolution process may be made in respect of **(a)** a corporate debtor with **(i)** assets and income below a level, **(ii)** class of creditors/amount of debt, **(iii)** other category of corporate persons notified by the Central Government. The fast track resolution process should be completed within 90 days from the insolvency commencement date. The resolution professional should file an application to the **AA** to extend the period beyond 90 days if instructed by a resolution passed at a meeting of the committee of creditors and supported by a vote of 75 per cent of the voting share. On being satisfied, the **AA** may extend the duration of the process once upto 45 days. **The process for conducting insolvency resolution process (discussed earlier) and the provisions relating to offences and penalties (discussed later) would apply to fast track process also.**

Voluntary Liquidation of Corporate Persons A corporate person who intends to liquidate itself voluntarily and has not committed any default may initiate liquidation proceedings in terms of the IBBI-specified conditions and procedural requirements. The voluntary liquidation proceedings of a corporate person registered as a company should meet the following conditions: **(a)** a declaration from majority of the directors verified by an affidavit stating that **(i)** they have made a full inquiry into the affairs of the company and have formed an opinion that either the company has no debt or it will be able to pay them in full from the proceeds of the assets to be sold, **(ii)** the company is not being liquidated to defraud any person. The declaration should be accompanied with the following documents: **(i)** audited financial statements and record of business operations for the previous two years or since its incorporation, whichever is later, **(ii)** a report of the valuation of the assets of the company prepared by a registered valuer. Within four weeks of the declaration, there should be a special resolution of the members of the company in a general meeting **(i)** requiring the company to be liquidated voluntarily or **(ii)** as a result of expiry of the period of its duration, fixed by its articles or on the occurrence of any event in respect of which the articles provide that the company would be dissolved, and appointing an insolvency professional to act as the liquidator. If the company owes any debt to any person, creditors representing two-thirds in value of the debt of the company should approve the resolution within 7 days. The company should notify the Registrar of Companies (ROCs)/IBBI about the resolution to liquidate the company/the subsequent approval by the creditors. The voluntary liquidation proceedings would be deemed to have commenced from the date of passing of the resolution. **The provisions of the IB Code pertaining to liquidation process of corporates (discussed earlier) and offences and penalties (discussed later) would apply to voluntary liquidation proceedings with necessary modifications**. Where the affairs of the corporate person have been completely wound-up, and its assets completely liquidated, the liquidator should make an application to the **AA** for its dissolution. It would pass an order that the corporate debtor should be dissolved from the date of that order. A copy of the order should within 14 days should be forwarded to the authority with which the corporate person is registered.

Adjudicating Authority for Corporate Persons The **AA** in relation to insolvency resolution and liquidation for corporate persons including corporate debtors and **personal guarantors** (i.e. an individual who is a surety in a contract of guarantee) would be the National Company Law Tribunal (**NCLT**) having territorial jurisdiction over the place where the registered office of the corporate person is located. It would be vested with all the powers of the Debt Recovery Tribunal (**discussed in earlier Section**). It would have jurisdiction to entertain/dispose of any **(a)** application or proceeding/claim made by or against the corporate debtor/person, including claims by or against any of its subsidiaries situated in India, **(b)** question of priorities/law/facts, arising out of, or in relation to, the insolvency resolution/liquidation proceedings.

Appeals and Appellate Authority Any person aggrieved by the order of the **AA** may prefer an appeal to the National Company Law Appellate Tribunal (**NCLAT**) within 30 days. An appeal against an order approving a resolution plan may be filed on the following grounds: **(i)** it is in contravention of the provisions of any law, **(ii)** there has been material irregularity in exercise of the powers by the resolution professional during the insolvency resolution period, **(iii)** the debts owed to operational creditors have not been provided for in the resolution plan in the IBBI-specified manner, **(iv)** the insolvency resolution process costs have not been provided for repayment in priority to all other debts, or **(v)** the resolution plan does not comply with any other

IBBI-specified criteria. An appeal against a liquidation order may be filed on grounds of material irregularity/fraud committed in relation to its liquidation order. Any person aggrieved by an order of the NCLAT may file an appeal to the Supreme Court of India on a question of law within 45 days. No civil court/authority would have jurisdiction to entertain any suit or proceedings in respect of any matter on which the NCLT/NCLAT has jurisdiction under the IB Code.

Fraudulent or Malicious Initiation of Proceedings If any person initiates the insolvency resolution process/liquidation proceedings fraudulently or with malicious intent, the **AA** may impose a penalty of at least one lakh rupees, but may extend it to one crore rupees. The penalty for initiation of voluntary liquidation proceedings with interest to defraud any person would be the same. If during the corporate insolvency resolution/liquidation process, it is found that any business of the corporate debtor has been carried on with intent to defraud its creditors or for any fraudulent purpose, the **AA** may pass an order that it would be liable to make such contributions to its assets of the corporate debtor as it may deem fit. Similarly, the **AA** may direct that a director/partner of the corporate debtor would be liable to make such contribution to the assets of the corporate debtor as it may deem fit, if **(a)** before the insolvency commencement date, he knew/ought to have known that there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process, and **(b)** he did not exercise due diligence in minimising the potential loss to the creditors of the corporate debtor.

Offences and Penalties ***Penalties*** The penalty for the various offences under the IB Code **detailed below** is **(i)** imprisonment for a term between 3 – 5 years, **(ii)** fine between ₹1,00,000 and ₹1 crore or both.

Offences The offences pertain to **(i)** transactions defrauding creditors, **(ii)** misconduct in course of corporate insolvency resolution process, **(iii)** falsification of books of the corporate debtor, **(iv)** willful and material omissions from statements relating to its affairs, **(v)** false representation to creditors, **(vi)** contravention of moratorium/resolution plan, **(vii)** false information in application, **(viii)** non-disclosure of dispute/repayment of debt by operational creditors, and **(ix)** providing false information in application by the corporate debtor.

Punishment for Concealment of Property: by an officer of the corporate debtor relate to: **(i)** concealment/removal within 12 months immediately preceding the insolvency commencement date any property/debt due to, from him, amounting to ₹10,000 or more, **(a)** willfully **(1)** concealing/destroying/mutilating/falsifying any book/paper affecting/relating its property/affairs, **(2)** making any false entry in any book/paper affecting/relating to property/affairs, **(3)** creating any security interest cover, transferring/disposing of any property of the debtor obtained on credit but not paid for, **(4)** **(a)** concealing the knowledge of doing by others of any of the above acts; **(b)** fraudulently parting with, altering/making any omission in any document affecting/relating to its property/affairs, **(ii)** at any time after the insolvency commencement date **(a)** committing any of the above-mentioned acts or having knowledge of the doing by others of any things mentioned above, **(b)** trading in pawn/pledge/otherwise receiving the property knowing it to be secured/transferred/disposed.

Transactions Defrauding Creditors: on/after the insolvency commencement date, an officer/corporate debtor has **(i)** made/caused to be made any gift/transfer of, charge on/caused or connived in the execution of a degree/order against its property, **(ii)** concealed/removed any part of its property within 2 months before the date of any unsatisfied judgment/decree/order for payment of money against it.

Misconduct in Course of Corporate Insolvency Resolution Process: an officer of the corporate debtor **(a)** does not **(i)** disclose all the details of the property/transactions/other information required by the resolution professional, **(ii)** deliver to him **(1)** all/part of the property, **(2)** all books/paper in his control/custody required to be delivered, **(b)** fails to inform it the information in his knowledge that a debt has been falsely proved by person during the resolution process, **(c)** prevents the production of any book/paper effecting/relating to its property/affairs, **(d)** accounts for any part of the property by fictitious losses/expenses or has attempted so at any meeting of its creditors in the 12 months immediately preceding. An insolvency professional deliberately contravening these provisions would be punishable with imprisonment upto 6 months/fine between ₹1 – 5 lakh or both.

Falsification of Books of Corporate Debtors: any person destroys/mutilates/alters/falsifies books/papers/securities or makes/is in the knowledge of making false/fraudulent entry in any register/books of account/document with intent to defraud/deceive any person.

Wilfull and Material Omission From Statement Relating to Affairs of Corporate Debtor: by an officer.

False Representation to Creditors: prior to/on or after the commencement date, an officer makes a false representation/commits any fraud to obtain the consent of the creditors to an agreement with its affairs during the resolution/liquidation process.

Contravention of Moratorium on Resolution Plan: **(i)** an officer/person knowingly/willfully committing/authorising/permitting contravention of the moratorium provisions by the corporate debtor/its officer, or creditor, **(ii)** corporate debtor/officer/creditors/on whom the approval resolution is binding, knowingly/willfully contravenes/abets any term(s) of the resolution.

False Information Furnished in Application: any person who furnishes false information in material particulars knowing it to be false or omits any material fact, knowing it to be material, would be punishable with fine between ₹1 lakh and ₹1 crore.

Non-disclosure of Dispute/Repayment of Debt by Operational Creditors: **(a)** an operational creditor willfully/knowingly concealing in an application for initiation of corporate insolvency resolution process the fact that the corporate debtor had notified him of a dispute in respect of the unpaid/full and final payment of unpaid operational debt, **(b)** any person who knowingly/willfully authorises/permits the concealment.

Providing False Information in Application by Corporate Debtors for Initiation of Resolution Process: **(a)** provision of information by the corporate debtor which is false in material particulars knowing it to be false and omission of any material fact knowing it to be material, **(b)** any person who knowingly/willfully authorises/permits the furnishing of such information. **Any application would be deemed to false in material particulars in case the facts mentioned/omitted, if true/not omitted, would have been sufficient to determine the existence of a default under the IB Code.**

Regulation of Insolvency Professionals, Agencies and Information Utilities

The main elements of the regulation are: **(i)** Insolvency and Bankruptcy Board of India (IBBI), **(ii)** Insolvency Professional Agencies, **(iii)** Insolvency Professional, **(iv)** Information Utilities, **(v)** Inspection and Investigation.

The Insolvency and Bankruptcy Board of India (IBBI) The powers and functions of the IBBI are discussed below.

- The IBBI, subject to the general direction of the Government would, perform the following functions: **(a)** register/renew/withdraw/suspend/cancel insolvency professional agencies/ professional/ utilities, **(b)** specify their minimum eligibility requirements, **(c)** levy fees/other charges for their registration, **(d)** specify by regulations standards for their functioning, **(e)** lay down the minimum curriculum for the examination of the insolvency professionals for their enrolment as members of the insolvency professional agencies, **(f)** carry out inspections and investigations on them and pass orders for compliance of the provisions of the IB Code/regulations, **(g)** monitor their performance and pass directions for compliance of the provisions of the IB Code/regulations, **(h)** call for any information and records from them, **(i)** publish specified information, data, research studies and other information, **(j)** specify the number of collecting and storing data by the information utilities and for providing access to them, **(k)** collect and maintain records relating to insolvency and bankruptcy cases and disseminate information relating to them, **(l)** constitute committees including, in particular, advisory/executive committees, **(m)** promote transparency and best practices in its governance, **(n)** maintain necessary websites and other universally accessible repositories of electronic information, **(o)** enter into memorandum of understanding with other statutory authorities, **(p)** issue necessary guidelines to the insolvency professional agencies/professionals and information utilities, **(q)** specify mechanism for redressal of grievances against the and pass orders relating to complaints filed against them for compliance of the provisions of IB Code/regulations, **(r)** conduct periodic study, research and audit their functioning and performance at specified intervals, **(s)** specify mechanisms for issuing regulations, including the conduct of public consultation, **(t)** make regulations and guidelines on matters relating to insolvency and bankruptcy under the IB Code, including mechanism for time-bound disposal of the assets of the corporate debtor/debtor, and **(u)** perform other prescribed functions.
- The IBBI may make model bye-laws to be to adopted by insolvency professional agencies providing for **(a)** minimum standards of professional competence, professional and ethical conduct of this members, **(b) non-discriminatory requirements** (i.e. lack of discrimination on the grounds of religion/caste/gender/ place of birth/other specified grounds) for enrolment of persons as their members, **(c)** manner of granting membership, **(d)** setting-up of a Governing Board for the internal governance and management in accordance with the IBBI-specified regulations, **(e)** information required to be submitted by members including the form and the time, **(f)** specific classes of persons to whom services would be provided at concessional rates or for no remuneration by members, **(g)** grounds on which penalties may be levied upon their members and its manner, **(h)** fair and transparent mechanism for redressal of grievances against them, **(i)** grounds under which the insolvency professional maybe expelled from their membership, **(j)** quantum and the manner of collecting fee for inducting persons as its members, **(k)** procedure for enrolment of persons as its members, **(l)** manner of conducting examinations for enrolment of insolvency professional who are members, **(m)** manner of monitoring and reviewing the working of insolvency professional who are members, **(n)** duties and other activities to be performed by members, **(o)** manner of conducting disciplinary proceedings against its members and imposing penalties, **(p)** manner of utilising the amount received as penalty imposed against any insolvency professional.

- While exercising its powers, the IBBI would have the same powers as are vested in a civil court under the Code of Civil Procedure, while trying a suit, in respect of the following matters: **(i)** discovery and production of books of accounts/other documents at the IBBI-specified place/time, **(ii)** summoning and enforcing the attendance of persons and examining them on oath, **(iii)** inspection of any books, registers and other documents of any person at any place, **(iv)** issuing of commissions for the examination of witnesses or documents.

Insolvency Professional Agencies A person would carry on its business as insolvency professional agencies under, and in accordance with, a certificate of registration issued by the IBBI. It would have regard to the following principles while registering them: to promote **(a)** their professional development and regulation, **(b)** services of competent insolvency professionals to cater to the needs of debtors, creditors and other specified persons, **(c)** good professional and ethical conduct amongst them, **(d)** their growth for the effective resolution of insolvency and bankruptcy processes, and **(e)** protect the interests of debtors, creditors and other specified persons.

- The application for registration should be made in the specified form and manner containing the specified particulars, and accompanied by the specified fee. On being satisfied that the application conforms with all the specified requirements, the IBBI would grant the certificate of registration or reject the application. It may suspend/cancel the certificate of registration on the ground that it has **(a)** obtained the registration by making a false statement/misrepresentation/any other unlawful means, **(b)** failed to comply with the requirements of the IBBI regulations or bye-laws made by the insolvency professional agency, **(c)** contravened any of the provisions of the IB Code/rules/regulations, **(d)** on any other specified ground. Any insolvency professional agency aggrieved by the order of the IBBI may prefer an appeal to the National Company Law Appellate Tribunal (NCLAT) in the specified form, within specified period, and in the specified manner.
- An insolvency professional agency would perform the following functions: **(a)** grant membership to persons who fulfil all requirements set out in the bye-laws on payment of membership fee, **(b)** lay down standards of professional conduct for its members, **(c)** monitor the performance of its members, **(d)** safeguard the rights, privileges and interests of members insolvency professionals, **(e)** suspend/cancel their membership on the grounds set out in its bye-laws, **(f)** redress the grievances of customers against them, and **(g)** publish information about its functions, list and performance of its members and other specified information.

Insolvency Professionals A person can render his services as insolvency professionals after being enrolled as a member of an IBBI-registered insolvency professional agency. After obtaining its membership, he should register himself with the IBBI within the specified time, in the specified manner and on payment of the specified fee.

- Where any insolvency resolution/fresh start/liquidation/bankruptcy process has been initiated, an insolvency professional should take necessary actions in respect of the liquidation of a corporate debtor.
- Every insolvency professional should abide by the following code of conduct: **(a)** take reasonable care and diligence while performing his duties, **(b)** comply with all the specified requirements and terms and conditions in the bye-laws of the insolvency professional agency of which he is a member and allow it to inspect his records, **(c)** submit a copy of

the records of every proceeding before the **AA** to the IBBI as well as to the insolvency professional agency of which he is a member, and **(e)** perform his functions in the specified manner and subject to the specified conditions.

Information Utilities To carry on business as information utility, a certificate of registration issued in that behalf by the IBBI would be required. The application for registration should be made in the specified form and manner, containing the specified particulars, and accompanied by the specified fee. On being satisfied that the application conforms to all the specified requirements, it would grant a certificate of registration in the specified form and manner and subject to the specified terms and conditions. It may suspend/cancel the certificate of registration on the grounds that it has **(a)** obtained registration by making a false statement/misrepresentation/any other unlawful means, **(b)** failed to comply with the requirements of the IBBI regulations, **(c)** contravened any of the provisions of the IB Code/rules/regulations, **(d)** on any other specified ground. Any aggrieved information utility may prefer an appeal to the NCLAT in the specified form, within the specified period, and in the specified manner.

Core Services An information utility should provide the specified services including **core services** to any person who complies with the specified terms and conditions. **Core services** mean service rendered by an information utility for **(a)** accepting electronic submission of financial information in the specified form/manner, **(b)** their safe and accurate recording and authentication/verification and **(c)** providing access to information stored with it to the specified persons. **Financial information** means records of **(i)** debt, **(ii)** liabilities of an insolvent, **(iii)** assets over which security interest has been created, **(iv)** instances of default against any debt, **(v)** balance sheet/cash flow statement and **(vi)** other specified information.

Obligations of Information Utility For providing core services, it should **(a)** create and store financial information in a universally accessible format, **(b)** accept electronic submission of financial information from concerned persons in the specified form and manner (**discussed below**), **(c)** accept, in the specified form and manner, electronic submission of financial information from persons who intend to submit it, **(d)** meet the specified minimum service quality standards, **(e)** get the information received from various persons authenticated by all the concerned parties before storing it, **(f)** provide access to the financial information stored by it to any person in the specified manner, **(g)** publish the specified statistical information, and **(h)** have inter-operatability with other information utilities.

Procedure Any person who intends to submit financial information or access the information should pay specified fee and submit information in the specified form and manner. A financial creditor should submit financial information and information relating to assets in relation to which any security interests has been created, in the specified form and manner. An operational creditor may submit financial information to the information utility in the specified form and manner. To update/modify/rectify errors in the submitted financial information, a person may make an application to the information utility stating reasons in the specified manner and within the specified time.

Inspection and Investigation Any person aggrieved by the functioning of an insolvency professional agency/insolvency professional/information utility may file a complaint to the IBBI in the specified form, within the specified time and in the specified manner. On receipt of a complaint or having reasonable grounds to believe that they have contravened the provisions of the IB Code/rules/

regulations/directions, it may direct any person(s) to act as an investigating authority to conduct their inspection/investigation within the specified time and in the specified manner. Any person who is likely to have any relevant document/record/information would be duty-bound to furnish them. The investigating agency may, in the course of its inspection or investigation, enter any building or place where it may have reason to believe that any document, record or information relating to the subject-matter of the inquiry may be found and may seize them or take extracts or copies. It would keep in its custody the books, registers, other documents and records seized for a period till the conclusion of the investigation as it considers necessary and return the same to the concerned person. A detailed report of inspection/investigation should be submitted to the IBBI by the investigating authority. Upon completion of an inspection/investigation, the IBBI may issue a show cause notice and carry out their inspection in the specified manner, giving the specified time for giving reply. The IBBI would constitute a disciplinary committee to consider the reports of the investigating authority. On the examination of the report, if the disciplinary committee is satisfied that sufficient cause exists, it may impose the penalty **detailed below** or suspend/cancel the registration. The penalty would be three times the amount of the **(i)** loss caused, or likely to have been caused, to persons concerned on account of such contravention, or **(ii)** unlawful gain made on account of such contravention, whichever is higher. The total amount should not exceed one crore rupees. The IBBI may direct any person who has made unlawful gain or averted loss by indulging in any activity in contravention of the IB Code/rules/regulations to disgorge an amount equivalent to the unlawful gain or aversion of loss. It may take required action to provide restitution to the person who suffered loss on account of any contravention from the amount so disgorged, if he is identifiable and the loss suffered is directly attributable to him. It may make regulations to specify the **(a)** procedure for claiming restitution, **(b)** period within which it may be claimed, and **(c)** manner in which it may be made.

Miscellaneous

The miscellaneous provisions of the IB Code include **(i)** insolvency and bankruptcy fund, **(ii)** powers of Government to issue directions/supersede IBBI, **(iii)** trial of offences by special courts, **(iv)** power to make rules/regulations.

Insolvency and Bankruptcy Fund There would be a Insolvency and Bankruptcy Fund (IB Fund) for insolvency resolution, liquidation and bankruptcy of person under the IB Code with the **(a)** grants made by the Central Government, **(b)** amount deposited by persons as contribution, **(c)** amount received form any other source, and **(d)** interest or other income received out of the investments made.

A person who has contributed any amount to the IB Fund may, in the event of proceedings initiated under these IB Code before an **AA**, make an application to it for withdrawal of funds upto the amount contributed by it, for **(i)** making payments to workmen, **(ii)** protecting its assets, **(iii)** meeting the incidental costs during the proceedings, **(iv)** other prescribed purposes. The Central Government would appoint an administrator to administer it in the prescribed manner.

Power of Central Government to Issue Directions The IBBI, in exercise of its powers/the performance of its functions, would be bound by the directions on questions of policy the Central Government may give in writing to it from time to time. The decision of the Government as to whether a question is one of policy or not would be final.

Power of Central Government to Supersede IBBI If at any time the Central Government is of the opinion that on account of grave emergency, the IBBI is **(a)** unable to discharge the functions and duties imposed on it, **(b)** has persistently not complied with any direction issued by it or in the discharge of the functions and duties imposed on it by or under the provisions of the IB Code and as a result of such non-compliance, its financial position/administration has deteriorated, **(c)** circumstances exist which render it necessary in the public interest, to do so, it may supersede it for a period not exceeding six months.

Trial of Offences by Special Court The offences under the IBBI Code would be tried by the Special Court established under the Companies Act. No court would take cognizance of any offence punishable under the IB Code act, save on a complaint made by the IBBI/Central Government/ any person authorised by it in this behalf. The special court would be deemed to be a court of session and the person conducting a prosecution would be deemed to be a public prosecutor. The High Court may exercise, so far as may be applicable, all the powers of the Code of Criminal Procedure as if a special court within the local limits of the jurisdiction of High Court were a court of session trying cases within the local limits of its jurisdiction.

Powers to Make Rules The Central Government may make the specified rules for carrying out the provisions of the IB Code.

Powers to Make Regulations The IBBI may make the specified regulations to carry out the provisions of the IB Code.

CONCLUDING OBSERVATIONS

- The three important tools of the recovery mechanism of NPAs are (i) Debt Recovery Tribunals (DRTs), (ii) Corporate Debt Restructuring (CDR) Scheme and (iii) Securitisation and Reconstruction of Financial Assets through SCs/RCs.
- The DRTs, as recovery mechanism for NPAs, comprise of DRTs, recovery officers and DRATs.
- The main elements of the DRT mechanism are: procedure of DRTs and modes of recovery of debts determined by the DRTs and DRATs.
- A bank which has to recover any debt should approach the appropriate DRT which would issue a summon to the concerned borrower to explain within 30 days as to why the relief should not be granted to the bank. The DRT may make an interim order by way of injunction/ stay/ attachment against the borrower to debar him from transferring, alienating or otherwise dealing with/disposing of any property/asset without its prior permission. It may also appoint a receiver of any property. The DRT would normally dispose of an application within 180 days. An appeal against an order of the DRT can be filed with a DRAT on depositing 75 per cent of the amount of debt due.
- There are two modes of recovery of debt. The recovery officer can recover the debt by **(i)** attachment/sale of property, **(ii)** arrest/detention in prison of the borrower and, **(iii)** appointment of a receiver to manage the property. The recovery officer can collect also the amount from other parties who owe money to the borrower.
- The objective of the CDR framework is to ensure timely and transparent mechanism for restructuring corporate debts of viable entities facing problems outside the purview of BIFR, DRT and other legal proceedings.

- The CDR system has a 3-tier structure: CDR standing forum, CDR empowered groups; and CDR cell.
- The CDR mechanism covers only multiple banking accounts/ syndication/consortium accounts with outstanding exposure of ₹20 crore and above. There are two categories of debt restructuring under the CDR system: Category 1 accounts classified as sub-standard and Category 2 accounts classified as doubtful.
- The accounting treatment of the restructured accounts would be governed by the applicable prudential norms. The asset classification would continue to be bank-specific as per the existing prudential norms.
- Banks should disclose in their annual accounts details about corporate debt restructuring.
- The norms on income recognition, asset classification and provisioning relating to projects under implementation involving overrun would conform to the specified norms.
- The main objective of the SRFAESI Act is to regulate securitisation and reconstruction of financial assets and enforcement of security interest.
- In terms of the regulation of the scheme of securitisation and reconstruction of financial assets, the SC/RC should be registered with the RBI, with a minimum net owned fund of ₹2 crore or an amount upto 15 per cent of the financial assets acquired. Securitisation means acquisition of financial assets (i.e., debt/receivables/ any financial assistance) by the SC/RC from its owner, either by raising funds from a QIB by issue of security receipts representing undivided interest in the financial asset concerned or otherwise. Asset reconstruction means acquisition by an SC/RC, of any right/interest of any bank in any financial asset, for its realisation.
- Any SC/RC can acquire financial assets of any bank/FI. All rights in relation to the assets would vest in the SC/RC. The bank may give a notice of acquisition of the financial assets by an SC/RC to the obligor (i.e., the person liable to the owner of the financial asset) or the concerned registering authority in whose jurisdiction the mortgage/charge/hypothecation/assignment/other interest in the asset has been registered. Any payment to the SC/SR, pursuant to the notice, would be a full discharge from all liability in respect of such payment. After the acquisition of financial assets, an SC/SR may offer security receipts to QIBs for subscription.
- The measures for asset reconstruction may be: takeover of management, sale/lease a part/whole of the business of the borrower, rescheduling of debts payable, enforcement of the security interest, settlement of dues payable by the borrower and taking possession of the secured assets.
- Any SC/RC may act as **(i)** an agent for a bank for the recovery of their dues from the borrower, **(ii)** a manager of the secured assets taken over by the secured creditor from the borrower.
- Any security interest credited in favour of a secured creditor can be enforced without the intervention of courts/tribunal, by the concerned creditor. In case of failure of a borrower to pay to the secured creditor, he may take rescourse to the following measures: **(a)** take possession/takeover the management of the secured assets, **(b)** takeover of the management of the business of the borrower, **(c)** appointment of a manager to manage the assets, and **(d)** to require any person who has acquired any secured asset(s) from the borrower and from whom money is due to the borrower, to pay to the secured creditor, sufficient money to pay the secured debt. Payment made by such person would give him a valid discharge as if the payment were made to the borrower. All rights in the secured assets would be vested in the transferee as if transfer had been made by the borrower (owner of the asset).
- Where dues of the secured creditor are not fully satisfied with the sale proceeds of the secured assets, he may approach the DRTs for recovery of the balance from the borrower.

- The secured creditors would be entitled to proceed against the guarantors/sell the pledged assets without first taking any of the measures specified above.
- The Government may set up a central registry for registration of transactions of securitisation/reconstruction of financial assets and creation of security interest. It may also appoint a central registrar for registration of such transactions. The particulars of such transactions would be entered in the central register.
- To carry out the provisions of the SRFAESI Act, the RBI has issued guidelines/directions, the main elements of which are: registration, asset reconstruction, functions of SCs/RCs, securitisation and prudential norms.
- An SC/RC should have a minimum net owned fund of 15 per cent of the total financial assets acquired by it on an aggregate basis or ₹100 crore, whichever is less. In no case should it be less than ₹2 crore.
- The elements relating to asset reconstruction are acquisition of financial assets, change/takeover of management/sale or lease of the business of the borrower, rescheduling of debts, enforcement of security interest, settlement of dues by the borrower and plan for realisation.
- The guidelines/directions relating to securitisation include: issue of security receipts and disclosures relating to **(i)** issuers of security receipts, **(ii)** terms of offer and **(iii)** disclosures on quarterly basis.
- The SCs/RCs should maintain a capital adequacy ratio of 15 per cent. The asset classification should be **(i)** standard **(ii)** NP (i.e., substandard doubtful and loss). The provisioning for NPAs are: sub-standard—10 per cent, doubtful—100 per cent on unsecured portion and 50 per cent of the remaining; loss assets—100 per cent written off/provided for. Income should be recognised on receipt basis.
- RBI's guidance notes for SCs/RCs relate to the acquisition of financial assets, engagement of outside agency and sales committee.
- Guidelines on sale of financial assets to SCs/RCs and related issues fall into four groups: **(i)** assets which can be sold, **(ii)** procedure for sale including pricing and valuation, **(iii)** prudential norms relating to provisioning/capital adequacy and exposures for banks and **(iv)** disclosure requirements.
- Securitisation (of standard assets) in a process by which performing assets are sold to a bankruptcy remote (i.e. the unlikelihood of the entity being subjected to voluntary/involuntary proceedings) special purpose vehicle (SPV) against immediate cash payment. It follows a two-stage process: **(i)** sale of performing assets to a bankruptcy remote SPV in return for immediate cash payment; **(ii)** repackaging and selling the security interests representing claims on incoming cashflows from the asset(s) to third party investors by issuance of tradeable debt securities. Exposures of banks/FIs/NBFCs (i.e. originators) to a securitisation transaction/exposure include exposures to **(i)** securities issued by the SPV, **(ii)** credit enhancement facility, **(iii)** liquidity facility and **(iv)** underwriting facility.
- The securitised asset is transferred from the balance sheet of the originator to the SPV as true sale so that the originator would not be required to maintain capital against the value of the transferred asset.
- The beneficial interest in the securitised assets are sold/transferred to the SPV (i.e. a trust/company/firm) on a without recourse basis.
- An option to repurchase fully performing asset(s) at the end of the securitisation scheme where the residual value of such assets has fallen below 10 per cent of the original amount sold to the SPV (i.e. clean up calls) could be retained by the originator.

- Credit enhancement facilities include all arrangements provided to the SPV that could result in an originator absorbing losses of the SPV/its investors.
- A liquidity facility is provided to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to the investors.
- An originator/third party service provider may act as an underwriter for the issue of securities by the SPV and treat the facility as an underwriting facility for capital adequacy purposes.
- Investment of banks in securities issued by the SPVs would attract all prudential norms applicable to non-SLR investments prescribed by the RBI. The maximum limit on investment by the originator in the securities issued by the SPVs is 10 per cent of the original amount of issue. The income on such securities may normally be recognised on accrual basis. However, if the income remains in arrears beyond 90 days, any future income should be recognised only on realisation. Appropriate provisioning for the diminution in the value of securitisation on account of overdues should be made as per the RBI norms for classification and valuation of investments by banks.
- Banks can sell assets to an SPV only on cash basis. Any loss on sale should be reflected in the profit and loss account for the period during which the sale is affected but any profit/premium should be amortised over the life of the concerned securities.
- The objective of the RBI guidelines is to ensure transparency, non-discrimination/arbitration in the action of SCs/RCs and to build a system of checks/balances while effecting changes in or takeover of the management of the business of the borrower for realisation of their dues. They can effect the change where their due amount is 25 per cent of the total assets of the borrower concerned and at least 75 per cent of the outstanding security receipts agree to the action if several secured creditors have financed him. The grounds for the proposed change are: **(i)** wilful default, **(ii)** adverse action affecting their interest/incompetence, **(iii)** sale/disposal of 10 per cent assets without prior approval, **(iv)** reasonable belief about inability to pay, **(v)** compromise with other creditors without its consent/an act of insolvency/discontinuance of business to the tune of 10 per cent of turnover, **(vi)** damage to all/significant part of the assets, **(vii)** material alteration of nature/scope, management control, ownership, **(viii)** serious disputes amongst the promoter/directors/partners, **(ix)** utilisation of funds for other than stated purpose and **(x)** fraudulent transaction in respect of the secured assets.
- Wilful default includes non-payment despite availability of cash/resources, routing of transactions through other banks to avoid payment and siphoning off funds/misrepresentation or falsification of records.
- The policy regarding change in or takeover of management should provide for **(i)** examination of the proposal by an independent advisory committee (IAC), **(ii)** consideration of the recommendations of the IAC by the Board of the SC/RC, **(iii)** due diligence by the SC/RC, **(iv)** identification of agencies/personnel to takeover, and **(v)** procedure for the restoration of the management to the borrower.
- A 60-day notice should be given to the borrower indicating the intention to effect the proposed change. Any objection from the borrower should be considered by the IAC. The Board of Directors should pass a reasoned order within 30 days from the expiry of the notice period regarding the proposed action. Action(s) taken by the SC/RC should be reported to the RBI.
- The guidelines on transfer of assets through securitisation and direct assignment of cash flows have two main elements: **(i)** Provisions relating to securitisation of standard assets, and **(ii)** Stipulations regarding transfer of standard assets through direct assignment of cash flows.

- The guidelines on securitisation of standard assets relate to the requirements to be met by the **(a)** originating banks and **(b)** banks other than the originators having securitisation exposure.
- The main requirements to be met by the originating banks are: **(1)** eligible assets, **(2)** minimum holding period, **(3)** minimum retention requirement, **(4)** limit on total retained exposures, **(5)** booking of profit upfront, **(6)** disclosures, **(7)** loan origination standards, and **(8)** treatment of securitised assets not meeting the requirements **(1)** to **(7)**.
- The main requirements to be met by banks other than originators having securitisation exposures are **(i)** due diligence, **(ii)** stress testing, **(iii)** credit monitoring and **(iv)** exposures not meeting stipulated requirements.
- The main elements of the guidelines on transaction involving transfer of assets through direct assignment of cashflows and the underlying securities are requirements to be met by the **(i)** originating, **(ii)** purchasing banks.
- The requirements to be met by originating banks are **(a)** assets eligible for transfer, **(b)** minimum holding period, **(c)** minimum retention requirement, **(d)** booking of profits upfront, **(5)** disclosures, **(b)** loan origination standards, and **(7)** treatment of assets sold not meeting the stipulated requirements.
- The purchasing banks have to fulfil the following stipulations: **(1)** restrictions on purchase of loans, **(2)** standards for due diligence, **(3)** stress testing, **(4)** credit monitoring, **(5)** true sales criteria, **(b)** representations/warranties, **(7)** repurchase of assets, **(8)** capital adequacy and other prudential norms and **(9)** treatment of exposures not meeting the stipulated requirements.
- The main elements of the IB Code are: **(a)** corporate insolvency resolution and liquidation, **(b)** regulation of insolvency professionals/agencies and information utilities and **(c)** miscellaneous provisions.
- The main elements of the corporate insolvency resolution and liquidation are: **(i)** corporate insolvency resolution process, **(ii)** liquidation process, **(iii)** fast track resolution process, **(iv)** voluntary liquidation, **(v)** adjudicating authority and **(vi)** offences and penalties.
- The main elements of the insolvency resolution process are: **(i)** initiation by financial creditor, **(ii)** initiation by operational creditor, **(iii)** initiation by corporate applicant, **(iv)** appointment of interim resolution professional, and **(vi)** appointment of resolution professional.
- The main elements of the liquidation process are: **(i)** initiation of liquidation process, **(ii)** appointment of liquidator, **(iii)** powers/duties of liquidators, **(iv)** liquidation estate, **(v)** powers of liquidator to access information, **(vi)** consolidation of claims, **(vii)** verification of claims, **(viii)** preferential transactions and relevant time, **(ix)** avoidance of undervalued transaction, **(x)** transactions defrauding creditors, **(xi)** extortionate credit transaction, **(xii)** secured creditors in liquidation proceedings, and **(xiii)** dissolution of corporate debtor.
- The main elements of the regulation of insolvency professionals/agencies and information utilities relate to: **(i)** Insolvency and Bankruptcy Board of India (IBBI), **(ii)** Insolvency Professional Agencies, **(iii)** Insolvency Professional, **(iv)** Information Utilities, **(v)** Inspection and Investigation.
- The miscellaneous provisions of the IB Code include **(i)** insolvency and bankruptcy fund, **(ii)** powers of Government to issue directions/supersede IBBI, **(iii)** trial of offences by special courts, **(iv)** power to make rules/regulations.

CHAPTER 12

Prudential Norms Relating to Capital Adequacy: Basel II Framework

INTRODUCTION

With a view to adopting the Basel Committee on Banking Supervision (BCBS) framework on capital adequacy which takes into account the elements of credit risk in various types of assets in the balance sheet as well as off-balance sheet business and also to strengthen the capital base of banks, the Reserve Bank of India (RBI), in April 1992 introduced a risk asset ratio system for banks (including foreign banks) in India as a capital adequacy measure. Essentially, under the above system, the balance sheet assets, non-funded items and other off-balance sheet exposures were assigned prescribed risk weights and banks had to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an ongoing basis. Until 2003, the capital adequacy ratio was appreciable only to credit risk assumed by banks. The RBI issued guidelines to banks in June 2004 on maintenance of capital charge for market risks for the available for sale investment portfolio on the lines of '**Amendment to the Capital Accord to Incorporate Market Risks**' issued by the BCBS in 1996.

The BCBS released the "**International Convergence of Capital Measurement and Capital Standards: A Revised Framework**" on June 26, 2004. The revised framework was updated in November 2005 to include trading activities and the treatment of double default effects and a **comprehensive version of the framework** was issued in June 2006 incorporating the constituents of capital and the 1996 amendment to the capital accord to incorporate market risk. The revised framework seeks to arrive at significantly more risk-sensitive approaches to capital requirements. It provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and supervisors/regulators to select approaches that are most appropriate for their operations and financial markets.

The revised framework consists of three-mutually reinforcing **Pillars**, namely, (i) **Minimum Capital Requirements**, (ii) S**upervisory Review of Capital Adequacy**, and (iii) **Market Discipline**. Under **Pillar 1**, the framework offers **three** distinct options for computing capital requirement for credit risk and **three** other options for computing capital requirement for operational risk. These options for credit and operational risks are based on increasing risk sensitivity and allow banks to select an approach that is most appropriate to the stage of development of its operations. The options available for computing capital for credit risk are (i) **Standardised Approach**, (ii) **Foundation Internal Rating Based Approach** and (iii) **Advanced Internal Rating Based Approach**. The options available for computing capital for operational risk are (i) **Basic Indicator Approach**, (ii) **Standardised Approach** and (iii) **Advanced Measurement Approach**.

Keeping in view its goal to have consistency and harmony with international standards, the RBI has mandated that all commercial banks in India adopt the **Standardised Approach (SA)** for credit risk and the **Basic Indicator Approach (BIA)** for operational risk. They should continue to apply the **Standardised Duration Approach (SDA)** for computing capital requirement for market risks. Foreign banks operating in India and Indian banks having operational presence outside India should migrate to the above selected approaches under the revised framework with effect from **March 31, 2008.** All other commercial banks should migrate to these approaches before **March 31, 2009**.

With a view to ensuring smooth transition to the revised framework and with a view to providing opportunity to banks to streamline their systems and strategies, banks were advised to have a parallel run of the revised framework. The Boards of Directors of the banks should review the results of the parallel run on a quarterly basis. The broad elements which need to be covered during the parallel run are as under:

(i) Banks should apply the prudential guidelines on capital adequacy – both current guidelines and these guidelines on the revised framework – on an on-going basis and compute their **Capital to Risk Weighted Assets Ratio (CRAR)** under both the guidelines.

(ii) An analysis of the bank's CRAR under both the guidelines should be reported to the Board of Directors at quarterly intervals.

(iii) A copy of the quarterly reports to the Board should be submitted to the RBI. While reporting the above analysis to the Board of Directors, banks should also furnish a comprehensive assessment of their compliance with the other requirements relevant under the revised framework, which will include the following, at the minimum:

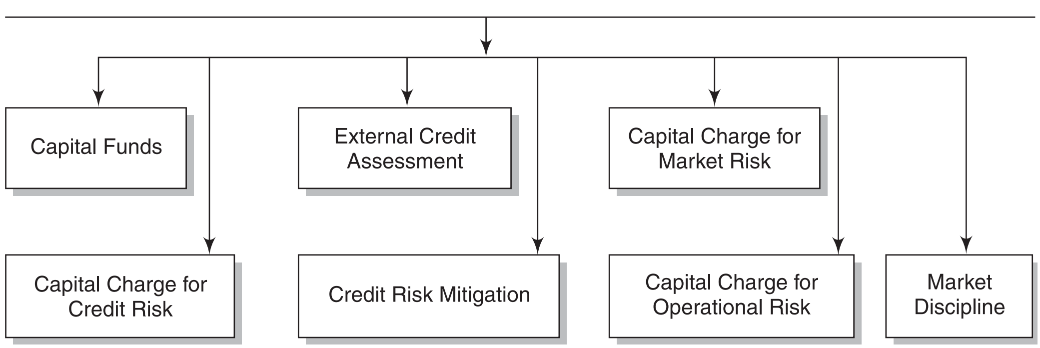
- **(a)** Board approved policy on utilisation of the credit risk mitigation techniques, and collateral management,
- **(b)** Board approved policy on disclosures,
- **(c)** Board approved policy on **Internal Capital Adequacy Assessment Process (ICAAP)** along with the capital requirement as per ICAAP,
- **(d)** Adequacy of bank's MIS to meet the requirements under the new capital adequacy framework, the initiatives taken for bridging gaps, if any, and the progress made in this regard,
- **(e)** Impact of the various elements/portfolios on the bank's CRAR under the revised framework,
- **(f)** Mechanism in place for validating the CRAR position computed as per the new capital adequacy framework and the assessments/findings/ recommendations of these validation exercises,
- **(g)** Action taken with respect to any advice/guidance/direction given by the Board in the past on the above aspects.

Banks are required to obtain the prior approval of the RBI to migrate to the **Internal Rating Based Approach (IRBA)** for credit risk and the **Standardised Approach (SA)** or the **Advanced Measurement Approach (AMA)** for operational risk. Banks that propose to migrate to these approaches should to undertake an objective and strict assessment of their compliance with the minimum requirements for entry and on-going use of those approaches as prescribed in the **International Convergence of Capital Measurement and Capital Standards (Comprehensive Version of the Revised Framework published by the Basel Committee on Banking Supervision in June 2006)**. These banks may also assess their compliance with the various processes relevant to these approaches. The above assessments would help these banks in preparing a realistic roadmap indicating the specific milestones, timeline, and plans for achieving smooth and meaningful migration to the advanced approaches. All banks should migrate to standardised approach for credit risk and basic indicator approach for operational risk on the effective date.

The revised capital adequacy norms are applicable uniformly to all commercial banks, both at the solo level (global position) as well as at the consolidated level. A **consolidated bank** is a group of entities where a licensed bank is the controlling entity. It includes all group entities under its control, except the exempted entities. In terms of guidelines on preparation of consolidated prudential reports, a consolidated bank may exclude group companies which are engaged in insurance business and businesses not pertaining to financial services. It should maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) as applicable to a bank on an ongoing basis.

The main elements of the new capital adequacy framework are portrayed in Exhibit 12.1.

Exhibit 12.1 New Capital Adequacy Framework



Sections 1-6 of the Chapter respectively discuss (i) capital funds, (ii) capital charge for credit risk (iii) external credit assessments, (iv) credit risk mitigation, (v) capital charge for market risk and (vi) market discipline. The main points are recapitulated in the last Section.

CAPITAL FUNDS

Banks are required to maintain a minimum CRAR of 9 per cent on an ongoing basis. The RBI will take into account the relevant risk factors and the internal capital adequacy assessments of each bank to ensure that the capital held by a bank is commensurate with the its overall risk profile. This would include, among others, the effectiveness of the its risk management systems in identifying, assessing/measuring, monitoring and managing various risks including interest rate risk in the banking book, liquidity risk, concentration risk and residual risk. Accordingly, the RBI would consider prescribing a higher level of minimum capital ratio for each bank under the **Pillar 2 framework** on the basis of their respective risk profiles and their risk management systems. Further, in terms of the **Pillar 2** requirements of the new capital adequacy framework, banks should operate at a level well above the minimum requirement.

The minimum capital maintained by banks on implementation of the revised framework would be subjected to a **prudential floor**, which should be the higher of the following amounts:

(a) Minimum capital required to be maintained as per the revised framework;

(b) A specified per cent of the minimum capital required to be maintained as per the **Basel I** framework for credit and market risks. **The capital adequacy norms as per the Basel I framework are given in Appendix 12-A on the website. The website address is http://www.mhhe.com/khanifs10e.** The specified per cent will progressively decline as indicated in Table 12.1.

Table 12.1 Prudential Floor

*Financial year ending**	*March 2008*	*March 2009*	*March 2010*
Prudential floor (as per cent of minimum capital requirement computed as per current Basel I framework for credit and market risks)	100	90	80

* The relevant periods would be March 2009, 2010, and 2011 for banks implementing the revised framework with effect from March 31, 2009.

The adequacy and the need for the capital floors would be reviewed periodically on the basis of the quality and integrity of Basel II implementation in banks. In case the supervisory assessments indicate satisfactory level and quality of compliance by banks, the capital floor may be dispensed with even before the above period. Banks should maintain, at both solo and consolidated level, a Tier 1 CRAR of at least 6 per cent. Banks which are below this level must achieve this ratio by March 31, 2010.

A bank should compute its Tier 1 CRAR and Total CRAR in the following manner:

$$\text{Tier 1 CRAR} = \frac{\text{Eligible Tier 1 capital funds}^1}{\text{Credit risk RWA}^* + \text{Market risk RWA} + \text{Operational risk RWA}}$$

*RWA = Risk Weighted Assets

$$\text{Total CRAR} = \frac{\text{Eligible Total capital funds}^2}{\text{Credit risk RWA} + \text{Market risk RWA} + \text{Operational risk RWA}}$$

Capital funds are broadly classified as Tier 1 and Tier 2 capital. **The main elements of the Tier I and Tier 2 Capital of Indian banks are depicted in Exhibit 12.2**.

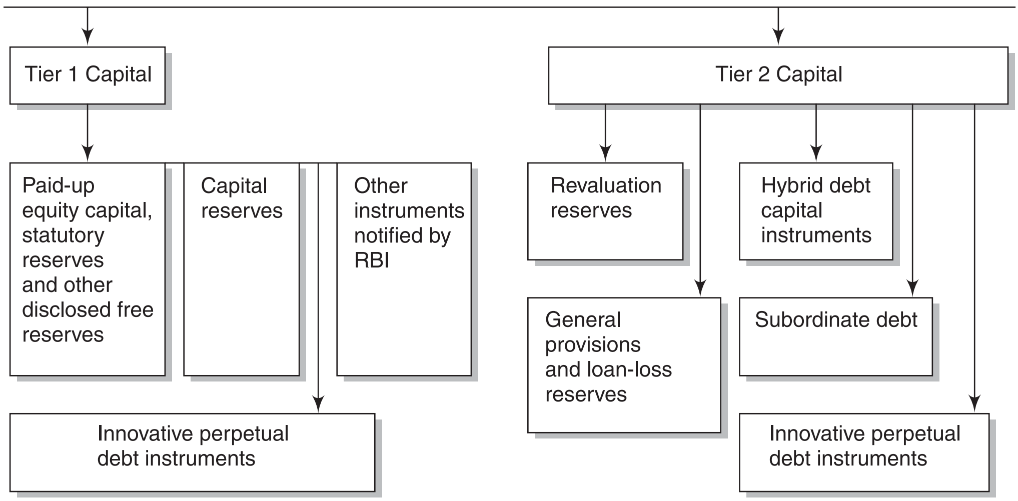
The elements of Tier 2 capital will be reckoned as capital funds up to a maximum of 100 per cent of Tier 1 capital, after making the deductions/adjustments as detailed below:

- Intangible assets and losses in the current period and those brought forward from previous periods,

[1]Total Tier 1 capital funds, subject to prudential limits for Innovative Perpetual Debt Instruments minus deductions from Tier 1 capital

[2]Total of eligible Tier 1 capital funds and eligible Tier 2 capital funds, subject to prudential limits for Innovative Tier 1 instruments, Upper Tier 2 instruments and subordinated debt instruments minus deductions from Tier 1 and Tier 2 capital.

Exhibit 12.2 Capital Funds for Indian Banks



- The DTA is computed as under: (i) DTA associated with accumulated losses; and (ii) The DTA (excluding DTA associated with accumulated losses), net of DTL. Where the DTL is in excess of the DTA (excluding DTA associated with accumulated losses), the excess should neither be adjusted against item (i) nor added to Tier 1 capital.
- Any gain-on-sale arising at the time of securitisation of standard assets,
- Banks should not recognise minority interests that arise from consolidation of less than wholly owned banks, securities or other financial entities in consolidated capital to the extent specified below: (i) The extent of minority interest in the capital of a less than wholly owned subsidiary which is in excess of the regulatory minimum for that entity, and (ii) In case the concerned subsidiary does not have a regulatory capital requirement, the deemed minimum capital requirement for that entity may be taken as 9 per cent of the risk weighted assets of that entity.
- Securitisation exposures: 50 per cent from Tier 1 and 50 per cent from Tier 2. Deductions from capital may be calculated net of any specific provisions maintained against the relevant securitisation exposures.
- In the case of investment in financial subsidiaries and associates, the treatment will be as under for the purpose of capital adequacy:
  (i) Investment above 30 per cent in the paid up equity, that is, equity shares, of financial entities which are not consolidated for capital purposes (including insurance entities) with the bank and investments in other instruments eligible for regulatory capital status in those entities **entirely** deducted at 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.
  (ii) Banks should ensure that majority owned financial entities that are not consolidated for capital purposes and for which the investment in equity and other instruments eligible for regulatory capital status is deducted, meet their respective regulatory capital requirements. In case of any shortfall in the regulatory capital requirements in the

de-consolidated entity, the shortfall deducted at 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital.

An indicative list of institutions which may be deemed to be financial institutions for capital adequacy purposes is as under: Banks, Mutual funds, Insurance companies, Non-banking financial companies, Housing finance companies, Merchant banking companies, and Primary dealers.

A bank's aggregate investment in all types of instruments eligible for capital status of investee banks/FIs/NBFCs/PDs listed below, excluding those deducted above, should not exceed 10 per cent of the investing bank's capital funds (Tier 1 plus Tier 2 capital, after above adjustments). Any investment in excess of this limit should be deducted at 50 per cent from Tier 1 and 50 per cent from Tier 2 capital. Investments in equity or instruments eligible for capital status issued by banks/FIs/NBFCs/Primary Dealers (PDs) which are within the aforesaid ceiling of 10 per cent and thus are not deducted from capital funds will attract a risk weight of 100 per cent or the risk weight as applicable to the ratings assigned to the relevant instruments, whichever is higher.

Banks' investment in the following instruments will be included in the above prudential limit of 10 **(a)** Equity shares; **(b)** Preference shares eligible for capital status; **(c)** Subordinated debt instruments; **(d)** Hybrid debt capital instruments; and **(e)** Any other instrument approved as in the nature of capital.

Elements of Tier 1 Capital

The elements of Tier 1 capital are listed below

For Indian Banks Tier 1 capital would include the following elements:

(i) Paid-up equity capital, statutory reserves, and other disclosed free reserves, if any;

(ii) Capital reserves representing surplus arising out of sale proceeds of assets;

(iii) Innovative perpetual debt instruments eligible for inclusion in Tier 1 capital which comply with the regulatory requirements as specified in **Appendix 12-B on the website. The website address is http://www.mhhe.com/khanifs10e**; and

(iv) Any other type of instrument generally notified by the RBI from time to time for inclusion in Tier 1 capital.

For Foreign Banks In India Tier 1 capital would include the following elements:

(i) Interest-free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

(ii) Statutory reserves kept in Indian books.

(iii) Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India.

(iv) Capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India.

(v) Interest-free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books.

(vi) Head Office borrowings in foreign currency by foreign banks operating in India for inclusion in Tier 1 capital which comply with the regulatory requirements as specified in **Appendix 12-C on the website. The website address is http://www.mhhe.com/khanifs10e**, and

(vii) Any other item specifically allowed by the RBI from time to time for inclusion in Tier 1 capital.

Notes:

(i) Foreign banks are required to furnish to the RBI, an undertaking to the effect that the bank will not remit abroad the 'capital reserve' and 'remittable surplus retained in India' as long as they function in India to be eligible for including this item under Tier 1capital.

(ii) These funds may be retained in a separate account titled as 'Amount Retained in India for Meeting Capital to Risk-weighted Asset Ratio (CRAR) Requirements' under 'Capital Funds'.

(iii) An auditor's certificate to the effect that these funds represent surplus remittable to Head Office once tax assessments are completed or tax appeals are decided and do not include funds in the nature of provisions towards tax or for any other contingency may also be furnished to the RBI.

(iv) The net credit balance, if any, in the inter-office account with Head Office/overseas branches will not be reckoned as capital funds. However, any debit balance in the Head Office account will have to be set-off against capital.

Limits on Eligible Tier 1 Capital The innovative perpetual debt instruments, eligible to be reckoned as Tier 1 capital, will be limited to 15 per cent of total Tier 1 capital as on March 31 of the previous financial year. This limit will be based on the amount of Tier 1 capital as on March 31 of the previous financial year, after deduction of goodwill, DTA and other intangible assets but before the allowable deduction of investments (discussed earlier). The innovative instruments in excess of the limit would be eligible for inclusion under Tier 2, subject to limits prescribed for Tier 2 capital.

Elements of Tier 2 Capital

The main elements of the Tier 2 capital are as follows:

Revaluation Reserves These reserves often serve as a cushion against unexpected losses, but they are less permanent in nature and cannot be considered as '**core capital**'. Revaluation reserves arise from revaluation of assets that are undervalued on the bank's books, typically bank premises. The extent to which the revaluation reserves can be relied upon as a cushion for unexpected losses depends mainly upon the level of certainty that can be placed on estimates of the market values of the relevant assets, the subsequent deterioration in values under difficult market conditions or in a forced sale, potential for actual liquidation at those values, tax consequences of revaluation, etc. Therefore, it would be prudent to consider revaluation reserves at a discount of 55 per cent while determining their value for inclusion in Tier 2 capital. Such reserves will have to be reflected on the face of the balance sheet as revaluation reserves.

General Provisions and Loss Reserves Such reserves, if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, can be included in Tier 2 capital. Adequate care must, however, be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier 2 capital. Banks are allowed to include the '**General Provisions on Standard Assets**', **Floating Provisions**[3] '**Provisions Held for Country Exposures**', and '**Investment Reserve Account**' in Tier 2

[3]Floating provisions held by banks, which is general in nature and not made against any identified assets may be treated as part of Tier 2 capital if such provisions are not netted off from gross NPAs to arrive at disclosure of net NPAs.

capital. However, these four items will be admitted as Tier 2 capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

Hybrid Debt Capital Instruments In this category fall a number of debt capital instruments, which combine certain characteristics of equity and certain characteristics of debt. Each has a particular feature, which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier 2 capital. Banks in India can recognise funds raised through debt capital instrument, which has a combination of characteristics of both equity and debt, as Upper Tier 2 capital, provided the instrument complies with the regulatory requirements specified in **Appendix 12-D on the website. The website address is http://www.mhhe.com/khanifs10e**.

Subordinated Debt To be eligible for inclusion in Tier 2 capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses, and should not be redeemable at the initiative of the holder or without the consent of the RBI. They often carry a fixed maturity, and as they approach maturity, they should be subjected to progressive discount, for inclusion in Tier 2 capital. Instruments with an initial maturity of less than 5 years or with a remaining maturity of one year should not be included as part of Tier 2 capital. The subordinated debt instruments eligible to be reckoned as Tier 2 capital should comply with the regulatory requirements specified in **Appendix 12-E on the website. The website address is http://www.mhhe.com/khanifs10e**.

Innovative Perpetual Debt Instruments (IPDI) The IPDI in excess of 15 per cent of Tier-1 to be included in Tier-2.

Any Other Instrument Any other type of instrument generally notified by the RBI from time to time for inclusion in Tier 2 capital.

Limits on Tier 2 Capital The Upper Tier 2 instruments along with other components of Tier 2 capital should not exceed 100 per cent of Tier 1 capital. This limit will be based on the amount of Tier 1 after deduction of goodwill, DTA and other intangible assets but before deduction of investments. The subordinated debt instruments eligible for inclusion in Lower Tier 2 capital will be limited to 50 per cent of Tier 1 capital after all deductions.

CAPITAL CHARGE FOR CREDIT RISK

The main elements of the Capital Charge for Credit Risk are portrayed in **Exhibit 12.3.**

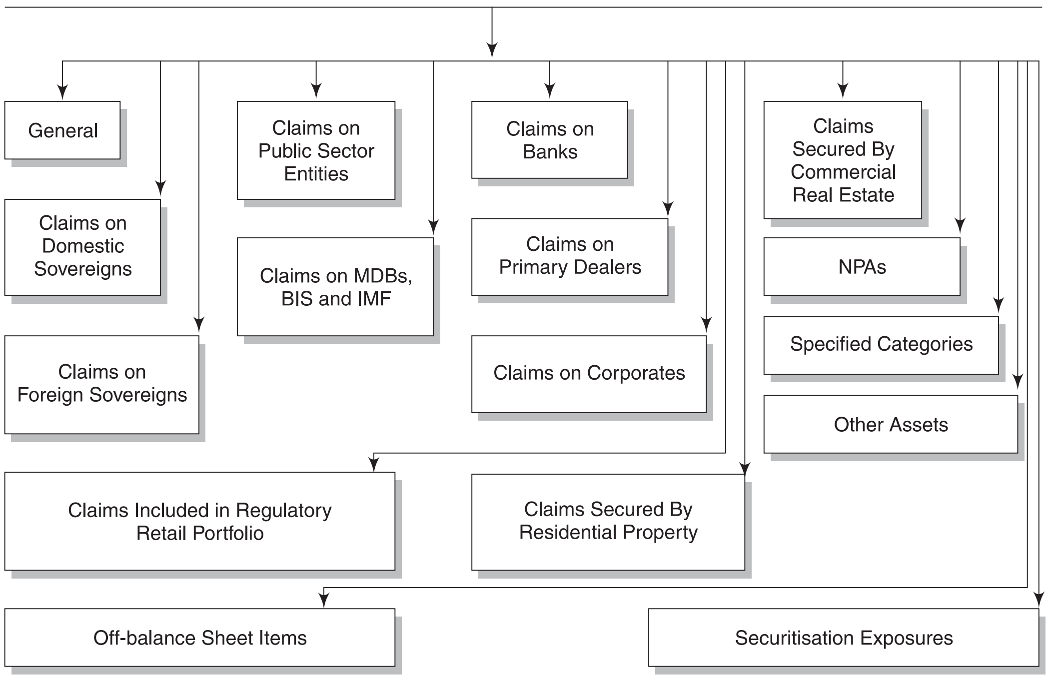
Under the standardised approach, the rating assigned by the eligible external credit rating agencies will largely support the measure of credit risk. The RBI has identified the external credit rating agencies that meet the eligibility criteria specified under the revised framework. Banks may rely upon the ratings assigned by the external credit rating agencies chosen by the RBI for assigning risk weights for capital adequacy purposes as per the mapping furnished in these guidelines.

Claims on Domestic Sovereigns

The applicable risk weights are as follows:

- Both fund-based and non-fund-based claims on the central government will attract a zero risk weight. The central government guaranteed claims will attract a zero risk weight.

Exhibit 12.3 Capital Charge for Credit Risk



- The direct loan/credit/overdraft exposure, if any, of banks to the state governments and the investments in the state government securities will attract zero risk weight. The state government guaranteed claims, will attract 20 per cent risk weight.
- The risk weight applicable to claims on central government exposures will also apply to the claims on the RBI, Deposit Insurance and Credit Guarantee Corporation (DICGC) and Credit Guarantee Fund Trust for Small Industries (CGTSI). The claims on ECGC will attract a risk weight of 20 per cent.

The above risk weights for both direct claims and guarantee claims will be applicable as long as they are classified as 'standard'/ performing assets. Where these sovereign exposures are classified as non-performing, they would attract risk weights as applicable to NPAs (which are detailed in a subsequent section).

Claims on Foreign Sovereigns

The applicable risk weights are listed below:

- Claims on foreign sovereigns will attract risk weights as per the rating assigned[4] to those sovereigns/sovereign claims by international rating agencies as shown in Table 12.2:

[4]For example: the risk weight assigned to an investment in US Treasury Bills by SBI branch in Paris, irrespective of the currency of funding, will be determined by the rating assigned to the Treasury Bills, as indicated in Table 12.2.

Table 12.2 Claims on Foreign Sovereigns – Risk Weights

S & P*/FITCH Ratings	AAA toAA	A	BBB	BB to B	Below B	Unrated
Moody's Ratings	Aaa to Aa	A	Baa	Ba to B	Below B	Unrated
Risk weight (%)	0	20	50	100	150	100

* Standard & Poor's

- Claims denominated in domestic currency of the foreign sovereign met out of the resources in the same currency raised in the jurisdiction[5] of that sovereign will, however, attract a risk weight of zero percent. However, in case a host supervisor requires a more conservative treatment to such claims in the books of the foreign branches of the Indian banks, they should adopt the requirements prescribed by the host country supervisors for computing capital adequacy.

Claims on Public Sector Entities (PSEs)

The applicable risk weights are as follows:

- Claims on domestic public sector entities will be risk weighted in a manner similar to claims on corporates.
- Claims on foreign PSEs will be risk weighted as per the rating assigned by the international rating agencies as shown in Table 12.3.

Table 12.3 Claims on Foreign PSEs – Risk Weights

S & P/ FITCH Ratings	AAA to AA	A	BBB	Below BB	Unrated
Moody's Ratings	Aaa to Aa	A	Baa to Ba	Below B	Unrated
Risk weight (%)	20	50	100	150	100

Claims on MDBs, BIS and IMF

Claims on the Bank for International Settlements (BIS), the International Monetary Fund (IMF) and the following eligible Multilateral Development Banks (MDBs) evaluated by the BCBS will be treated similar to claims on scheduled banks meeting the minimum capital adequacy requirements and assigned a uniform 20 per cent risk weight:

- World Bank Group: IBRD and IFC
- Asian Development Bank
- African Development Bank
- European Bank for Reconstruction & Development
- Inter-American Development Bank
- European Investment Bank
- European Investment Fund

[5]For example: the risk weight assigned to an investment in US Treasury Bills by SBI branch in New York will attract a zero per cent risk weight, irrespective of the rating of the claim, if the investment is funded from out of the USD denominated resources of SBI, New York. In case the SBI, New York, did not have any USD denominated resources, the risk weight will be determined by the rating assigned to the Treasury Bills, as indicated in Table 12.2.

- Nordic Investment Bank
- Caribbean Development Bank
- Islamic Development Bank
- Council of Europe Development Bank.

Similarly, claims on the International Finance Facility for Immunisation (IFFIm) will also attract a 20 per cent risk weight.

Claims on Banks

The applicable risk weights are listed follows:

- The claims on banks incorporated in India and foreign bank branches of foreign banks in India will be risk weighted as shown in Table 12.4.

Table 12.4 Claims on Banks Incorporated in India and Foreign Bank Branches in India

Level of CRAR (per cent) of the Investee Bank (Where Available)	*Risk Weight*			
	All Scheduled Banks (Commercial, Regional Rural Banks, Local Area Banks and Co-operative Banks)		*All Non-Scheduled Banks (Commercial, Regional Rural Banks, Local Area Banks and Co-operative Banks)*	
	Investments within 10% limit (per cent)	*All other claims (per cent)*	*Investments within 10% limit (per cent)*	*All other claims (per cent)*
1	*2*	*3*	*4*	*5*
9 and above	Higher of 100 per cent or the risk weight as per the rating	20	Higher of 100 per cent or the risk weight as per the rating	100
6 to <9	150	50	250	150
3 to >6	250	100	350	250
0 to <3	350	150	625	350
Negative	625	625	Full deduction	625

Notes

(i) In the case of banks where no capital adequacy norms have been prescribed by the RBI, the lending/investing banks may calculate the CRAR of the cooperative bank concerned, notionally, by obtaining necessary information from the investee bank, using the capital adequacy norms as applicable to the commercial banks. In case, it is not found feasible to compute CRAR on such notional basis, the risk weight of 350 of 625 per cent, as per the risk perception of the investing bank, should be applied uniformly to the investing bank's entire exposure.

(ii) In case of banks where capital adequacy norms are not applicable at present, the matter of investments in their capital-eligible instruments would not arise for now. However, column No. 2 and 4 of the table above will become applicable to them, if in future they issue any capital instruments where other banks are eligible to invest.

- The claims on foreign banks will be risk weighted as under as per the ratings assigned by international rating agencies as shown in Table 12.5.

Table 12.5 Claims on Foreign Banks – Risk Weights

S & P/FITCH Ratings	AAA to AA	A	BBB	BB to B	Below B	Unrated
Moody's Ratings	Aaa to Aa	A	Baa	Ba to B	Below B	Unrated
Risk weight (%)	20	50	50	100	150	50

- The claims on a bank which are denominated in 'domestic[6]' foreign currency met out of the resources in the same currency raised in that jurisdiction will be risk weighted at 20 per cent provided the bank complies with the minimum CRAR prescribed by the concerned bank regulator(s). However, in case a host supervisor requires a more conservative treatment for such claims in the books of the foreign branches of the Indian banks, they should adopt the requirements prescribed by the host supervisor for computing capital adequacy.

Claims on Primary Dealers

The claims on Primary Dealers should be risk weighted in a manner similar to claims on corporates.

Claims on Corporates

Claims on corporates[7] should be risk weighted as per the ratings assigned by the rating agencies registered with the SEBI and chosen by the RBI. Table 12.6 indicates the risk weight applicable to claims on corporates.

Table 12.6 Part A Long Term Claims on Corporate – Risk Weights

Domestic rating agencies	AAA	AA	A	BBB	BB & Below	Unrated
Risk weight (%)	20	30	50	100	150	100

Table 12.6 Part B Short Term Claims on Corporate – Risk Weights

Short term ratings				*Risk weights (%)*
CARE	CRISIL	Fitch	ICRA	
PR1+	P1+	F1+ (ind)	A1+	20
PR1	P1	F1 (ind)	A1	30
PR2	P2	F2 (ind)	A2	50
PR3	P3	F3 (ind)	A3	100
PR 4 & PR5	P4 & 5	F4/F5 (ind)	A4/A5	150
Unrated	Unrated	Unrated	Unrated	100

The standard risk weight for unrated claims on corporates up to the threshold level specified below will be 100 per cent. No claim on an unrated corporate may be given a risk weight preferential to that assigned to its sovereign of incorporation.

The RBI may increase the standard risk weight for unrated claims where a higher risk weight is warranted by the overall default experience. As part of the supervisory review process, the RBI would also consider whether the credit quality of unrated corporate claims held by individual

[6]For example: A Euro denominated claim of SBI branch in Paris on BNP Paribas, Paris which is funded from out of the Euro denominated deposits of SBI, Paris will attract a 20% risk weight irrespective of the rating of the claim, provided BNP Paribas complies with the minimum CRAR stipulated by its regulator/supervisor in France. If BNP Paribas were breaching the minimum CRAR, the risk weight will be as indicated in Table 12.4 above.

[7]Claims on corporates will include all fund based and non fund based exposures other than those which qualify for inclusion under 'sovereign', 'bank', 'regulatory retail', 'residential mortgage', 'Non performing assets', specified category addressed separately in these guidelines.

banks should warrant a standard risk weight higher than 100 per cent. To begin with, for the financial year 2008-09, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of ₹50 crore will attract a risk weight of 150 per cent. With effect from April 1, 2009, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of ₹10 crore will attract a risk weight of 150 per cent. The threshold of ₹50 crore (and ₹10 crore) will be with reference to the aggregate exposure on a single counterparty for the bank as a whole.

With a view to reflect a higher element of inherent risk which may be latent in entities whose obligations have been subjected to re-structuring/re-scheduling either by the banks on their own or along with other bankers/creditors, unrated standard/performing claims on these entities should be assigned a higher risk weight of 125 per cent until satisfactory performance under the revised payment schedule has been established for one year from the date when the first payment of interest/ principal falls due under the revised schedule.

The claims on non-resident corporates will be risk weighted as shown in Table 12.7 as per the ratings assigned by international rating agencies. For the financial year 2008-09, all fresh sanctions or renewals in respect of unrated claims on nonresident corporates in excess of ₹50 crore will attract a risk weight of 150 per cent. With effect from April 1, 2009, all fresh sanctions or renewals in respect of unrated claims on non-resident corporates in excess of ₹10 crore will attract a risk weight of 150 per cent. The threshold of ₹50 crore (and ₹10 crore) will be with reference to the aggregate exposure on a single counterparty for the bank as a whole.

Table 12.7 Claims on Non-resident Corporates – Risk Weights

S & P/ FITCH Ratings	AAA to AA	A	BBB to BB	Below BB	Unrated
Moody's Ratings	Aaa to Aa	A	Baa to Ba	Below Ba	Unrated
Risk weight (%)	20	50	100	150	100

Claims Included in the Regulatory Retail Portfolios

Claims (include both fund-based and non-fund based) that meet all the four criteria listed below may be considered as retail claims for regulatory capital purposes and included in a regulatory retail portfolio.

(i) Orientation Criterion The exposure (both fund-based and non fundbased) is to an individual person(s) or to a small business. **Person** here would mean any legal person capable of entering into contracts and would include but not be restricted to individual, HUF, partnership firm, trust, private limited companies, public limited companies, co-operative societies and so on. **Small business** is one where the total average annual turnover is less than ₹50 crore. The turnover criterion will be linked to the average of the last three years in the case of existing entities; projected turnover in the case of new entities; and both actual and projected turnover for entities which are yet to complete three years.

(ii) Product Criterion The exposure (both fund-based and non fundbased) takes the form of any of the following: revolving credits and lines of credit (including overdrafts), term loans and leases (e.g., instalment loans and leases, student and educational loans) and small business facilities and commitments.

(iii) Granularity Criterion Banks must ensure that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75 per cent risk weight. One way of achieving this is that no aggregate exposure to one counterpart should exceed 0.2 per cent of the overall regulatory retail portfolio. '**Aggregate exposure**' means gross amount (i.e. not taking any benefit for credit risk mitigation into account) of all forms of debt exposures (e.g. loans or commitments) that individually satisfy the three other criteria. In addition, '**one counterpart**' means one or several entities that may be considered as a single beneficiary (e.g. in the case of a small business that is affiliated to another small business, the limit would apply to the bank's aggregated exposure on both businesses). While banks may appropriately use the group exposure concept for computing aggregate exposures, they should evolve adequate systems to ensure strict adherence with this criterion. The NPAs under retail loans are to be excluded from the overall regulatory retail portfolio when assessing the granularity criterion for risk-weighting purposes.

(iv) Low Value of Individual Exposures The maximum aggregated retail exposure to one counterpart should not exceed the absolute threshold limit of ₹5 crore.

Claims included in this portfolio should be assigned a risk-weight of 75 per cent, except as provided for non performing assets (discussed in a subsequent section).

The following claims, both fund based and non-fund based, should be excluded from the regulatory retail portfolio:

(a) Exposures by way of investments in securities (such as bonds and equities), whether listed or not;
(b) Mortgage loans to the extent that they qualify for treatment as claims secured by residential property[8] or claims secured by commercial real estate[9];
(c) Loans and advances to bank's own staff which are fully covered by superannuation benefits and/or mortgage of flat/ house;
(d) Consumer credit, including personal loans and credit card receivables;
(e) Capital market exposures;
(f) Venture capital funds.

For the purpose of ascertaining compliance with the absolute threshold, **exposure** would mean sanctioned limit or the actual outstanding, which ever is higher, for all fund based and non-fund based facilities, including all forms of off-balance sheet exposures. In the case of term loans and EMI-based facilities, where there is no scope for redrawing any portion of the sanctioned amounts, **exposure** would mean the actual outstanding.

The RBI would evaluate at periodic intervals the risk weight assigned to the retail portfolio with reference to the default experience for these exposures. As part of the supervisory review process, the RBI would also consider whether the credit quality of regulatory retail claims held by individual banks should warrant a standard risk weight higher than 75 per cent.

Claims Secured by Residential Property

Lending to individuals meant for acquiring residential property which are fully secured by mortgages on the residential property that is or will be occupied by the borrower, or that is rented, should be risk weighted as indicated below, provided the loan to value ratio (LTV) is not more than 75 per cent, based on Board approved valuation policy.

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[8]Mortgage loans qualifying for treatment as claims secured by residential property is given subsequently.
[9]As defined subsequently.

Amount of loan	*Risk weight (%)*
Up to ₹20 lakh	50
₹20 lakh and above	75

The LTV ratio should be computed as a percentage with total outstanding in the account (viz. "principal+accrued interest+other charges pertaining to the loan" without any netting) in the numerator and the realisable value of the residential property mortgaged to the bank in the denominator.

Lending for acquiring residential property which meets the above criteria but have LTV ratio of more than 75 per cent will attract a risk weight of 100 per cent.

All other claims secured by residential property would attract the higher of the risk weight applicable to the counterparty or to the purpose for which the bank has extended finance.

Loans/exposures to intermediaries for on-lending will not be eligible for inclusion under claims secured by residential property but will be treated as claims on corporates or claims included in the regulatory retail portfolio as the case may be.

Investments in mortgage backed securities (MBS) backed by exposures as discussed above will be governed by the guidelines pertaining to securitisation exposures (discussed in a subsequent section).

Claims Secured by Commercial Real Estate

Claims secured by commercial real estate are defined as "fund based and non-fund based exposures secured by mortgages on commercial real estates (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction etc.)" Exposures to entities for setting up Special Economic Zones (SEZs) or for acquiring units in SEZs which includes real estate would also be treated as commercial real estate exposure. The will attract a risk weight of 150 per cent.

Investments in mortgage backed securities (MBS) backed by exposures will be governed by the guidelines pertaining to securitisation exposures discussed in a subsequent section.

Non-performing Assets (NPAs)

The **unsecured portion** of NPA [other than a qualifying residential mortgage loan net of specific provisions (including partial write-offs)], will be risk-weighted as follows:

(i) 150 per cent risk weight when specific provisions are less than 20 per cent of the outstanding amount of the NPA;

(ii) 100 per cent risk weight when specific provisions are at least 20 per cent of the outstanding amount of the NPA;

(iii) 50 per cent risk weight when specific provisions are at least 50 per cent of the outstanding amount of the NPA.

For the purpose of computing the level of specific provisions in NPAs for deciding the risk-weighting, all funded NPA exposures of a single counterparty (without netting the value of the eligible collateral) should be reckoned in the denominator.

For the purpose of defining the secured portion of the NPA, eligible collateral will be the same as recognised for credit risk mitigation purposes (discussed subsequently). Hence, other forms of collateral like land, buildings, plant, machinery, current assets, etc. will not be reckoned while computing the secured portion of NPAs for capital adequacy purposes.

In addition to the above, where an NPA is fully secured by the following forms of collateral that are not recognised for credit risk mitigation purposes, either independently or along with other eligible collateral a 100 per cent risk weight may apply, net of specific provisions, when provisions reach 15 per cent of the outstanding amount:

(i) Land and building which are valued by an expert valuer and where the valuation is not more than three years old, and

(ii) Plant and machinery in good working condition at a value not higher than the depreciated value as reflected in the audited balance sheet of the borrower, which is not older than eighteen months.

The above collaterals will be recognised only where the bank has clear title to realise the sale proceeds thereof and can appropriate the same towards the amounts due to the bank. The bank's title to the collateral should be well documented. These forms of collaterals are not recognised anywhere else under the standardised approach.

Claims secured by residential property, which are NPA will be risk weighted at 100 per cent net of specific provisions. If the specific provisions in such loans are at least 20 per cent but less than 50 per cent of the outstanding amount, the risk weight applicable to the loan net of specific provisions will be 75 per cent. If the specific provisions are 50 per cent or more the applicable risk weight will be 50 per cent.

Specified Categories

Fund based and non-fund based claims on the following segments which are considered as high risk exposures will attract a higher risk weight of 150 per cent: (a) Venture capital funds; and (b) Commercial real estate.

The RBI may, in due course, decide to apply a 150 per cent or higher risk weight reflecting the higher risks associated with any other claim that may be identified as a high risk exposure.

Consumer credit, including personal loans and credit card receivables, but excluding educational loans, will attract a higher risk weight of 125 per cent or higher, if warranted by the external rating (or, the lack of it) of the counterparty. As gold and gold jewellery are eligible financial collateral, the counterparty exposure in respect of personal loans secured by gold and gold jewellery will be worked out under the comprehensive approach discussed later. The 'exposure value after risk mitigation' would attract the risk weight of 125 per cent.

'Capital market exposures' and claims on 'Non-deposit taking systemically important non-banking financial companies', as defined by the RBI from time to time, will attract a higher risk weight of 125 per cent or a risk weight warranted by the external rating (or the lack of it) of the counterparty, whichever is higher.

All investments in the paid-up equity of non-financial entities which are not consolidated for capital purposes with the bank would be assigned a 125 per cent risk weight.

Investment up to 30 per cent in the paid-up equity of financial entities, which are not consolidated for capital purposes with the bank, shall be assigned a 125 per cent risk weight or a risk weight warranted by the external rating (or the lack of it) of the counterparty, whichever is higher. The investment in paid-up equity of financial entities which are specifically exempted from 'capital market exposure' shall be assigned a 100 per cent risk weight.

Bank's investments in innovative perpetual debt instruments eligible for inclusion as Tier 1 capital, debt capital instruments eligible for inclusion as Upper Tier 2 capital and subordinated debt eligible for inclusion as Lower Tier 2 capital issued by other banks/financial institutions will attract risk weight of 100 per cent or the risk weight as applicable to the ratings assigned to the relevant instruments, or a risk weight warranted by the external rating (or the lack of it) of the counterparty, whichever is higher.

Other Assets

Loans and advances to bank's own staff which are fully covered by superannuation benefits and/ or mortgage of a flat/ house will attract a 20 per cent risk weight. Since a flat / house is not an eligible collateral and since banks normally recover the dues by adjusting the superannuation benefits only at the time of cessation from service, the concessional risk weight shall be applied without any adjustment of the outstanding amount. In case a bank is holding eligible collateral in respect of amounts due from a staff member, the outstanding amount in respect of that staff member may be adjusted to the extent permissible, as indicated in a subsequent section.

Other loans and advances to bank's own staff will be eligible for inclusion under regulatory retail portfolio and will therefore attract a 75 per cent risk weight. All other assets will attract a uniform risk weight of 100 per cent.

Off-balance Sheet Items

The stipulations relating to the off-balance sheet items are discussed below:

The total risk weighted off-balance sheet credit exposure is calculated as the sum of the risk-weighted amount of the market related and non-market related off-balance sheet items. The riskweighted amount of an off-balance sheet item that gives rise to credit exposure is generally calculated by means of a two-step process: **(a)** the notional amount of the transaction is converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method, and **(b)** the resulting credit equivalent amount is multiplied by the risk weight applicable to the counterparty or to the purpose for which the bank has extended finance or the type of asset, whichever is higher. Where the off-balance sheet item is secured by eligible collateral or guarantee, the credit risk mitigation guidelines (discussed later) may be applied.

Non-market-Related Off-balance Sheet Items **(i)** The credit equivalent amount in relation to a non-market related off-balance sheet item like, direct credit substitutes, trade and performance related contingent items and commitments with certain drawdown, other commitments, etc. will be determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor (CCF). **(ii)** Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility[10], the amount of undrawn commitment to be included in calculating the off-balance sheet nonmarket related credit exposures is the

[10]For example: (a) In the case of a cash credit facility for ₹100 lakh (which is not unconditionally cancellable) where the drawn portion is ₹60 lakh, the undrawn portion of ₹40 lakh will attract a CCF of 20% (since the cash credit facility is subject to review / renewal normally once a year). The credit equivalent amount of ₹8 lakh (20% of ₹40 lakh) will be assigned the appropriate risk weight as applicable to the counterparty / rating to arrive at the risk weighted asset for the undrawn portion. The drawn portion (₹60 lakh) will attract a risk weight as applicable to the counterparty / rating. (b) A term loan of ₹700 crore is sanctioned for a large project which can be drawn down in stages over a three year period. The terms of sanction allow draw down in three stages – ₹150 crore in Stage I, ₹200 crore in Stage II and ₹350 crore in Stage III, where the borrower needs the bank's explicit approval for draw down under Stages II and III after completion of certain formalities. If the borrower has drawn already ₹50 crore under Stage I, then the undrawn portion would be computed with reference to Stage I alone i.e.,it will be ₹100 crore. If Stage I is scheduled to be completed within one year, the CCF will be 20% and if it is more than one year then the applicable CCF will be 50%.

maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms a part of bank's on-balance sheet credit exposure. **(iii)** In the case of irrevocable commitments to provide off-balance sheet facilities, the original maturity will be measured from the commencement of the commitment until the time the associated facility expires. For example an irrevocable commitment with an original maturity of 12 months, to issue a 6 month documentary letter of credit, is deemed to have an original maturity of 18 months. Irrevocable commitments to provide off-balance sheet facilities should be assigned the lower of the two applicable credit conversion factors. For example, an irrevocable commitment with an original maturity of 15 months (50 per cent - CCF) to issue a six month documentary letter of credit (20 per cent - CCF) would attract the lower of the CCF), that is, the CCF applicable to the documentary letter of credit, namely, 12 per cent.

(iv) The credit conversion factors for non-market related off-balance sheet transactions are as shown in Table 12.8: **(v)** In regard to non-market related off-balance sheet items, the following transactions with non-bank counterparties will be treated as claims on banks.

- Guarantees issued by banks against the counter guarantees of other banks.
- Rediscounting of documentary bills discounted by other banks and bills discounted by banks which have been accepted by another bank will be treated as a funded claim on a bank.

Table 12.8 Credit Conversion Factors – Non-market Related Off-balance Sheet Items

Sr.No.	*Instruments conversion factor (%)*	*Credit*
1.	Direct credit substitutes e.g. general guarantees of indebtedness (including standby L/Cs serving as financial guarantees for loans and securities, credit enhancements, liquidity facilities forsecuritisation transactions), and acceptances (including endorsements with the character of acceptance), *(i.e., the risk of loss depends on the credit worthiness of the counterparty or the party against whom a potential claim is acquired)*	100
2.	Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties, indemnities and standby letters ofcredit related to particular transaction).	50
3.	Short-term self-liquidating trade letters of credit arising from the Movement of goods (e.g. documentary credits collateralised by the underlying shipment) for both issuing bank and confirming bank.	20
4.	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the bank. (*These items are to be risk weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.)*	100
5.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown.*(These items are to be risk weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.)*	100

(*Contd*)

(*Contd*)

6.	Lending of banks' securities or posting of securities as collateral by banks, including instances where these arise out of repo style transactions (i.e., repurchase / reverse repurchase and securities lending / securities borrowing transactions)	100
7.	Note issuance facilities and revolving/non-revolving underwriting facilities	
8.	Commitments with certain drawdown	50
9.	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of	100
	(a) up to one year	
	(b) over one year.	20
	Similar commitments that are unconditionally cancellable at any time by the bank without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness	50 0
10.	Take-out Finance in the books of taking-over institution	100
	(i) Unconditional take-out finance	50
	(ii) Conditional take-out finance	

In all the above cases, banks should be fully satisfied that the risk exposure is in fact on the other bank. If they are satisfied that the exposure is on the other bank they may assign these exposures the risk weight applicable to banks.

Market Related Off-balance Sheet Items **(i)** In calculating the risk weighted off-balance sheet credit exposures arising from market related off-balance sheet items for capital adequacy purposes, the bank should include all its market related transactions held in the banking and trading book which give rise to off-balance sheet credit risk. **(ii)** The credit risk on market related off-balance sheet items is the cost to a bank of replacing the cash flow specified by the contract in the event of counterparty default. This would depend, among other things, upon the maturity of the contract and on the volatility of rates underlying the type of instrument. **(iii)** Market related off-balance sheet items would include: (a) Interest rate contracts – including single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate futures; (b) Foreign exchange contracts, including contracts involving gold, – includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options; (c) Any other market related contracts specifically allowed by the RBI which give rise to credit risk. **(iv)** Exemption from capital requirements is permitted for (a) Foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and (b) Instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments. **(v)** The credit equivalent amount of a market related off-balance sheet item, whether held in the banking book or trading book must be determined by the current exposure method.

Current Exposure Method **(i)** The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of current credit exposure and potential future credit exposure of these contracts. **(ii) Current credit exposure** is defined as the sum of the positive mark-to-market value of these contracts. The current exposure method requires periodical calculation of the current credit exposure by marking these contracts to market, thus capturing the current credit exposure. **(iii)** Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated **in Table 12.9** according to the nature and residual maturity of the instrument. **(iv)** For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract. **(v)** For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on factor is subject to a floor of 0.5 per cent **(vi)** No potential future credit exposure would be calculated for single currency floating/ floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their markto- market value. **(vii)** Potential future exposures should be based on effective rather than apparent notional amounts. In the event that the stated notional amount is leveraged or enhanced by the structure of the transaction, banks must use the effective notional amount when determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the BPLR would have an effective notional amount of USD 2 million.

Table 12.9 Credit Conversion Factor for Market Related Off-balance Sheet Items

Residual maturity	*Conversion factor to be applied on notional principal amount*	
	Interest rate contract (%)	*Gold and exchange rate contract (%)*
One year or less	0.25	1.0
Over one year to five years	0.5	5.0
Over 5 years	1.5	7.5

Failed Transactions **(i)** With regard to unsettled securities and foreign exchange transactions, banks are exposed to counterparty credit risk from trade date, irrespective of the booking or the accounting of the transaction. They should develop, implement and improve systems for tracking and monitoring the credit risk exposure arising from unsettled transactions as appropriate for producing management information that facilitates action on a timely basis. **(ii)** Banks must closely monitor securities and foreign exchange transactions that have failed, starting from the day they fail for producing management information that facilitates action on a timely basis. Failed transactions give rise to risk of delayed settlement or delivery. **(iii)** Failure of transactions settled through a delivery-versus-payment system (DvP), providing simultaneous exchanges of securities for cash, expose banks to a risk of loss on the difference between the transaction valued at the agreed settlement price and the transaction valued at current market price (i.e. positive current exposure). Failed transactions where cash is paid without receipt of the corresponding receivable (securities, foreign currencies, or gold,) or, conversely, deliverables were delivered without receipt of the corresponding cash payment (non-DvP, or free-delivery) expose banks to a risk of loss on the full amount of cash paid or deliverables delivered. Therefore, a capital charge is required for failed transactions and must be calculated as under. The following capital treatment is applicable to all failed transactions, including transactions through recognised clearing houses. repurchase and reverse-repurchase agreements as well as securities lending and borrowing that have failed to settle are excluded from this capital treatment. **(iv) For DvP**

Transactions If the payments have not yet taken place 5 business days after the settlement date, banks are required to calculate a **capital charge** by multiplying the positive current exposure of the transaction by the appropriate factor as under:

Number of working days after the agreed settlement date	*Corresponding risk multiplier (%)*
From 5 to 15	9
From 16 to 30	50
From 31 to 45	75
46 or more	100

In order to capture the information, banks will need to upgrade their information systems in order to track the number of days after the agreed settlement date and calculate the corresponding capital charge. **(v) For Non-DvP Transactions (Free Deliveries)** after the first contractual payment/delivery leg, the bank that has made the payment will treat its exposure as a loan if the second leg has not been received by the end of the business day. If the dates when two payment legs are made are the same according to the time zones where each payment is made, it is deemed that they are settled on the same day. For example, if a bank in Tokyo transfers Yen on day X (Japan Standard Time) and receives corresponding US Dollar via CHIPS on day X (US Eastern Standard Time), the settlement is deemed to take place on the same value date. Banks shall compute the capital requirement using the counterparty risk weights prescribed in these guidelines. However, if five business days after the second contractual payment/delivery date the second leg has not yet effectively taken place, the bank that has made the first payment leg will deduct from capital the full amount of the value transferred plus replacement cost, if any. This treatment will apply until the second payment/delivery leg is effectively made.

Securitisation Exposures

The main features relating to capital adequacy for securitisation process are discussed below:

General A securitisation transaction which meets the minimum requirements prescribed in the guidelines on securitisation of standard assets issued (discussed in an earlier chapter) would qualify for the following prudential treatment of securitisation exposures for capital adequacy purposes. Banks' exposures to a **securitisation transaction**, referred to as securitisation exposures, can include, but are not restricted to the following: **as investor, as credit enhancer, as liquidity provider, as underwriter, as provider of credit risk mitigants**. Cash collaterals provided as credit enhancements should also be treated as securitisation exposures. The terms used in this section with regard to securitisation would be as defined in the above guidelines. Further, the following definitions would be applicable: **(a)** A '**credit enhancing interest only strip (I/Os)**' is an on-balance sheet exposure that is recorded by the originator, which **(i)** represents a valuation of cash flows related to future margin income to be derived from the underlying exposures, and **(ii)** is subordinated to the claims of other parties to the transaction in terms of priority of repayment, **(b)** '**Implicit support**' is the support provided by a bank to a securitisation in excess of its predetermined contractual obligation, and **(c)** A '**gain-on-sale**' is any profit realised at the time of sale of the securitised assets to SPV.

Banks should hold regulatory capital against all of their securitisation exposures, including those arising from the provision of credit risk mitigants to a securitisation transaction, investments in asset-backed securities, retention of a subordinated tranche, and extension of a liquidity facility or credit enhancement, as set forth in the following paragraphs. The repurchased securitisation exposures must be treated as retained securitisation exposures.

An originator in a securitisation transaction which does not meet the minimum requirements prescribed in the securitisation of standard assets guidelines and, therefore, does not qualify for de-recognition should hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised[11]. Additionally, the originator should deduct any 'gain on sale' on such transaction from Tier 1 capital.

Deduction of Securitisation Exposures from Capital Funds When a bank is required to deduct a securitisation exposure from regulatory capital, the deduction must be made 50 per cent from Tier 1 and 50 per cent from Tier 2, except where expressly provided otherwise. Deductions from capital may be calculated net of any specific provisions maintained against the relevant securitisation exposures.

- Credit enhancements, including credit enhancing I/Os (net of the gain-on-sale that should be deducted from Tier 1 as specified below) and cash collaterals, which are required to be deducted must be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2.
- Banks should deduct from Tier 1 capital any "**gain-on-sale**", if permitted to be recognised.
- Any rated securitisation exposure with a long term rating of '**B+** and below' when not held by an originator, and a long term rating of '**BB+** and below' when held by the originator should be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.
- Any unrated securitisation exposure, except an eligible liquidity facility should be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capital. In an unrated and ineligible liquidity facility, both the drawn and undrawn portions should be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.
- The holdings of securities devolved on the originator through underwriting should be sold to third parties within three-month following the acquisition failing which, any holding in excess of 20 per cent of the original amount of issue, including secondary market purchases, shall be deducted 50 per cent from Tier 1 and 50 per cent from Tier 2 capital.

Implicit Support The originator should not provide any implicit support to investors in a securitisation transaction. When a bank is deemed to have provided implicit support to a securitisation: (a) It must, at a minimum, hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. Additionally, the bank would need to deduct any gain-on-sale, as defined above, from Tier 1 capital. Furthermore, in respect of securitisation transactions where the bank is deemed to have provided implicit support it is required to disclose publicly that **(a)** it has provided non-contractual support **(b)** the details of the implicit support and **(c)** the impact of the implicit support on the bank's regulatory capital.

Where a securitisation transaction contains a clean up call and the clean up call can be exercised by the originator in circumstances where exercise of the clean up call effectively provides credit enhancement, the clean up call should be treated as implicit support and the concerned securitisation transaction will attract the above prescriptions.

[11]For example: If in a securitisation transaction of ₹100, the pool consists of 80% of AAA securities, 10% of BB securities and 10% of unrated securities and the transaction does not meet the true sale criterion, then the originator will be deemed to be holding all the exposures in that transaction. Consequently, the AAA rated securities will attract a risk weight of 20% and the face value of the BB rated securities and the unrated securities will be deducted. Thus the consequent impact on the capital will be ₹21.44 (16*9% + 20).

Application of External Ratings The following operational criteria concerning the use of external credit assessments apply:

- A bank must apply external credit assessments from eligible external credit rating agencies consistently across a given type of securitisation exposure. Furthermore, a bank cannot use the credit assessments issued by one external credit rating agency for one or more tranches and those of another external credit rating agency for other positions (whether retained or purchased) within the same securitisation structure that may or may not be rated by the first external credit rating agency. Where two or more eligible external credit rating agencies can be used and these assess the credit risk of the same securitisation exposure differently, the higher risk should be applied.
- If the CRM provider is not recognised as an eligible guarantor, the covered securitisation exposures should be treated as unrated.
- In the situation where a credit risk mitigant is not obtained by the SPV but rather applied to a specific securitisation exposure within a given structure (e.g. ABS tranche), the bank must treat the exposure as if it is unrated.
- The other aspects of application of external credit assessments will be as per guidelines given in the Section of this Chapter dealing with the external credit assessment.

Risk Weighted Securitisation Exposures Banks should calculate the risk weighted amount of an on-balance sheet securitisation exposure by multiplying the principal amount (after deduction of specific provisions) of the exposures by the applicable risk weight. The risk-weighted asset amount of a securitisation exposure is computed by multiplying the amount of the exposure by the appropriate risk weight determined in accordance with issue specific rating assigned to those exposures by the chosen external credit rating agencies as indicated in Table 12.10:

Table 12.10 Securitisation Exposures–Risk Weight Mapping to Long-term Ratings

Domestic rating agencies	AAA	AA	A	BBB	BB	B and below or Unrated
Risk weight for banks other than the originators (%)	20	30	50	100	350	Deduction*
Risk weight for originator (%)	20	30	50	100	Deduction*	

The risk-weighted asset amount of a securitisation exposure in respect of MBS backed by commercial real estate exposure is computed by multiplying the amount of the exposure by the appropriate risk weight determined in accordance with issue specific rating assigned to those exposures by the chosen external credit rating agencies as indicated in Table 12.11:

Table 12.11 Commercial Real Estate Securitisation Exposures–Risk Weight Mapping to Long-term Ratings

Domestic rating agencies	AAA	AA	A	BBB	BB	B and below or Unrated
Risk weight for banks other than the originators (%)	50	75	100	150	400	Deduction*
Risk weight for originator (%)	50	75	100	150	Deduction*	

Banks are not permitted to invest in unrated securities issued by an SPV as a part of the securitisation transaction. However, securitisation exposures assumed by banks which may become unrated or may be deemed to be unrated, would be deducted for capital adequacy purposes.

Off-balance Sheet Securitisation Exposures Banks should calculate the risk weighted amount of a rated off-balance sheet securitisation exposure by multiplying the credit equivalent amount of the exposure by the applicable risk weight. The credit equivalent amount should be arrived at by multiplying the principal amount of the exposure (after deduction of specific provisions) with a 100 per cent credit conversion factor, unless otherwise specified. If the off-balance sheet exposure is not rated, it must be deducted from capital, except an unrated eligible liquidity facility.

Recognition of Credit Risk Mitigant The treatment below applies to a bank that has obtained a credit risk mitigant on a securitisation exposure. **Credit risk mitigant** include guarantees and eligible collateral as specified in these guidelines. **Collateral** in this context refers to that used to hedge the credit risk of a securitisation exposure rather than for hedging the credit risk of the underlying exposures of the securitisation transaction.

When a bank other than the originator provides credit protection to a securitisation exposure, it must calculate a capital requirement on the covered exposure as if it were an investor in that securitisation. If a bank provides protection to an unrated credit enhancement, it must treat the credit protection provided as if it were directly holding the unrated credit enhancement.

Capital requirements for the guaranteed/protected portion will be calculated according to CRM methodology for the standardised approach (discussed later).

Liquidity Facilities A liquidity facility will be considered as an 'eligible' facility only if it satisfies all minimum requirements prescribed in the guidelines relating to securitisation of standard assets. The rated liquidity facilities will be risk weighted or deducted as per the appropriate risk weight determined in accordance with the specific rating assigned to those exposures by the chosen external credit rating agencies as indicated in the tables presented above. (**Tables 12.10 and 12.11**).

The unrated eligible liquidity facilities will be exempted from deductions and treated as follows: **(a)** The drawn and undrawn portions of an unrated eligible liquidity facilities would attract a risk weight equal to the highest risk weight assigned to any of the underlying individual exposures covered by this facility, and **(b)** The undrawn portion of an unrated eligible liquidity will attract the following credit conversion factors for calculating the credit equivalent amount: **(i)** 20 per cent for facilities with an original maturity of one year or less, or **(ii)** 50 per cent for facilities with an original maturity of more than one year.

EXTERNAL CREDIT ASSESSMENTS

The main features of the external credit assessment are discussed in this Section.

Eligible Credit Rating Agencies

The RBI has undertaken the detailed process of identifying the eligible credit rating agencies, whose ratings may be used by banks for assigning risk weights for credit risk. In line with the provisions of the Revised Framework, where the facility provided by the bank possesses rating assigned by an eligible credit rating agency, the risk weight of the claim will be based on this rating.

In accordance with the principles laid down in the revised Basel framework, the RBI has decided that banks may use the ratings of the following domestic credit rating agencies (arranged in alphabetical order) for the purposes of risk weighting their claims for capital adequacy purposes: **(a)** Credit Analysis and Research (CARE) Limited, **(b)** CRISIL Limited, **(c)** FITCH India, and **(d)** ICRA Limited. The banks may use the ratings of the following international credit rating agencies (arranged in alphabetical order) for the purposes of risk weighting their claims for capital adequacy purposes where specified: **(a)** Fitch, **(b)** Moodys, and **(c)** Standard & Poor's.

Scope of Application of External Ratings

Banks should use the chosen credit rating agencies and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. They cannot "cherry pick" the assessments provided by different credit rating agencies. If a bank has decided to use the ratings of some of the chosen credit rating agencies for a given type of claim, it can use only the ratings of those credit rating agencies, despite the fact that some of these claims may be rated by other chosen credit rating agencies whose ratings the bank has decided not to use. Banks should not use one agency's rating for one corporate bond, while using another agency's rating for another exposure to the same counterparty, unless the respective exposures are rated by only one of the chosen credit rating agencies, whose ratings the bank has decided to use. External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group.

Banks must disclose the names of the credit rating agencies that they use for the risk weighting of their assets, the risk weights associated with the particular rating grades as determined by the RBI through the mapping process for each eligible credit rating agency as well as the aggregated risk weighted assets as required vide **Table 12.DF.5**.

To be eligible for risk-weighting purposes, the external credit assessment must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it. For example, if a bank is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with timely repayment of both principal and interest.

To be eligible for risk weighting purposes, the rating should be in force and confirmed from the monthly bulletin of the concerned rating agency. The rating agency should have reviewed the rating at least once during the previous 15 months.

An eligible credit assessment must be publicly available. In other words, a rating must be published in an accessible form and included in the external credit rating agency's transition matrix. Consequently, ratings that are made available only to the parties to a transaction do not satisfy this requirement.

For assets in the bank's portfolio that have contractual maturity upto one year, short term ratings accorded by the chosen credit rating agencies would be relevant. For other assets which have a contractual maturity of more than one year, long term ratings accorded by the chosen credit rating agencies would be relevant.

Cash credit exposures tend to be generally rolled over and also tend to be drawn on an average for a major portion of the sanctioned limits. Hence, even though a cash credit exposure may be sanctioned for period of one year or less, these exposures should be reckoned as long term exposures and accordingly the long term ratings accorded by the chosen credit rating agencies will be relevant. Similarly, banks may use long term ratings of a counterparty as a proxy for an unrated short term exposure on the same counterparty subject to strict compliance with the requirements for use of multiple rating assessments and applicability of issue rating to issuer/other claims as indicated subsequently in this Section.

Mapping Process

The Basel revised framework recommends the development of a mapping process to assign the ratings issued by eligible credit rating agencies to the isk weights available under the **Standardised Risk Weighting Framework**. The mapping process is required to result in a risk weight assignment consistent with that of the level of credit risk. A mapping of the credit ratings awarded by the chosen domestic credit rating agencies has been furnished below which should be used by banks in assigning risk weights to the various exposures.

Long Term Ratings

On the basis of the above factors as well as the data made available by the rating agencies, the ratings issued by the chosen domestic credit rating agencies have been mapped to the appropriate risk weights applicable as per the standardised approach under the revised framework. The rating risk weight mapping furnished in the Table 12.12 should be adopted by all banks in India:

Table 12.12 Risk Weight Mapping of Long Term ratings of the Chosen Domestic Rating Agencies

Long term ratings of the chosen credit rating agencies operating in India	*Standardised approach risk weights (%)*
AAA	20
AA	30
A	50
BBB	100
BB & Below	150
Unrated	100

Where **"+" or "–"** notation is attached to the rating, the corresponding main rating category risk weight should be used. For example, **A+ or A–** would be considered to be in the **A** rating category and assigned 50 per cent risk weight.

If an issuer has a long-term exposure with an external long term rating that warrants a risk weight of 150 per cent, all unrated claims on the same counterparty, whether short-term or long-term, should also receive a 150 per cent risk weight, unless the bank uses recognised credit risk mitigation techniques for such claims.

Short Term Ratings

For risk-weighting purposes, short-term ratings are deemed to be issue specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalised to other short-term claims. In no event can a short-term rating be used to support a risk weight for an unrated long-term claim. Short-term assessments may only be used for short-term claims against banks and corporates.

Notwithstanding the above restriction on using an issue specific short term rating for other short term exposures, the following broad principles will apply. The unrated short term claim on counterparty will attract a risk weight of at least one level higher than the risk weight applicable to the rated short term claim on that counter-party. If a short-term rated facility to counterparty attracts a 20 per cent or a 50 per cent risk-weight, unrated short-term claims to the same counter-party cannot attract a risk weight lower than 30 per cent or 100 per cent respectively. Similarly, if an issuer has a short-term exposure with an external short term rating that warrants a risk weight of 150 per cent, all unrated claims on the same counter-party, whether long-term or short-term, should also receive a 150 per cent risk weight, unless the bank uses recognised credit risk mitigation techniques for such claims.

In respect of the issue specific short term ratings the following risk weight mapping shown in Table 12.13 should be adopted by banks.

Table 12.13 Risk Weight Mapping of Short Term Ratings of the Domestic Rating Agencies

Short term ratings				*Risk weights (%)*
CARE	CRISIL	Ftich	ICRA	
PR1+	P1+	F1+ (ind)	A1+	20
PR1	P1	F1 (ind)	A1	30
PR2	P2	F2 (ind)	A2	50
PR3	P3	F3 (ind)	A3	100
PR4 & PR5	P4 & P5	F4/F5 (ind)	A4/A5	150

Where **"+" or "–"** notation is attached to the rating, the corresponding main rating category risk weight should be used for **PR2/ P2/ F2/ A2** and below, unless specified otherwise. For example, **P2+ or P2–** would be considered to be in the **P2** rating category and assigned 50 per cent risk weight.

The above risk weight mapping of both long term and short term ratings of the chosen domestic rating agencies would be reviewed annually by the RBI.

Use of Unsolicited Ratings

A rating would be treated as solicited only if the issuer of the instrument has requested the credit rating agency for the rating and has accepted the rating assigned by the agency. As a general rule, banks should use only **solicited rating from the chosen credit rating agencies.** No ratings issued by the credit rating agencies on an unsolicited basis should be considered for risk weight calculation as per the standardised approach.

Use of Multiple Rating Assessments

Banks should be guided by the following in respect of exposures/ obligors having multiple ratings from the chosen credit rating agencies chosen by the bank for the purpose of risk weight calculation:

- If there is only one rating by a chosen credit rating agency for a particular claim, that rating would be used to determine the risk weight of the claim.
- If there are two ratings accorded by the chosen credit rating agencies which map into different risk weights, the higher risk weight should be applied.
- If there are three or more ratings accorded by the chosen credit rating agencies with different risk weights, the ratings corresponding to the two lowest risk weights should be

referred to and the higher of those two risk weights should be applied, that is, the second lowest risk weight.

Applicability of Issue Rating to Issuer/Other Claims

Where a bank invests in a particular issue that has an issue specific rating by a chosen credit rating agency, the risk weight of the claim will be based on this assessment. Where the bank's claim is not an investment in a specific assessed issue, the following general principles will apply:

- In circumstances where the borrower has a specific assessment for an issued debt—but the bank's claim is not an investment in this particular debt - the rating applicable to the specific debt (where the rating maps into a risk weight lower than that which applies to an unrated claim) may be applied to the bank's unassessed claim only if this claim ranks pari passu or senior to the specific rated debt in all respects and the maturity of the unassessed claim is not later than the maturity of the rated claim,[12] except where the rated claim is a short term obligation. If not, the rating applicable to the specific debt cannot be used and the unassessed claim will receive the risk weight for unrated claims.
- If either the issuer or single issue has been assigned a rating which maps into a risk weight equal to or higher than that which applies to unrated claims, a claim on the same counterparty, which is unrated by any chosen credit rating agency, will be assigned the same risk weight as is applicable to the rated exposure, if this claim ranks pari passu or junior to the rated exposure in all respects.
- Where a bank intends to extend an issuer or an issue specific rating assigned by a chosen credit rating agency to any other exposure which the bank has on the same counterparty and which meets the above criterion, it should be extended to the entire amount of credit risk exposure the bank has with regard to that exposure, that is, both principal and interest.
- With a view to avoiding any double counting of credit enhancement factors, no recognition of credit risk mitigation techniques should be taken into account if the credit enhancement is already reflected in the issue specific rating accorded by a chosen credit rating agency relied upon by the bank.
- Where unrated exposures are risk weighted based on the rating of an equivalent exposure to that borrower, **the general rule is that foreign currency ratings would be used only for exposures in foreign currency**.

CREDIT RISK MITIGATION

The main elements of the revised credit risk mitigation are discussed in this Section. They are depicted in **Exhibit 12.4**.

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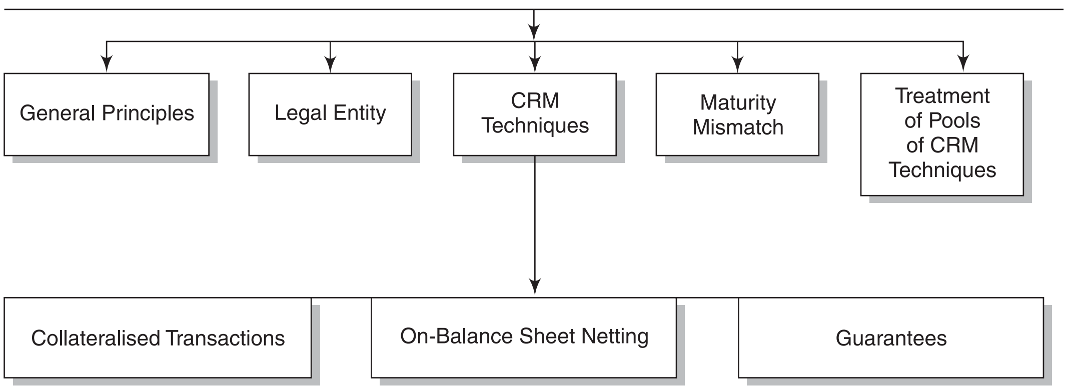
[12]In a case where a short term claim on a counterparty is rated as P1+ and a long term claim on the same counterparty is rated as AAA, then a bank may assign a 30% risk weight to an unrated short term claim and 20% risk weight to an unrated long term claim on that counterparty where the seniority of the claim ranks pari-passu with the rated claims and the maturity of the unrated claim is not later than the rated claim. In a similar case where a short term claim is rated P1+ and a long term claim is rated A, the bank may assign Basel II Final Guidelines 50% risk weight to an unrated short term or long term claim.

Exhibit 12.4 Credit Risk Mitigation (CRM)



General Principles

Banks use a number of techniques to mitigate the credit risks to which they are exposed. For example, exposures may be collateralised in whole or in part by cash or securities, deposits from the same counterparty, guarantee of a third party, and so on. The revised approach to credit risk mitigation allows a wider range of credit risk mitigants to be recognised for regulatory capital purposes than is permitted under the 1988 framework provided these techniques meet the requirements for **legal certainty** described **below**.

Legal Certainty In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met. All documentation used in collateralised transactions and guarantees must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review, which should be well documented, to verify this. Such verification should have a well founded legal basis for reaching the conclusion about the binding nature and enforceability of the documents. Banks should also undertake such further review as necessary to ensure continuing enforceability.

Credit risk mitigation approach as detailed in this section is applicable to the banking book exposures. This will also be applicable for calculation of the counterparty risk charges for OTC derivatives and repo-style transactions booked in the trading book.

The general principles applicable to use of credit risk mitigation techniques are as under:

- No transaction in which credit risk mitigation (CRM) techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.
- The effects of CRM will **not** be double counted. Therefore, no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM.
- Principal-only ratings will not be allowed within the CRM framework.
- While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). The **residual risks** include legal, operational, liquidity and market risks. Therefore, banks must employ robust procedures and processes to control

these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile. Where these risks are not adequately controlled, the RBI may impose additional capital charges or take other supervisory actions. The disclosure requirements prescribed in **Table 12.DF-6 – Market Discipline)** must also be observed for banks to obtain capital relief in respect of any CRM techniques.

Credit Risk Mitigation Techniques—Collateralised Transactions

A **collateralised transaction** is one in which: Banks have a **(i)** credit exposure and that credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty. The term, "**counterparty**" is used to denote a party to whom a bank has an on- or off-balance sheet credit exposure, and **(ii)** a specific lien on the collateral and the requirements of legal certainty are met.

Overall Framework and Minimum Conditions The Basel II revised framework allows banks to adopt either the **Simple Approach**, which, similar to the 1988 Accord, substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralised portion of the exposure (generally subject to a 20 per cent floor), or the comprehensive approach, which allows fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral. Banks in India should adopt the **Comprehensive Approach**, which allows fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral. Under this approach, banks which take eligible financial collateral (e.g. cash or securities, more specifically defined below), are allowed to reduce their credit exposure to a counterparty when calculating their capital requirements to take account of the risk mitigating effect of the collateral. The credit risk mitigation is allowed only on an account-by-account basis, even within regulatory retail portfolio. However, before capital relief will be granted the **standards** set out below must be met:

- In addition to the general requirements for legal certainty, the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral). Furthermore, banks must take all steps necessary to fulfill those requirements under the law applicable to the their interest in the collateral for obtaining and maintaining an enforceable security interest, for example, by registering it with a registrar.
- In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty—or by any related group entity—would provide little protection and so would be ineligible.
- Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.
- Where the collateral is held by a custodian, banks must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

A capital requirement will be applied to a bank on either side of the collateralised transaction: for example, both repos and reverse repos will be subject to capital requirements. Likewise, both sides of securities lending and borrowing transactions will be subject to explicit capital charges, as will the posting of securities in connection with a derivative exposure or other borrowing.

The Comprehensive Approach In the comprehensive approach, when taking collateral, banks will need to calculate their adjusted exposure to a counterparty for capital adequacy purposes in order to take account of the effects of that collateral. Banks are required to adjust both the amount of the exposure to the counterparty and the value of any collateral received in support of that counterparty to take account of possible future fluctuations in the value of either, occasioned by market movements. These adjustments are referred to as '**haircuts**'. The application of haircuts will produce volatility adjusted amounts for both exposure and collateral. The volatility adjusted amount for the exposure will be higher than the exposure and the volatility adjusted amount for the collateral will be lower than the collateral, unless either side of the transaction is cash. In other words, the 'haircut' for the exposure will be a premium factor and the 'haircut' for the collateral will be a discount factor.

The purpose underlying the application of haircut is to capture the market-related volatility inherent in the value of exposures as well as of the eligible financial collaterals. Since the value of credit exposures acquired by the banks in the course of their banking operations, would not be subject to market volatility, (since the loan disbursal/investment would be a "**cash**" transaction) though the value of eligible financial collateral would be the haircut stipulated in Table 12.14 would apply in respect of credit transactions only to the eligible collateral but not to the credit exposure of the bank. On the other hand, exposures of banks, arising out of repo-style transactions would require upward adjustment for volatility, as the value of security sold/lent/pledged in the repo transaction, would be subject to market volatility. Hence, such exposures would attract haircut.

Additionally where the exposure and collateral are held in different currencies, an additional downwards adjustment must be made to the volatility adjusted collateral amount to take account of possible future fluctuations in exchange rates.

Where the volatility-adjusted exposure amount is greater than the volatility-adjusted collateral amount (including any further adjustment for foreign exchange risk), banks should calculate their risk-weighted assets as the difference between the two multiplied by the risk weight of the counterparty. The framework for performing calculations of capital requirement is indicated below.

Calculation of Capital Requirement For a collateralised transaction, the exposure amount after risk mitigation is calculated as follows:

$$\mathbf{E^*} = \max\{0, [E \times (1 + H_e) - C \times (1 - H_c - H_{fx})]\} \quad \mathbf{(12.1)}$$

where:

- $\mathbf{E^*}$ = the exposure value after risk mitigation
- $\mathbf{E}$ = current value of the exposure for which the collateral qualifies as a risk mitigant
- $\mathbf{H_e}$ = haircut appropriate to the exposure
- $\mathbf{C}$ = the current value of the collateral received
- $\mathbf{H_c}$ = haircut appropriate to the collateral
- $\mathbf{H_{fx}}$ = haircut appropriate for currency mismatch between the collateral and exposure

The exposure amount after risk mitigation (**i.e., E***) will be multiplied by the risk weight of the counterparty to obtain the risk-weighted asset amount for the collateralised transaction. Illustrative examples calculating the effect of credit risk mitigation is furnished in **Appendix 12-F on the website. The website address is http://www.mhhe.com/khanifs10e.**

Eligible Financial Collateral The following collateral instruments are eligible for recognition in the comprehensive approach:

- Cash (as well as certificates of deposit or comparable instruments, including fixed deposit receipts, issued by the lending bank) on deposit with the bank which is incurring the counterparty exposure,
- Gold including both bullion and jewellery. However, the value of the collateralised jewellery should be arrived at after notionally converting these to 99.99 purity,
- Securities issued by Central and State Governments,
- Kisan Vikas Patra and National Savings Certificates provided no lock-in period is operational and if they can be encashed within the holding period,
- Life insurance policies with a declared surrender value of an insurance company which is regulated by an insurance sector regulator,
- Debt securities rated by a chosen credit rating agency in respect of which the banks should be sufficiently confident about the market liquidity[13] where these are either: **(a)** Attracting 100 per cent or lesser risk weight, that is, rated at least **BBB(-)** when issued by public sector entities and other entities (including banks and Primary Dealers); or **(b)** Attracting 100 per cent or lesser risk weight, that is, rated at least **PR3/P3/F3/A3** for short-term debt instruments.
- Debt securities not rated by a chosen credit rating agency in respect of which the banks should be sufficiently confident about the market liquidity where these are: **(a)** issued by a bank; and **(b)** listed on a recognised exchange; and **(c)** classified as senior debt; and **(d)** all rated issues of the same seniority by the issuing bank are rated at least **BBB(-) or PR3/P3/F3/A3** by a chosen credit rating agency; and **(e)** the bank holding the securities as collateral has no information to suggest that the issue justifies a rating below **BBB(-) or PR3/P3/F3/A3** (as applicable) and; **(f)** banks should be sufficiently confident about the market liquidity of the security.
- Equities (including convertible bonds) that are listed on a recognised stock exchange and are included in the following indices: '**BSESENSEX**' and '**BSE-200**' of the Bombay Stock Exchange; '**S&P CNX NIFTY**' and '**Junior NIFTY**' of the National Stock Exchange and the main index of any other recognised stock exchange, in the jurisdiction of bank's operation Units of mutual funds regulated by the securities regulator of the jurisdiction of the bank's operation mutual funds where, **(1)** a price for the units is publicly quoted daily, that is, where the daily NAV is available in public domain, and **(2)** mutual fund is limited to investing in the instruments listed above.

Haircuts In principle, banks have two ways of calculating the haircuts: **(i)** standard supervisory haircuts, using parameters set by the Basel Committee, and **(ii)** own-estimate haircuts, using banks' own internal estimates of market price volatility. Banks in India should use only the standard supervisory haircuts for both the exposure as well as the collateral. The Standard Supervisory Haircuts (assuming daily mark-to-market, daily re-mergining and a 10 business-day holding period),[14] expressed as percentages, would be as shown in Table 12.14:

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[13]A debenture would meet the test of liquidity if it is traded on a recognised stock exchange(s) on at least 90% of the trading days during the preceding 365 days. Further, liquidity can be evidenced in the trading during the previous one month in the recognised stock exchange if there are a minimum of 25 trades of marketable lots in securities of each issuer.

[14]Holding period will be the time normally required by the bank to realise the value of collateral.

Table 12.14 Standard Supervisory Haircuts for Sovereign and Other Securities Which Constitute Exposure and Collateral

	Issue rating for debt securities	*Residual maturity (in years)*	*Haircut (in percentage)*
(A)	Securities issued/ guaranteed by the Government of India and issued by the State Governments (Sovereign securities)		
(i)	Rating not applicable–as Government securities are not currently rated in India	= 1 year	0.5
		> 1year and < or = 5 years	2
		> 5 years	4
(B)	Domestic debt securities other than those indicated at Item No. (A) above including the securities guaranteed by Indian State Governments		
(ii)	AAA to AA PR1/P1/F1/A1	= 1 year	1
		> 1year and <or = 5 years	4
		> 5 years	8
(iii)	A to BBB PR2 / P2 / F2 /A2; PR3 /P3 / F3 / A3 and Unrated specified bank securities	= 1 year	2
		> 1year and < or = 5 years	6
		> 5 years	12
(iv)	Units of mutual funds		Highest haircut applicable to any of the above securities. In which the eligible mutual fund can invest
(C)	Cash in the same currency		0

The ratings indicated in Table 12.14 represent the ratings assigned by the domestic rating agencies. In the case of exposures toward debt securities issued by foreign Central Governments and foreign corporates, the haircut may be based on ratings of the international rating agencies, as indicated Table 12.15:

Table 12.15 Standard Supervisory Haircut for Exposures and Collaterals Which Are Obligations of Foreign Central Sovereigns/Foreign Corporates

Issue rating for debt securities as assigned by international rating agencies	*Residual maturity*	*Sovereigns*	*Other issues*
AAA to AA/A-1	= 1 year	0.5	1
	> 1 year and < or = 5 years	2	4
	> 5 years	4	8
A to BBB/ A-2/A-3/P-3 and unrated bank securities	= 1 year	1	2
	> 1 year and < or = 5 years	3	6
	> 5 years	6	12

Sovereign will include RBI, DICGC and CGTSI, which are eligible for zero per cent risk weight.

Banks may apply a zero haircut for eligible collateral where it is a National Savings Certificate, Kisan Vikas Patras, surrender value of insurance policies and banks' own deposits.

The standard supervisory haircut for currency risk where exposure and collateral are denominated in different currencies is eight per cent (also based on a 10-business day holding period and daily mark-to-market).

For transactions in which the banks' exposures are unrated or bank lends non-eligible instruments (i.e, non-investment grade corporate securities), the haircut to be applied on a exposure should be 25 per cent. (Since, at present, the repos are allowed only in the case of Government securities, the banks are not likely to have any exposure which will attract the provisions of this clause. However, this would be relevant, if in future, repos/security lending transactions are permitted in the case of unrated corporate securities).

Where the collateral is a basket of assets, the haircut on the basket will be,

$$\mathrm{H} = \sum_i a_i H_i$$

where $\mathbf{a_i}$ is the weight of the asset (as measured by the amount/value of the asset in units of currency) in the basket and $\mathbf{H_i}$, the haircut applicable to that asset.

Adjustment for Different Holding Periods For some transactions, depending on the nature and frequency of the revaluation and remargining provisions, different holding periods (other than 10 business-days) are appropriate. The framework for collateral haircuts distinguishes between repo-style transactions (i.e. repo/reverse repos and securities lending/borrowing), "other capital-marketdriven transactions" (i.e. OTC derivatives transactions and margin lending) and secured lending. In capital-market-driven transactions and repo-style transactions, the documentation contains remargining clauses; in secured lending transactions, it generally does not. In view of different holding periods, in the case of these transactions, the minimum holding period shall be taken as indicated below:

Transaction type	*Minimum holding period*	*Condition*
Repo-style transaction	5 business days	Daily remargining
Other capital market transactions	10 business days	Daily remargining
Secured lending	20 business days	Daily revaluation

The haircut for the transactions with other than 10 business-days minimum holding period, as indicated above, will have to be adjusted by scaling up/down the haircut for 10 business days indicated in the Table 12.14, as per the formula given below.

Adjustment For Non-Daily Mark-to-Market or Remargining In case a transaction has margining frequency different from daily margining assumed, the applicable haircut for the transaction will also need to be adjusted by using the formula given below.

Formula for Adjustment for Different Holding Periods and/or Non-Daily Mark-to-Market or Remargining Adjustment for the variation in holding period and margining/mark-to-market, as indicated above will be done as per the following formula (Eq. 12.2):

$$\text{H} = \frac{N_R + (T_M - 1)}{10} \tag{12.2}$$

where

H = haircut;

$\mathbf{H_{10}}$ = 10 – business-day standard supervisory haircut for instrument

$\mathbf{N_R}$ = actual number of business days between remargining for capital market transactions or revaluation for secured transactions.

$\mathbf{T_M}$ = minimum holding period for the type of transaction

Capital Adequacy Framework for Repo-/Reverse Repo-style Transactions The repo-style transactions also attract capital charge for counterparty credit risk (CCR), in addition to the credit risk and market risk. The CCR is defined as the risk of default by the counterparty in a repo-style transaction, resulting in non-delivery of the security lent/pledged/sold or non-repayment of the cash.

(A) Treatment in the Books of the Borrower of Funds Where a bank has borrowed funds by selling/lending or posting, as collateral, of securities, the '**exposure**' will be an off-balance sheet exposure equal to the 'market value' of the securities sold/lent as scaled up after applying appropriate haircut. For the purpose, the haircut as per Table 12.14 would be used as the basis which should be applied by using the formula in Eq. 12.2 to reflect minimum (prescribed) holding period of five business-days for repo-style transactions and the variations, if any, in the frequency of re-margining, from the daily margining assumed for the standard supervisory haircut. The 'off-balance sheet exposure' will be converted into 'on-balance sheet' equivalent by applying a credit conversion factor of 100 per cent., as per item 5 in Table 12.8.

The amount of money received will be treated as collateral for the securities lent/sold/pledged. Since the collateral is cash, the haircut for it would be zero.

The credit equivalent amount arrived at above, net of amount of cash collateral, will attract a risk weight as applicable to the counterparty.

As the securities will come back to the books of the borrowing bank after the repo period, it will continue to maintain the capital for the credit risk in the securities in the cases where the securities involved in repo are held under HTM category, and capital for market risk in cases where the securities are held under AFS/HFT categories. The capital change for credit risk/specific risk would be determined according to the credit rating of the issuer of the security. In the case of Government securities, the capital charge for credit/specific risk will be 'zero'.

(B) Treatment in the Books of the Lender of Funds The amount lent will be treated as on-balance sheet/funded exposure on the counter party, collateralised by the securities accepted under the repo. The exposure, being cash, will receive a zero haircut. The collateral will be adjusted downwards/marked down as per applicable haircut. The amount of exposure reduced by the adjusted amount of collateral, will receive a risk weight as applicable to the counterparty, as it is an on- balance sheet exposure. The lending bank will not maintain any capital charge for the security received by it as collateral during the repo period, since such collateral does not enter its balance sheet but is only held as a bailee.

Credit Risk Mitigation Techniques—On-balance Sheet Netting

On-balance sheet netting is confined to loans/advances and deposits, where banks have legally enforceable netting arrangements, involving specific lien with proof of documentation. They may calculate capital requirements on the basis of net credit exposures subject to the following conditions. Where a bank **(a)** has a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt; **(b)** is able at any time to determine the loans/advances and deposits with the same counterparty that are subject to the netting agreement; and **(c)** monitors and controls the relevant exposures on a net basis, it may use the net exposure of loans/advances and deposits as the basis for its capital adequacy calculation in accordance with the formula in Eq 12.1. Loans/advances are treated as exposure and deposits as collateral. The haircuts will be zero except when a currency mismatch exists.

Credit Risk Mitigation Techniques—Guarantees

Where guarantees are direct, explicit, irrevocable and unconditional banks may take account of such credit protection in calculating capital requirements. A range of guarantors are recognised. As under the 1988 Accord, a substitution approach will be applied. Thus only guarantees issued by entities with a lower risk weight than the counterparty will lead to reduced capital charges since the protected portion of the counterparty exposure is assigned the risk weight of the guarantor, whereas the uncovered portion retains the risk weight of the underlying counterparty. Detailed operational requirements for guarantees eligible for being treated as a CRM are as under:

Operational Requirements for Guarantees A guarantee (counter-guarantee) must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible. The guarantee must be irrevocable; there must be no clause in the contract that would allow the protection provider unilaterally to cancel the cover or that would increase the effective cost of cover as a result of deteriorating credit quality in the guaranteed exposure. The guarantee must also be unconditional; there should be no clause in the guarantee outside the direct control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due.

All exposures will be risk weighted after taking into account risk mitigation available in the form of guarantees. When a guaranteed exposure is classified as non-performing, the guarantee will cease to be a credit risk mitigant and no adjustment would be permissible on account of credit risk mitigation in the form of guarantees. The entire outstanding, net of specific provision and net of realisable value of eligible collaterals/credit risk mitigants, will attract the appropriate risk weight.

Additional Operational Requirements for Guarantees In addition to the legal certainty requirements discussed earlier, in order for a guarantee to be recognised, the following conditions must be satisfied:

- On the qualifying default/non-payment of the counterparty, the bank is able in a timely manner to pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment.
- The guarantee is an explicitly documented obligation assumed by the guarantor.
- Except as noted in the following sentence, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments etc. Where a guarantee covers payment of principal only, interests and other uncovered payments should be treated as an unsecured amount.

Range of Eligible Guarantors (Counter-guarantors) Credit protection given by the following entities will be recognised: (i) Sovereigns, sovereign entities (including BIS, IMF, European Central Bank and European Community as well as MDBs, ECGC and CGTSI), banks and primary dealers with a lower risk weight than the counterparty; and (ii) Other entities rated **AA(-)** or better. This would include guarantee cover provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor. The rating of the guarantor should be an entity rating which has factored in all the liabilities and commitments (including guarantees) of the entity.

Risk Weights The protected portion is assigned the risk weight of the protection provider. Exposures covered by State Government guarantees will attract a risk weight of 20 per cent. The uncovered portion of the exposure is assigned the risk weight of the underlying counterparty.

Proportional Cover Where the amount guaranteed, or against which credit protection is held, is less than the amount of the exposure, and the secured and unsecured portions are of equal seniority, that is, the bank and the guarantor share losses on a pro-rata basis capital relief will be afforded on a proportional basis, that is, the protected portion of the exposure will receive the treatment applicable to eligible guarantees, with the remainder treated as unsecured.

Currency Mismatches Where the credit protection is denominated in a currency different from that in which the exposure is denominated, that is, there is a currency mismatch the amount of the exposure deemed to be protected will be reduced by the application of a haircut HFX, that is,

$$GA = G \times (1 - H_{FX}) \qquad \textbf{(12.3)}$$

where:

G = nominal amount of the credit protection

$\mathbf{H_{FX}}$ = haircut appropriate for currency mismatch between the credit protection and underlying obligation.

Banks using the supervisory haircuts will apply a haircut of 8 per cent for currency mismatch.

Sovereign Guarantees and Counter-guarantees A claim may be covered by a guarantee that is indirectly counterguaranteed by a sovereign. Such a claim may be treated as covered by a sovereign guarantee provided that: **(i)** the sovereign counter-guarantee covers all credit risk elements of the claim; **(ii)** both the original guarantee and the counter-guarantee meet all operational requirements for guarantees, except that the counterguarantee need not be direct and explicit to the original claim; and (iii) the cover should be robust and no historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct sovereign guarantee.

Maturity Mismatch

For the purposes of calculating risk-weighted assets, a maturity mismatch occurs when the residual maturity of a collateral is less than that of the underlying exposure. Where there is a maturity mismatch and the CRM has an original maturity of less than one year, the CRM is not recognised for capital purposes. In other cases where there is a maturity mismatch, partial recognition is given to the CRM for regulatory capital purposes as detailed below:

In case of loans collateralised by the bank's own deposits, even if the tenor of such deposits is less than three months or deposits have maturity mismatch vis-à-vis the tenor of the loan, the above provisions regarding derecognition of collateral would not be attracted provided an explicit consent of the depositor has been obtained from the depositor (i.e., borrower) for adjusting the maturity proceeds of such deposits against the outstanding loan or for renewal of such deposits till the full repayment of the underlying loan.

Definition of Maturity The maturity of the underlying exposure and the maturity of the collateral should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the counterparty is scheduled to fulfil its obligation, taking into account any applicable grace period. For the collateral, embedded options which may reduce the term of the collateral should be taken into account so that the shortest possible effective maturity is used. The maturity relevant here is the residual maturity.

Risk Weights for Maturity Mismatches As outlined above, collateral with maturity mismatches are recognised only when their original maturities are greater than or equal to one year. As a result, the maturity of collateral for exposures with original maturities of less than one year must be matched to be recognised. In all cases, collateral with maturity mismatches will no longer be recognised when they have a residual maturity of three months or less.

When there is a maturity mismatch with recognised credit risk mitigants (collateral, on-balance sheet netting and guarantees) the following adjustment will be applied.

$$Pa = P \times (t - 0.25) \div (T - 0.25) \qquad \textbf{(12.4)}$$

Where:

Pa = value of the credit protection adjusted for maturity mismatch
P = credit protection (e.g. collateral amount, guarantee amount) adjusted for any haircuts
t = min (T, residual maturity of the credit protection arrangement) expressed in years
T = min (5, residual maturity of the exposure) expressed in years

Treatment of Pools of CRM Techniques

In the case where a bank has multiple CRM techniques covering a single exposure (e.g. a bank has both collateral and guarantee partially covering an exposure), the bank will be required to subdivide the exposure into portions covered by each type of CRM technique (e.g. portion covered by collateral, portion covered by guarantee) and the risk-weighted assets of each portion must be calculated separately. When credit protection provided by a single protection provider has differing maturities, they must be subdivided into separate protection as well.

CAPITAL CHARGE FOR MARKET RISK

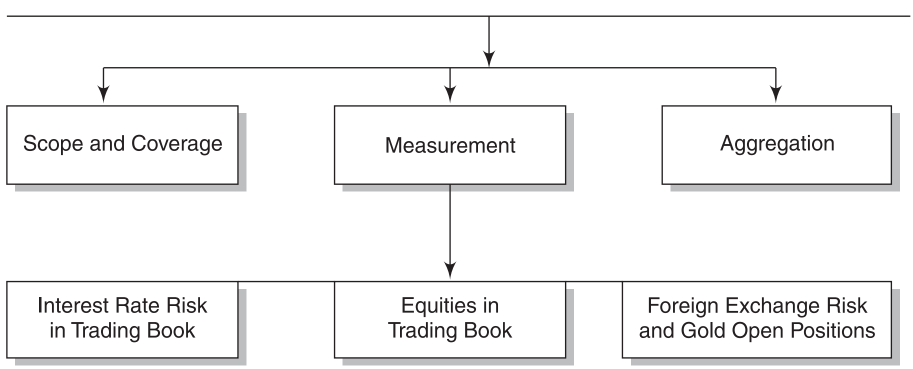
Market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from movements in market prices. The market risk positions subject to capital charge requirement are: **(i)** The risks pertaining to interest rate related instruments and equities in the trading book; and **(ii)** Foreign exchange risk (including open position in precious metals) throughout the bank (both banking and trading books).

The guidelines in this regard are organised under the following five sections:

Section	*Particulars*
(A)	Scope and coverage of capital charge for market risk
(B)	Measurement of capital charge for interest rate risk in the trading book
(C)	Measurement of capital charge for equities in the trading book
(D)	Measurement of capital charge for foreign exchange risk and gold open positions
(E)	Aggregation of capital charge for market risks

The main elements of the capital charge for market risk are portrayed in **Exhibit 12.5**.

Exhibit 12.5 Capital Charge for Market Risk



Section A: Scope and Coverage of Capital Charge for Market Risks

These guidelines seek to address the issues involved in computing capital charges for interest rate related instruments in the trading book, equities in the trading book and foreign exchange risk (including gold and other precious metals) in both trading and banking books. The trading book for the purpose of capital adequacy will include: **(i)** Securities included under the Held for trading category **(ii)** Securities included under the Available for sale category **(iii)** Open gold position limits **(iv)** Open foreign exchange position limits **(v)** Trading positions in derivatives, and (vi) Derivatives entered into for hedging trading book exposures.

Banks are required to manage the market risks in their books on an ongoing basis and ensure that the capital requirements for market risks are being maintained on a continuous basis, that is, at the close of each business day. They are also required to maintain strict risk management systems to monitor and control intra-day exposures to market risks.

Capital for market risk would not be relevant for securities which have already matured and remain unpaid. These securities will attract capital only for credit risk. On completion of 90 days delinquency, these will be treated on par with NPAs for deciding the appropriate risk weights for credit risk.

Section B: Measurement of Capital Charge for Interest Rate Risk

This section describes the framework for measuring the risk of holding or taking positions in debt securities and other interest rate related instruments in the trading book.

The capital charge for interest rate related instruments would apply to current market value of these items in bank's trading book. Since banks are required to maintain capital for market risks on an ongoing basis, they are required to mark to market their trading positions on a daily basis. The current market value will be determined as per the RBI guidelines on valuation of investments. (**discussed in an earlier chapter**).

The minimum capital requirement is expressed in terms of two separately calculated charges, **(i)** "**specific risk**" charge for each security, which is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer, both for short (short position is not allowed in India except in derivatives) and long positions, and **(ii)** "**general market risk**" charge towards interest rate risk in the portfolio, where long and short positions (which is not allowed in India except in derivatives) in different securities or instruments can be offset.

For the debt securities held under AFS (Available For Sale) category, in view of the possible longer holding period and attendant higher specific risk, the banks should hold total capital charge for market risk equal to greater of (a) or (b) below:

(a) Specific risk capital charge, computed notionally for the AFS securities treating them as held under HFT (Held For Trading) category (as computed according to Table 12.16: Part A/C/E, as applicable) plus the general market risk capital charge.

(b) Alternative total capital charge for the AFS category computed notionally treating them as held in the banking book (as computed in accordance with Table 12.16: Part B/D/F, as applicable)

Specific Risk The capital charge for specific risk is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer. The specific risk charges for various kinds of exposures would be as applied as detailed below:

S. No.	*Nature of debt securities/ issuer*	*Table to be followed*
(a)	Central, State and Foreign Central Governments' bonds:	
	(i)Held in HFT category	Table 12.16 - Part A
	(ii) Held in AFS category	Table 12.16 - Part B
(b)	Banks' Bonds:	
	(i)Held in HFT category	Table 12.16 - Part C
	(ii) Held in AFS category	Table 12.16 - Part D
(c)	Corporate Bonds and Securitised Debt:	
	(i)Held in HFT category	Table 12.16 - Part E
	(ii) Held in AFS category	Table 12.16 - Part F

Table 12.16 Part A: Specific Risk Capital Charge for Sovereign Securities Issued by Indian and Foreign Sovereigns – Held by Banks Under HFT Category

Sr. No.	*Nature of investment*	*Residual maturity*	*Specific risk capital (as % of exposure)*
(A)	Indian Central Government and State Governments		
1.	Investment in Central and State Government Securities	All	0.00
2.	Investments in other approved securities guaranteed by Central Government	All	0.00
3.	Investments in other approved securities guaranteed by State Governments	6 months or less	0.28
		More than 6 months and Up to and including 24 months	1.13
		More than 24 months	1.80
4.	Investment in other securities where payment of interest and repayment of principal are guaranteed by Central Government	All	0.00
5.	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Governments	6 months or less	0.28
		More than 6 months and Up to and including 24 months	1.13
		More than 24 months	1.80
(B)	Foreign Central Governments		
1.	AAA to AA	All	0.00
2.	A to BBB	6 months or less	0.28
		More than 6 months and Up to and including 24 months	1.13
		More than 24 months	1.80
3.	BB to B	All	9.00
4.	Below B	All	13.50
5.	Unrated	All	13.50

Table 12.16 Part B: Alternative Total Capital Charge for Securities Issued by Indian and Foreign Sovereigns – Held by Banks Under AFS Category

Sr. No.	*Nature of investment*	*Residual maturity*	*Specific risk capital (as % of exposure)*
(A)	Indian Central Government and State Governments		
1.	Investment in Central and StateGovernment Securities	All	0.00
2.	Investments in other approved securities guaranteed by Central/Government	All	0.00

(*Contd*)

(*Contd*)

3.	Investments in other approved securities guaranteed by State Government	All	1.80
4.	Investment in other securities where payment of interest and repayment of principal are guaranteed by Central Government	All	0.00
5.	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Governments	All	1.80
(B)	Foreign Central Governments		
1.	AAA to AA	All	0.00
2.	A	All	1.80
3.	BBB	All	4.50
4.	BB to B	All	9.00
5.	Below B	All	13.50
	Unrated	All	13.50

Table 12.16 Part C: Specific Risk Capital Charge for Bonds Issued by Banks – Held by Banks Under HFT Category

Level of CRAR (where available) (per cent)	*Residual maturity*	*Specific risk capital charge*			
		All Scheduled Banks (Commercial, Co-Operative and Regional Rural Banks)		*All Non-Scheduled Banks (Commercial, Co-Operative and Regional Rural Banks)*	
		Investments within 10 per cent limit (per cent)	*All other claims (per cent)*	*Investments within 10 per cent limit (per cent)*	*All other claims (per cent)*
1	*2*	*3*	*4*	*5*	*6*
9 and above	months or less	1.40	0.28	1.40	1.40
	Greater than 6 months and up to and including 24 months	5.65	1.13	5.65	5.65
	Exceeding 24 months	9.00	1.80	9.00	9.00
6 to <9	All maturities	13.50	4.50	22.50	13.50
3 to <6	All maturities	22.50	9.00	31.50	22.50
0 to <3	All maturities	31.50	13.50	56.25	31.50
Negative	All maturities	56.25	56.25	Full deduction	56.25

Notes

(i) In the case of banks where no capital adequacy norms have been prescribed by the RBI, the lending/investing bank may calculate the CRAR of the bank concerned, notionally, by obtaining necessary information from the investee bank and using the capital adequacy norms as applicable to the commercial banks. In case, it is not found feasible to compute CRAR on such notional basis, the specific risk capital charge of 31.50 or 56.25 per cent, as per the risk perception of the investing bank, should be applied uniformly to the investing bank's entire exposure.

(ii) In case of banks where capital adequacy norms are not applicable at present, the matter of investments in their capital-eligible instruments would not arise for now. However, column 3 and 5 of the Table 12.16- Part C will become applicable to them, if in future they issue any capital instruments where other banks are eligible to invest.

Table 12.16 Part D: Alternative Total Capital Charge for Bonds Issued by Banks – Held by Banks Under AFS Category

Level of CRAR (where available) (per cent)	*Alternative Total Capital Charge*			
	All Scheduled Banks (Commercial, Co-Operative and Regional Rural Banks		*All Non-Scheduled Banks (Commercial, Co-Operative and Regional Rural Banks*	
	Investments within 10 % limit (per cent)	*All other claims (per cent)*	*Investments within 10 per cent limit (per cent)*	*All other claims (per cent)*
1	*2*	*3*	*4*	*5*
9 and above	9.00	1.80	9.00	9.00
6 to <9	13.50	4.50	22.50	13.50
3 to <6	22.50	9.00	31.50	22.50
0 to <3	31.50	13.50	50.25	31.50
Negative	56.25	56.25	Full deduction	56.25

Notes

(i) In the case of banks where no capital adequacy norms have been prescribed by the RBI, the lending/investing bank may calculate the CRAR of the bank concerned, notionally, by obtaining necessary information from the investee bank and using the capital adequacy norms as applicable to the commercial banks. In case, it is not found feasible to compute CRAR on such notional basis, the specific risk capital charge of 31.50 or 56.25 per cent, as per the risk perception of the investing bank, should be applied uniformly to the investing bank's entire exposure.

(ii) In case of banks where capital adequacy norms are not applicable at present, the matter of investments in their capital-eligible instruments would not arise for now. However, column 3 and 5 of the Table 12.16- Part D will become applicable to them, if in future they issue any capital instruments where other banks are eligible to invest.

Table 12.16 Part E: Specific Risk Capital Charge for Corporate Bonds and Securitised Debt Instruments (SDIs) (Other Than Bank Bonds)—Held by Banks Under HFT Category

*Rating by the ECAI**	*Residual maturity*	*Specific risk capital charge*		
		Corporate bonds (per cent)	*Securitisation exposures (per cent)*	*Securitisation exposures (SDIs) relating to commercial real estate exposures (per cent)*
1	*2*	*3*	*4*	*5*
AAA to BBB	months or less	0.28	0.28	0.56
	Greater than 6 months and to and including 24 months	1.14	1.14	2.28
	Exceeding	1.80	1.80	3.60

(*Contd*)

(*Contd*)

	24 months			
BB	All maturities	13.50	31.50	36.00
B and Below	All maturities	13.50	Deduction	Deduction
Unrated (if permitted)	All maturities	13.50@	Deduction	Deduction

*These ratings indicate the ratings assigned by Indian rating agencies/ECAIs or foreign rating agencies. In the case of foreign ECAIs the ratings symbols used here correspond to Standard and Poor. The modifiers **"+" or "–"** have been subsumed with the main rating category.
@In case the amount invested is less than the threshold limit, the capital charge will be 9 per cent.

Table 12.16 Part F: Specific Risk Capital Charge Corporate Bonds and Securitised Debt Instruments (SDIs) (Other Than Bank Bonds) - Held by Banks Under AFS Category.

Rating by the ECAIs#	*Specific risk capital charge*		
	Corporate bonds (per cent)	*Securitisation exposures (SDIs) (per cent)*	*Securitisation exposures (SDIs) relating to commercial real estate exposures(per cent)*
1	*3*	*4*	*5*
AAA	1.80	1.80	4.50
AA	2.70	2.70	6.75
A	4.50	4.50	9.00
BBB	9.00	9.00	13.50
BB	13.50	31.50 (Deduction in the case of originator)	36.00 (Deduction in the case of originator)
B and Below	13.50	Deduction	Deduction
Unrated (if permitted)	13.50 @	Deduction	Deduction

#These ratings indicate the ratings assigned by Indian rating agencies/ECAIs or foreign rating agencies. In the case of foreign ECAIs the ratings symbols used here correspond to Standard and Poor. The modifiers **"+" or "–"** have been subsumed with the main rating category.

Banks should, in addition to computing the counterparty credit risk (CCR) charge for OTC derivatives as part of capital for credit risk as per the standardised approach covered above, compute the specific risk charge for OTC derivatives in the trading book as required in terms of **Appendix 12-F on the website. The website address is http://www.mhhe.com/khanifs10e.**

General Market Risk The capital requirements for general market risk are designed to capture the risk of loss arising from changes in market interest rates. The capital charge is the sum of four components: **(i)** the net short (short position is not allowed in India except in derivatives) or long position in the whole trading book; **(ii)** a small proportion of the matched positions in each time-band (the "**vertical disallowance**"); **(iii)** a larger proportion of the matched positions across different timebands (the "**horizontal disallowance**"), and **(iv)** a net charge for positions in options, where appropriate.

The Basel Committee has suggested two broad methodologies for computation of capital charge for market risks. One is the standardised method and the other is the banks' internal risk management models method. As banks in India are still in a nascent stage of developing internal risk management models, it has been decided that, to start with, banks may adopt the standardised method. Under the standardised method there are two principal methods of measuring market risk, **(i)** a **"maturity" method and (ii) a "duration" method**. As "duration" method is a more accurate method of measuring interest rate risk, it has been decided to adopt standardised duration method to arrive at the capital charge. Accordingly, banks are required to measure the general market risk charge by calculating the price sensitivity (modified duration) of each position separately. Under this method, the mechanics are as follows: **(i)** First calculate the price sensitivity (modified duration) of each instrument; **(ii)** Next apply the assumed change in yield to the modified duration of each instrument between 0.6 and 1.0 percentage points depending on the maturity of the instrument (see Table-**12.17 below**); **(iii)** Slot the resulting capital charge measures into a maturity ladder with the fifteen time bands as set out in **Table 12.17**; **(iv)** Subject long and short positions (short position is not allowed in India except in derivatives) in each time band to a 5 per cent vertical disallowance designed to capture basis risk; and **(v)** Carry forward the net positions in each time-band for horizontal offsetting subject to the disallowances set out in Table 12.18.

Table 12.17 Duration Method – Time Bands and Assumed Changes in Yield Time Bands Assumed Change in Yield

Time bands	*Assumed change in yield*	*Time bands*	*Assumed change in yield*
Zone 1		Zone 3	
1 month or less	1.00	3.6 to 4.3 years	0.75
1 to 3 months	1.00	4.3 to 5.7 years	0.70
3 to 6 months	1.00	5.7 to 7.3 years	0.65
6 to 12 months	1.00	7.3 to 9.3 years	0.60
Zone 2		9.3 to 10.6 years	0.60
1.0 to 1.9 years	0.90	10.6 to 12 years	0.60
1.9 to 2.8 years	0.80	12 to 20 years	0.60
2.8 to 3.6 years	0.75	Over 20 years	0.60

Table 12.18 Horizontal Disallowances

Zones	*Time band*	*Within the zones (%)*	*Between adjacent zones (%)*	*Between zones 1 and 3 (%)*
Zone 1	1 month or less	40		
	1 to 3 months			
	3 to 6 months			
	6 to 12 months		40	
Zone 2	1.0 to 1.9 years	30		
	1.9 to 2.8 years			
	2.8 to 3.6 years			100

(*Contd*)

(*Contd*)

Zone 3	3.6 to 4.3 years		
	4.3 to 5.7 years		
	5.7 to 7.3 years		40
	7.3 to 9.3 years		
	9.3 to 10.6 years	30	
	10.6 to 12 years		
	12 to 20 years		
	Over 20 years		

Capital Charge for Interest Rate Derivatives The measurement of capital charge for market risks should include all interest rate derivatives and off-balance sheet instruments in the trading book and derivatives entered into for hedging trading book exposures which would react to changes in the interest rates, like FRAs, interest rate positions etc. The details of measurement of capital charge for interest rate derivatives are furnished in **Appendix 12-F on the website. The website address is http://www.mhhe.com/khanifs10e**.

Capital Charge for Interest Rate Risk in Foreign Currencies Details of computing capital charges for interest rate risks in foreign currencies are as under: **(i)** Capital charges should be calculated for each currency separately and then summed with no offsetting between positions of opposite sign; **(ii)** In the case of those currencies in which business is insignificant (where the turnover in the respective currency is less than 5 per cent of overall foreign exchange turnover), separate calculations for each currency are not required. The bank may, instead, slot within each appropriate time-band, the net long or short position for each currency. However, these individual net positions are to be summed within each time-band, irrespective of whether they are long or short positions, to produce a gross position figure. The gross positions in each time-band will be subject to the assumed change in yield set out in Table 12.18 with no further offsets.

Section C: Measurement of Capital Charge for Equity Risk

The capital charge for equities would apply on their current market value in bank's trading book. Minimum capital requirement to cover the risk of holding or taking positions in equities in the trading book is set out below. This is applied to all instruments that exhibit market behaviour similar to equities but not to nonconvertible preference shares (which are covered by the interest rate risk requirements described earlier). The instruments covered include equity shares, whether voting or non-voting, convertible securities that behave like equities, for example: units of mutual funds, and commitments to buy or sell equity.

Specific and General Market Risk Capital charge for specific risk (akin to credit risk) will be 9 per cent and specific risk is computed on the banks' gross equity positions (i.e. the sum of all long equity positions and of all short equity positions – short equity position is, however, not allowed for banks in India). The general market risk charge will also be 9 per cent on the gross equity positions.

Section D: Measurement of Capital Charge for Foreign Exchange Risk

Foreign exchange open positions and gold open positions are at present risk-weighted at 100 per cent. Thus, capital charge for market risks in foreign exchange and gold open position is

9 per cent. These open positions, **limits or actual whichever is higher,** would continue to attract capital charge at 9 per cent. This capital charge is in addition to the capital charge for credit risk on the on-balance sheet and off-balance sheet items pertaining to foreign exchange and gold transactions.

Section E: Aggregation of the Capital Charge for Market Risks

As explained earlier, capital charges for specific risk and general market risk are to be computed separately before aggregation. For computing the total capital charge for market risks, the calculations may be plotted in Proforma 12.1:

Proforma 12.1

(₹ in crore)

Risk category	*Capital charge*
I. Interest Rate (a+b)	
(a) General market risk	
(i) Net position (parallel shift)	
(ii) Horizontal disallowance (curvature)	
(iii) Vertical disallowance (basis)	
(iv) Options	
(b) Specific risk	
II. Equity (a+b)	
(a) General market risk	
(b) Specific risk	
III. Foreign Exchange and Gold	
IV. Total capital charge for market risks (I+II+III)	

CAPITAL CHARGE FOR OPERATIONAL RISK

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes legal risk, but excludes strategic and reputational risk. The legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

The Measurement Methodologies

The new capital adequacy framework has outlined three methods for calculating operational risk capital charges in a continuum of increasing sophistication and risk sensitivity: **(i)** the Basic Indicator Approach (BIA); **(ii)** the Standardised Approach (TSA); and **(iii)** Advanced Measurement Approaches (AMA). Banks should move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices. The new capital adequacy framework provides that internationally active banks and banks with significant operational risk exposures should use an approach that is more sophisticated than the Basic Indicator Approach and that is appropriate for the risk profile of the institution. However, to begin with, banks in India should compute the capital requirements for operational risk under the Basic Indicator Approach (BIA). The RBI will review the capital requirement produced by the BIA for general credibility, especially in relation to a bank's peers and in the event that credibility is lacking, appropriate supervisory action under Pillar 2 will be considered.

The Basic Indicator Approach Under the Basic Indicator Approach (BIA), banks must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted as **alpha**) of positive annual gross income. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average. If negative gross income distorts a bank's **Pillar 1** capital charge, the RBI will consider appropriate supervisory action under **Pillar 2**. The charge may be expressed as follows:

$$\mathbf{KBIA = [\ .\ (GI1...n \times \alpha\ .)]/n}$$

Where

KBIA = the capital charge under the Basic Indicator Approach
GI = annual gross income, where positive, over the previous three years
n = number of the previous three years for which gross income is positive
α = 15 per cent, which is set by the BCBS, relating the industry wide level of required capital to the industry wide level of the indicator.

Gross income is defined as "net interest income" plus "net non-interest income". It is intended that this measure should: **(i)** be gross of any provisions (e.g. for unpaid interest) and write-offs made during the year; **(ii)** be gross of operating expenses, including fees paid to outsourcing service providers, in addition to fees paid for services that are outsourced, fees received by banks that provide outsourcing services should be included in the definition of gross income; **(iii)** exclude reversal during the year in respect of provisions and writeoffs made during the previous year(s); **(iv)** exclude income recognised from the disposal of items of movable and immovable property; **(v)** exclude realised profits/losses from the sale of securities in the "held to maturity" category; **(vi)** exclude income from legal settlements in favour of the bank; **(vii)** exclude other extraordinary or irregular items of income and expenditure; and **(viii)** exclude income derived from insurance activities (i.e. income derived by writing insurance policies) and insurance claims in favour of the bank.

Banks should compute capital charge for operational risk under the Basic Indicator Approach as follows:

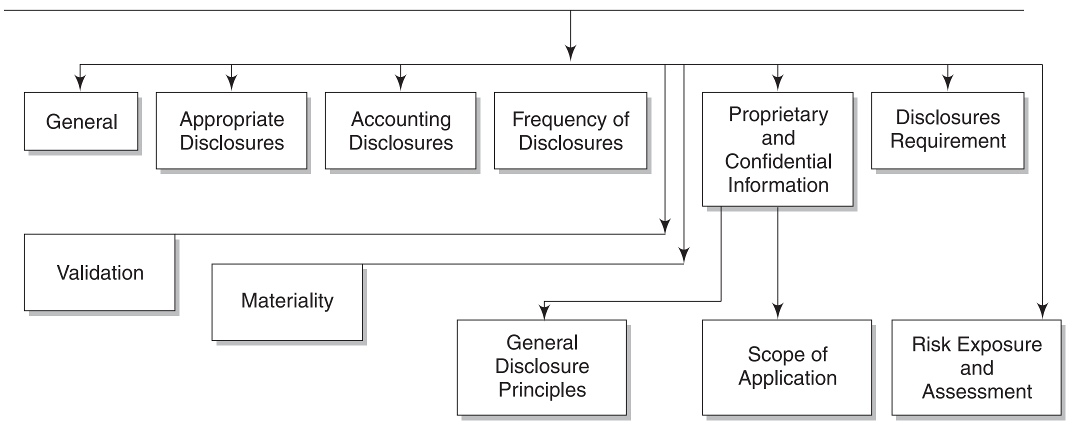
- Average of [Gross income * alpha] for each of the last three financial years, excluding years of negative or zero gross income
- Gross income = Net profit (+) Provisions and contingencies (+) operating expenses (Schedule 16) (–) items (iii) to (viii) above.
- Alpha = 15 per cent

As a point of entry for capital calculation, no specific criteria for use of the BIA are set out in the new capital adequacy framework. Nevertheless, banks using this approach should comply with the Committee's guidance on Sound Practices for the Management and Supervision of Operational Risk, February 2003 and the Guidance Note on Management of Operational Risk issued by the Reserve Bank of India in October 2005. (**These are discussed in a subsequent chapter**).

MARKET DISCIPLINE

The main elements of market discipline are portrayed in Exhibit 12.6.

Exhibit 12.6 Market Discipline



General

The purpose of market discipline (detailed in **Pillar 3**) in the revised framework is to complement the minimum capital requirements (detailed under **Pillar 1**) and the supervisory review process (detailed under **Pillar 2**). The aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and, hence, the capital adequacy of the bank.

In principle, banks' disclosures should be consistent with how senior management and the Board of Directors assess and manage the risks of the bank. Under **Pillar 1**, banks use specified approaches/ methodologies for measuring the various risks they face and the resulting capital requirements. Providing disclosures that are based on a common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and comprehensive disclosure framework that enhances comparability.

Achieving Appropriate Disclosure

Market discipline can contribute to a safe and sound banking environment. Hence, non-compliance with the prescribed disclosure requirements would attract a penalty, including financial penalty. However, it is not intended that direct additional capital requirements would be a response to non-disclosure, except as **indicated below**.

In addition to the general intervention measures, the revised framework also anticipates a role for specific measures. Where disclosure is a qualifying criterion under **Pillar 1** to obtain lower risk weightings and/or to apply specific methodologies, there would be a direct sanction (not being allowed to apply the lower risk weighting or the specific methodology).

Interaction with Accounting Disclosures

The **Pillar 3** disclosure framework does not conflict with requirements under accounting standards, which are broader in scope. The BCBS has taken considerable efforts to see that the narrower focus of **Pillar 3**, which is aimed at disclosure of bank capital adequacy, does not conflict with the broader accounting requirements. The RBI will consider future modifications to the market discipline disclosures as necessary in light of its ongoing monitoring of this area and industry developments.

Scope and Frequency of Disclosures

Banks, including consolidated banks, should provide all **Pillar 3** disclosures, both qualitative and quantitative, as at end-March each year along with the annual financial statements. With a view to enhance the ease of access to the **Pillar 3** disclosures, banks may make their annual disclosures both in their annual reports as well as their respective **websites**. Banks with capital funds of ₹100 crore or more should make interim disclosures on the quantitative aspects, on a stand alone basis, on their respective **websites** as at end-September each year. The qualitative disclosures that provide a general summary of a bank's risk management objectives and policies, reporting system and definitions may be published only on an annual basis.

In recognition of the increased risk sensitivity of the revised framework and the general trend towards more frequent reporting in capital markets, all banks with capital funds of ₹500 crore or more, and their significant bank subsidiaries, must disclose their Tier 1 capital, total capital, total required capital and Tier 1 ratio and total capital adequacy ratio, on a quarterly basis on their respective **websites**.

The disclosure on the **websites** should be made in a web page titled "**Basel II Disclosures**" and the link to this page should be prominently provided on the home page of the bank's website. Each of these disclosures pertaining to a financial year should be available on the **websites** until disclosure of the third subsequent annual (March end) disclosure[15] is made.

Validation

The disclosures in this manner should be subjected to adequate validation. For example, since information in the annual financial statements would generally be audited, the additional material published with such statements must be consistent with the audited statements. In addition, supplementary material (such as Management's Discussion and Analysis) that is published should also be subjected to sufficient scrutiny (e.g. internal control assessments, etc.) to satisfy the validation issue. If material is not published under a validation regime, for instance in a stand alone report or as a section on a website, then management should ensure that appropriate verification of the information takes place, in accordance with the general disclosure principle set out below. In the light of the above, **Pillar 3** disclosures will not be required to be audited by an external auditor, unless specified.

Materiality

A bank should decide which disclosures are relevant for it based on the materiality concept. **Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions**. This definition is consistent with International Accounting Standards and with the national accounting framework. The RBI recognises the need for a qualitative judgment of whether, in light of the particular circumstances, a user of financial

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[15]For example: Disclosures for the financial year ending March 31, 2009 (i.e., June/ September/ December 2008 and March 2009) should be available until disclosure as on March 31, 2012.

information would consider the item to be material (user test). It is not necessary to set specific thresholds for disclosure as the user test is a useful benchmark for achieving sufficient disclosure. However, with a view to facilitate smooth transition to greater disclosures as well as to promote greater comparability among the banks' **Pillar 3** disclosures, the materiality thresholds have been prescribed for certain limited disclosures. Notwithstanding the above, banks should apply the user test to these specific disclosures and where considered necessary make disclosures below the specified thresholds also.

Proprietary and Confidential Information

The proprietary information encompasses information (for example on products or systems) that, if shared with competitors, would render a bank's investment in these products/systems less valuable, and, hence, would undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship. This has an impact on what banks should reveal in terms of information about their customer base, as well as details on their internal arrangements, for instance methodologies used, parameter estimates, data etc. The requirements set out below strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information.

General Disclosure Principle Banks should have a formal disclosure policy approved by the Board of Directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency.

Scope of Application **Pillar 3** applies at the top consolidated level of the banking group to which the framework applies (**as indicated above under paragraph 3 Scope of Application**). Disclosures related to individual banks within the groups would not generally be required to be made by the parent bank. An exception to this arises in the disclosure of total and Tier 1 capital ratios by the top consolidated entity where an analysis of significant bank subsidiaries within the group is appropriate, in order to recognise the need for these subsidiaries to comply with the framework and other applicable limitations on the transfer of funds or capital within the group. Pillar 3 disclosures will be required to be made by the individual banks on a stand-alone basis when they are not the top consolidated entity in the banking group.

Effective Date of Disclosures

The first of the disclosures as per these guidelines should be made as on the effective date, namely, March 31, 2008 or 2009. Banks should, however, make the Pillar 3 disclosures at an earlier date.

The Disclosure Requirements

The following sections set out in tabular form are the disclosure requirements under **Pillar 3**. Additional definitions and explanations are provided in a series of footnotes.

Table 12.DF-1 Scope of Application

Qualitative Disclosures

(a) The name of the top bank in the group to which the framework applies.

(b) An outline of differences in the basis of consolidation for accounting and regulatory purposes, with a brief description of the entities[16] within the group (i) that are fully consolidated;[17] (ii) that are pro-rata consolidated;[18] (iii) that are given a deduction treatment; and (iv) that are neither consolidated nor deducted (e.g. where the investment is risk-weighted).

Quantitative Disclosures

(c) The aggregate amount of capital deficiencies[19] in all subsidiaries not included in the consolidation i.e. that are deducted and the name(s) of such subsidiaries.

(c) The aggregate amounts (e.g. current book value) of the bank's total interests in insurance entities, which are risk-weighted[20] as well as their name, their country of incorporation or residence, the proportion of ownership interest and, if different, the proportion of voting power in these entities. In addition, indicate the quantitative impact on regulatory capital of using this method versus using the deduction.

Table 12.DF-2 Capital Structure

Qualitative Disclosures

(a) Summary information on the terms and conditions of the main features of all capital instruments, especially in the case of capital instruments eligible for inclusion in Tier 1 or in Upper Tier 2.

Quantitative Disclosures

(b) The amount of Tier 1 capital, with separate disclosure of:
- paid-up share capital;
- reserves;
- innovative instruments;[21]
- other capital instruments;
- amounts deducted from Tier 1 capital, including goodwill and investments.

(c) The total amount of Tier 2 capital (net of deductions from Tier 2 capital).

(d) Debt capital instruments eligible for inclusion in Upper Tier 2 capital
- Total amount outstanding
- Of which amount raised during the current year
- Amount eligible to be reckoned as capital funds

(e) Subordinated debt eligible for inclusion in Lower Tier 2 capital
- Total amount outstanding
- Of which amount raised during the current year
- Amount eligible to be reckoned as capital funds

(f) Other deductions from capital, if any.

(g) Total eligible capital.

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[16]Entity = securities, insurance and other financial subsidiaries, commercial subsidiaries, significant minority equity investments in insurance, financial and commercial entities.

[17]viz. subsidiaries as in consolidated accounting, e.g. AS-21.

[18]viz. Joint ventures in consolidated accounting, e.g. AS-27.

[19]A capital deficiency is the amount by which actual capital is less than the regulatory capital requirement. Any deficiencies which have been deducted on a group level in addition to the investment in such subsidiaries are not to be included in the aggregate capital deficiency.

[20]See paragraph 3.

[21]Innovative perpetual debt instruments (or head office borrowings of foreign banks eligible for similar treatment) and any other type of instrument that may be allowed from time to time.

Table 12.DF-3 Capital Adequacy

Qualitative Disclosures

(a) A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities.

Quantitative Disclosures

(b) Capital requirements for credit risk:
- Portfolios subject to standardised approach
- Securitisation exposures.

(c) Capital requirements for market risk:
- Standardised duration approach;
  - — Interest rate risk
  - — Foreign exchange risk (including gold)
  - — Equity risk

(d) Capital requirements for operational risk:
- Basic indicator approach;

(e) Total and Tier 1 capital ratio:
- For the top consolidated group; and
- For significant bank subsidiaries (stand alone or sub-consolidated depending on how the Framework is applied).

Risk Exposure and Assessment

The risks to which banks are exposed and the techniques that banks use to identify, measure, monitor and control those risks are important factors market participants consider in their assessment of an institution. In this section, several key banking risks are considered: credit risk, market risk, and interest rate risk in the banking book and operational risk. Also included in this Section are disclosures relating to credit risk mitigation and asset securitisation, both of which alter the risk profile of the institution. Where applicable, separate disclosures are set out for banks using different approaches to the assessment of regulatory capital.

General Qualitative Disclosure Requirement For each separate risk area (e.g. credit, market, operational, banking book interest rate risk) banks must describe their risk management objectives and policies, including: (i) strategies and processes; (ii) the structure and organisation of the relevant risk management function; (iii) the scope and nature of risk reporting and/or measurement systems; and (iv) policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

Credit risk General disclosures of credit risk provide market participants with a range of information about overall credit exposure and need not necessarily be based on information prepared for regulatory purposes. Disclosures on the capital assessment techniques give information on the specific nature of the exposures, the means of capital assessment and data to assess the reliability of the information disclosed.

Table 12.DF-4 Credit Risk: General Disclosures for all Banks

Qualitative Disclosures

(a) The general qualitative disclosure requirement (paragraph 10.13) with respect to credit risk, including:
- Definitions of past due and impaired (for accounting purposes);
- Discussion of the bank's credit risk management policy;

Quantitative Disclosures

(b) Total gross credit risk exposures[22], Fund based and Non-fund based separately.

(c) Geographic distribution of exposures[23], Fund based and Non-fund based separately
- Overseas
- Domestic

(d) Industry[24] type distribution of exposures, fund based and non-fund basedseparately

(e) Residual contractual maturity breakdown of assets,[25]

(g) Amount of NPAs (Gross)
- Substandard
- Doubtful 1
- Doubtful 2
- Doubtful 3
- Loss

(h) Net NPAs

(i) NPA Ratios
- Gross NPAs to gross advances
- Net NPAs to net advances

(j) Movement of NPAs (Gross)
- Opening balance
  - Additions
  - Reductions
  - Closing balance

(k) Movement of provisions for NPAs
- Opening balance
- Provisions made during the period
- Write-off
- Write-back of excess provisions
- Closing balance

(l) Amount of Non-Performing Investments

(m) Amount of provisions held for non-performing investments

(n) Movement of provisions for depreciation on investments
- Opening balance
- Provisions made during the period
- Write-off
- Write-back of excess provisions
- Closing balance

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[22]That is after accounting offsets in accordance with the applicable accounting regime and without taking into account the effects of credit risk mitigation techniques, e.g. collateral and netting.

[23]That is, on the same basis as adopted for Segment Reporting adopted for compliance with AS-17.

[24]The industries break-up may be provided on the same lines as prescribed for DSB returns. If the exposure to any particular industry is more than 5% of the gross credit exposure as computed under (b) above it should be disclosed separately.

[25]Banks shall use the same maturity bands as used for reporting positions in the ALM returns.

Table 12.DF-5 Credit Risk: Disclosures for Portfolios Subject to the Standardised Approach

Qualitative Disclosures

(a) For portfolios under the standardised approach:
- Names of credit rating agencies used, plus reasons for any changes;
- Types of exposure for which each agency is used; and
- A description of the process used to transfer public issue ratings onto comparable assets in the banking book;

Quantitative Disclosures

(b) For exposure[26] amounts after risk mitigation subject to the standardised approach, amount of a bank's outstandings (rated and unrated) in the following three major risk buckets as well as those that are deducted;
- Below 100 per cent risk weight
- 100 per cent risk weight
- More than 100 per cent risk weight
- Deducted

Table 12.DF-6 Credit Risk Mitigation: Disclosures for Standardised Approaches[27]

Qualitative Disclosures

(a) The general qualitative disclosure requirement with respect to credit risk mitigation including:
- policies and processes for collateral valuation and management;
- a description of the main types of collateral taken by the bank;
- the main types of guarantor counterparty and their ceditworthiness; and
- information about (market or credit) risk concentrations within the mitigation taken

Quantitative Disclosures

(b) For disclosed credit risk portfolio under the standardised approach, the total exposure[28] that is covered by:
- eligible financial collateral; after the application of haircuts.

Table 12.DF-7 Securitisation: Disclosure for Standardised Approach

Qualitative Disclosures

(a) The general qualitative disclosure requirement with respect to securitisation, including a discussion of:
- the bank's objectives in relation to securitisation activity, including the extent to which these activities transfer credit risk of the underlying securitised exposures away from the bank to other entities;
- the roles played by the bank in the securitisation process[29] and an indication of the extent of the bank's involvement in each of them; and
- the regulatory capital approach that the bank follows for its securitisation activities.

(*Contd*)

[26]As defined for disclosures in Table 12.4

[27]At a minimum, banks must give the disclosures in this Table in relation to credit risk mitigation that has been recognised for the purposes of reducing capital requirements under this Framework. Where relevant, banks are encouraged to give further information about mitigants that have not been recognised for that purpose.

[28]As defined for disclosures in Table 12.DF-4 after application of haircuts for exposure.

[29]For example: originator, investor, servicer, provider of credit enhancement, liquidity provider, swap provider.

(*Contd*)

- Summary of the bank's accounting policies for securitisation activities,
- including:
- recognition of gain on sale; and
- key assumptions for valuing retained interests, including any significant changes since the last reporting period and the impact of such changes;

(b) Names of ECAIs used for securitisations and the types of securitisation exposure for which each agency is used.

Quantitative Disclosures

(c) The total outstanding exposures securitised by the bank and subject to the securitisation framework by exposure type.[30, 31]

(d) For exposures securitised by the bank and subject to the securitisationframework:[32]
- amount of impaired/past due assets securitised; and
- losses recognised by the bank during the current period[33] broken down by exposure type.

(e) Aggregate amount of securitisation exposures retained or purchased[34] broken down by exposure type.

(f) Aggregate amount of securitisation exposures retained or purchased broken down into a meaningful number of risk weight bands. Exposures that have been deducted entirely from Tier 1 capital, credit enhancing I/Os deducted from Total Capital, and other exposures deducted from total capital should be disclosed separately by type of underlying exposure type.

(g) Summary of securitisation activity presenting a comparative position for two years, as a part of the Notes on Accounts to the balance sheet:
- total number and book value of loan assets securitised – by type of underlying assets;
- sale consideration received for the securitised assets and gain/loss on sale on account of securitisation; and
- form and quantum (outstanding value) of services provided by way of credit enhancement, liquidity support, post-securitisation asset servicing, etc.

Table 12.DF-8 Market Risk in Trading Book

Qualitative disclosures

(a) The general qualitative disclosure requirement for market risk including the portfolios covered by the standardised approach.

Quantitative disclosures

(b) The capital requirements for:
- interest rate risk;
- equity position risk; and
- foreign exchange risk;

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[30]For example, credit cards, home equity, auto, etc.

[31]Securitisation transactions in which the originating bank does not retain any securitisation exposure should be shown separately but need only be reported for the year of inception.

[32]Where relevant, banks are encouraged to differentiate between exposures resulting from activities in which they act only as sponsors, and exposures that result from all other bank securitisation activities that are subject to the securitisation framework.

[33]For example, write-offs/provisions (if the assets remain on the bank's balance sheet) or write-downs of I/O strips and other residual interests.

[34]Securitisation exposures, include, but are not restricted to, securities, liquidity facilities, other commitments and credit enhancements such as I/O strips, cash collateral accounts and other subordinated assets.

Table 12.DF-9 Operational Risk

Qualitative disclosures

- In addition to the general qualitative disclosure requirement, the approach(es) for operational risk capital assessment for which the bank qualifies.

Table 12.DF-10 Interest rate risk in the banking book (IRRBB)

Qualitative Disclosures

(a) The general qualitative disclosure requirement (paragraph 10.13), including the nature of IRRBB and key assumptions, including assumptions regarding loan prepayments and behaviour of non-maturity deposits, and frequency of IRRBB measurement.

Quantitative Disclosures

(b) The increase (decline) in earnings and economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring IRRBB, broken down by currency (where the turnover is more than 5 per cent of the total turnover).

CONCLUDING OBSERVATIONS

- Capital adequacy norms take into account the element of risk in various types of assets in the balance sheet as well as the off-balance sheet business and also strengthen the capital base of banks. Banks have to maintain unimpaired capital funds equivalent to the prescribed ratio in the aggregate of the risk weighted assets and other exposures on an ongoing basis (CRAR). Until 2003, the CRAR was applicable only to credit risk assumed by banks. Capital charge for market risk for the held for trading category of investment of banks was introduced during 2004-2005. Banks had to provide capital for market risk for the available for sale investment portfolio from March 31, 2006. In terms of the Basel II framework, revised capital adequacy norms are now applicable to banks both at solo level as well as consolidated level. The revised framework consists of three mutually reinforcing pillars, namely, minimum capital requirements, supervisory review of capital adequacy and market discipline. Apart from credit and market risks, the Basel II framework includes operational risk. The framework offers distinct options to compute the capital requirements for credit risk and operational risk.
- The main elements of the new capital adequacy framework are capital funds, capital charge for credit risk, external credit assessments, credit risk mitigation, capital charge for market risk and market discipline.
- A bank should compute its CRAR as follows:
  - — Tier I CRAR = (Eligible tier I capital funds)¸ [(credit risk weighted assets) + (market risk weighted assets) + (operational risk weighted assets)]
  - — Total CRAR = (Eligible total funds)¸ (credit risk weighted assets + market risk weighted assets + operational risk weighted assets).
- Capital funds are broadly classified as tier 1 and tier 2 capital. The elements of the tier 1 capital are: paid-up capital, statutory reserves and other disclosed free resources; capital reserves; innovative perpetual debt instruments; and other instruments notified by the RBI. The main components of the tier-2 capital are: **(1)** revaluation reserves, **(2)** hybrid debt capital instruments, **(3)** general provisions and loan-loss reserves, **(4)** subordinated debt, and **(5)** innovative perpetual debt instruments.

- The main elements of the capital charge for credit risk are the following: **(i)** general, **(ii)** claims on domestic sovereigns, **(iii)** claims on foreign sovereign, **(iv)** claims on public sector entities, **(v)** claims on BIS/IMF etc., **(vi)** claims on banks, **(vii**) claims on PDs, **(viii)** claims on corporates, **(ix)** claims included in regulatory retail portfolios, **(x)** claims secured by residential property, **(xi)** claims secured by commercial real estate, **(xii)** NPAs, **(xiii)** specified categories, **(xiv)** other assets, **(xv)** off-balance sheet items and (xvi) securitisation process.
- Banks may use the ratings by external rating agencies for assigning risk weights for credit risk for capital adequacy purposes. The main elements of the external credit assessment are eligible credit rating agencies, scope of application of external ratings, mapping process, long item ratings, short-term ratings, use of unsolicited ratings, use of multiple rating assessments, and applicability of issue rating to issuer/other claims.
- Banks use a number techniques to mitigate the credit risks to which they are exposed. The revised approach allows a wide range of risk mitigants for regulatory capital purposes. The important components of the RBI guidelines in this respect are legal certainty; CRM techniques such as collateralised transactions, on-balance sheet netting, and guarantees; maturity mismatch; and treatment of pools of CRM techniques.
- Market risk is the risk of losses in on-balance sheet and off-balance sheet positions arising from movements in market prices. The market risks positions subject to capital charge requirement are: **(i)** risks pertaining to interest rate related instruments and equities in the trading book and **(ii)** foreign exchange risk in both banking and trading books. The main elements of the framework of capital charge for market risk are: measurement of capital charge for **(i)** interest rate risk in the trading book, **(ii)** equities in the trading book, **(iii)** foreign exchange risk and gold open positions, and (iv) aggregation of capital charge for market risks.
- The minimum capital charge for interest rate risk in trading book is expressed in terms of specific risk and general market risk. The charge for specific risk is designed to protect against an adverse movement in the price of the individual security owing to factors specific to it. It is graduated for various exposures. The capital requirement for general market risk is designed to capture the risk of loss arising from change in market interest rates. There are two broad methodologies to compute the capital charge for market risks, namely, the standarised method and the internal risk management method. There are two principal standardised methods of measuring risk: the maturity method and the duration method. The measurement capital charge for market risk should also include all interest derivatives and off-balance sheet instruments in the trading book and derivatives entered into for hedging book exposures and which would react to changes in interest rates like FRAs and IRS positions. The general market risk charge should be 9 per cent.
- Operational risks are the risks of loss resulting from inadequate or failed internal processes, people and system or from external events including legal risks. The revised capital adequacy framework outlines three methods for calculating operational risk capital charge: Basic Indicator Approach; Standardised Approach; and Advanced Measurement Approach. Banks should move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices.
- Banks should compute capital charge for operational risk under the Basic Indicator Approach as follows:
  - — Average of [gross income × alpha] for each of the last 3 financial years
  - — Gross income = Net Profit (+) provisions and contingencies + operating expenses – specified items
  - — Alpha = 15 per cent

- Market discipline aims at developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes and, hence, the capital adequacy of the bank. The major elements of the market discipline framework of the revised capital adequacy norms are: appropriate disclosures; accounting disclosures; frequency of disclosures; proprietary and confidential information in terms of general disclosure principles and scope of application; disclosure requirements; and risk exposure and assessment.

CHAPTER 13

Risk Management in Banks

INTRODUCTION

Banks are in the business of risk management and, hence, are incentivised to develop sophisticated risk management systems. The basic components of risk management system are identifying the risks the bank is exposed to, assessing their magnitude, monitoring them, controlling/mitigating them using a variety of procedures and setting aside capital for potential losses. This chapter discusses the important dimensions of risk management in banks. **They are portrayed in Exhibit 13.1.** A brief account of risks to which banks are exposed is given Section 1. Sections 2–4 respectively cover the RBI prescribed risk management framework in terms of: (a) asset-liability management practices, (b) credit risk management, (c) operational risk management, and (d) stress testing by Indian banks in the perspective of international practices. The last Section contains some concluding observations.

BANKING RISKS

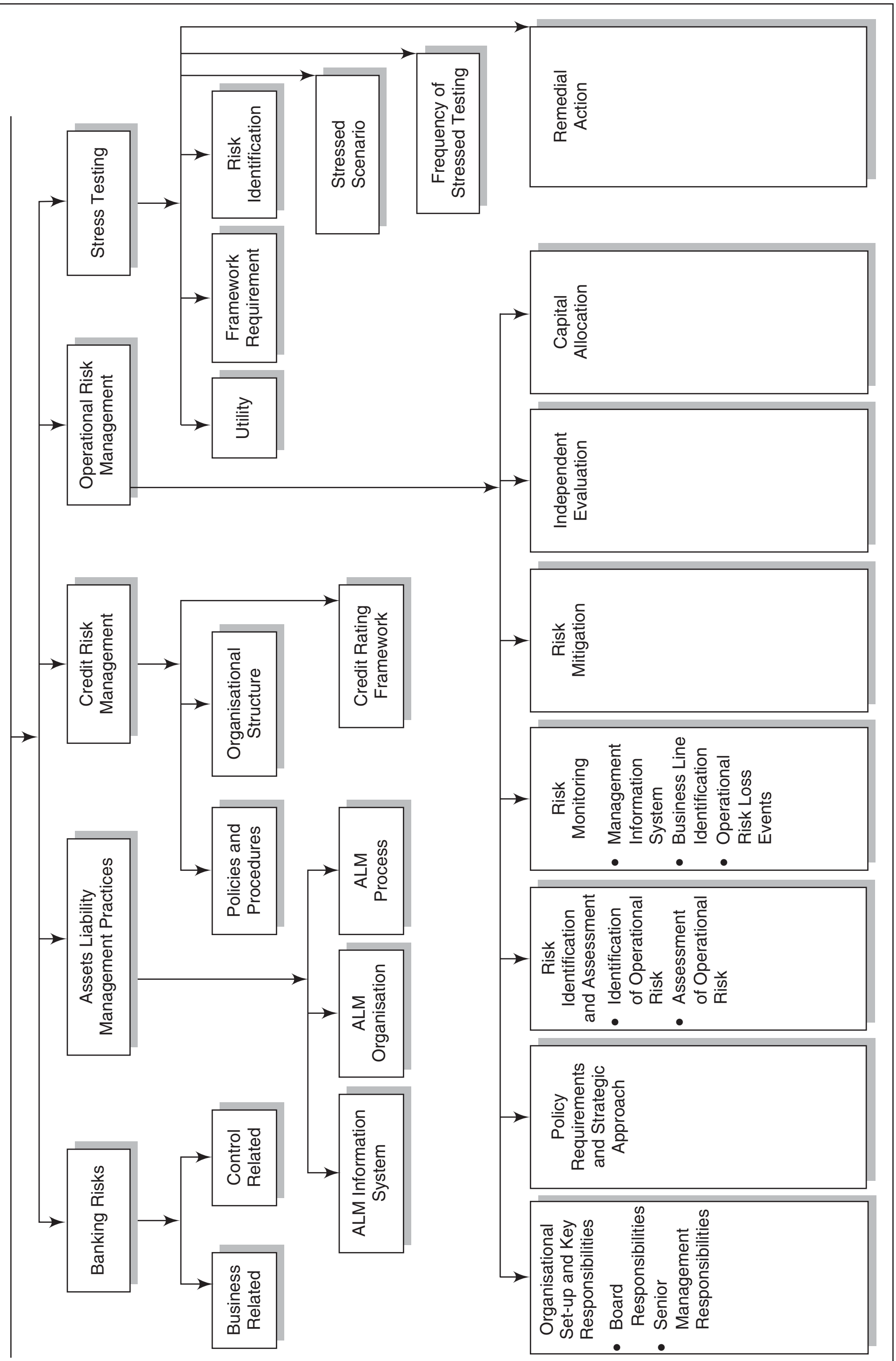
Banking risks can be categorised into: (i) business-related risks and (ii) capital-related risks.

Business Related Risks

The business-related risks to which banks are exposed are associated with their operational activities and market environment. They fall into six categories: namely, (a) credit risk, (b) market risk comprising of interest rate risk, foreign exchange risk, equity price risk; commodity price risk and liquidity risk; (c) country risk; (d) business environment risk; (e) operational risk; and (f) group risk.

Credit Risk Credit risk, a major risk faced by banks, is inherent to any business of lending funds to individuals, corporates, trade, industry, agriculture, transport, or banks/financial institutions. It is defined as the possibility of losses associated with a diminution in the credit quality of the borrowers/counterparties. In a bank's credit portfolio, losses stem from outright default due to

Exhibit 13.1 Risk Management in Banks



inability or unwillingness of borrower(s)/counterparty(ies) to meet their commitments, as also due to the risk inherent in the nature of business activity and environment.

Credit risk relating to borrower(s), may arise due to non-payment of principal/interest amount; non-payment of guarantee or letter of credit liabilities on devolvement; in case of export business, non-receipt of proceeds against bills financed; in case of security trading, funds/securities settlement are not effected; in case of cross border exposure, the funds are not received due to seizure or restrictions imposed by the sovereign and so on. As regards risks related to the business activity financed, these may include obsolescence of technology/product(s) design, competition, inadequate supply of inputs, lack of infrastructural facilities, Government rules/regulations and so on.

In addition, banks may also face risks caused by a concentration of their credit portfolio in certain types of loan facilities like overdrafts, cash credit, term loans, lease/hire-purchase finance and so on. Further, the concentration risk may be caused due to high exposures in a single/ group of borrowers or in a specific economic/industrial sector.

Market Risks Market risk is caused due to changes in the market variables, having an adverse impact on the earnings of a bank or on its capital. These variables may include unfavourable changes in the interest rates, foreign exchange rates, equity prices and commodity prices and so on. The market risk also includes liquidity risk which may arise when a bank is unable to meet its liabilities as and when these fall due and may need to borrow funds at higher rates to fund such liabilities. The various risks associated with market risks are discussed below:

Interest Rate Risk Interest rate risk, which forms a part of the market risk, has become more prominent after the removal of regulatory interest rates restrictions on banks by the RBI. Deregulation of interest rates has caused keen competition and exposed banks to a greater interest rate risk. A bank's net interest income, i.e., the difference between interest received on its assets (loans/advances, investments) and interest paid on its liabilities (deposits), which is a major source of profitability, has been shrinking. The interest rate risk may be on account of the following:

Mismatch Risk or Gap Risk In a situation where short term deposits of, say, one year maturity have been utilised for investment in long term securities of, say, 5 years, it would result in a mismatch. In case interest rates on deposits increase while the interest income on term loans and long-term securities remain the same, the interest spread would get reduced, having an adverse impact on the bank's interest income.

Basis Risk Changes in interest rates both of assets and liabilities, would affect the interest income. In a regime of falling interest rates, the interest rate on assets (loans/advances) may be lowered, while the interest rates on deposits, particularly fixed deposits, may continue at the contracted higher rate. Such a situation may result in a reduction in the interest income and, thus, it is a form of interest rate risk.

Price Risk The value of an investment made at a specific interest rate, may suffer a set back/ depreciate if there is an increase in the market interest rates'. However, any decline in the interest rates may result in a gain (appreciation) in the value of the investments in a banks' portfolio. This change in the value of the investments is on account of the present value of the cash flows when discounted by the new interest rates.

Foreign Exchange (Forex) Risk This risk is caused by an adverse exchange rate movement which affects a banks' foreign currency exposures when it is holding foreign exchange assets or liabilities that have not been hedged. Forex risk may include three types of commonly understood risks, namely: transaction exposure, translation exposure and economic exposure.

Transaction Exposure This risk arises due to an adverse movement of the exchange rate, from the time the transaction is budgeted till the time the exposure is extinguished by sale or purchase of foreign currency against the home currency.

Translation Exposure This arises from the need to translate foreign currency assets and liabilities into the home currency, for the purpose of finalising the accounts for any given period. It can, thus, be defined as the risk which will alter the domestic currency value of assets and liabilities in the balance sheet, which arises when the values of these assets and liabilities are translated at foreign exchange rates, resulting in a reported gain or loss.

Economic Exposure It can be defined as a change in the future earning power and cash flows, as a result of an adjustment of the currencies. It represents a change in the competitive position. Economic exposure to an exchange rate is the risk that the change in the exchange rates is likely to affect company's competitive position in the market.

Equity Price Risk Such a risk arises due to the potential of banks to suffer losses on their exposures in the capital markets, due to adverse movements in the prices of equity.

Commodity Price Risk A commodity is defined as a physical product which is or can be traded on a secondary market, for example, agriculture products, minerals, oils and precious metals and so on. The commodity price risk is often quite complex and more volatile than risks associated with currencies or interest rates. Banks in developed markets use derivatives to hedge the commodity price risk. Indian banks are yet to get into such business and, thus, are not exposed to the commodity price risk.

Liquidity Risk Liquidity risk is caused by a mismatch in the maturity of assets and liabilities. Bank deposits generally, have a much shorter contractual maturity than loans and liquidity management needs to provide a cushion to cover anticipated deposit withdrawals. This risk may arise when a bank is unable to meet its liabilities as these become due for payment and it may have to fund the same at a cost much higher than the market cost. This may happen due to a mismatch of the timings of inflows and outflows of funds and from funding of long term assets by short term liabilities. Banks having surplus liquidity may also suffer due to idling of funds.

Country Risk Country risk arises due to cross-border lending and investment, particularly when a foreign country is unable to service and repay its debts. The country risk may include risk arising out of a currency transfer problem, the political currency situation in the country and/or cross border risk.

Currency Transfer Risk Such a risk arises when a borrower may be able to repay his debt in its local currency, but not in foreign currency. This type of situation may arise when foreign exchange shortages restrict a country's cross border foreign exchange market.

Political Risk/Non-Sovereign Risk Such a risk arises when the borrower is not able to repatriate the funds due to restrictions imposed for political reasons. Non-sovereign risk may include risks associated with the economic environment, legislative process and legal framework of the borrower' country and risks of appropriation and expropriation.

Cross Border Risk Such a risk may arise when the borrower is a resident of a country other than where the cross border assets are booked, and includes exposures to local residents, denominated in currencies other than the local currency.

Sovereign Risk This risk is associated with lending to the Government or taking their guarantee, particularly when they claim immunity from legal process or might not abide by a judgment and it might prove difficult to secure redress through legal action.

Business Environment Risk Such a risk can arise due to lending policies/strategies, particularly relating to identification of target markets, products and customer base and so on, without proper planning and study of the business environment.

Operational Risk Operational risk is caused due to deficient and fast changing internal processes/systems/procedures; non-conducive work environment; demotivated, untrained and incompetent staff or external events and so on. Operational risk may also be caused by actions of the bank which are not in conformity with the laws of the country, or they may arise due to a lack of knowledge of the laws of other countries, particularly in a foreign exchange business, cross-border dealings and so on. In addition, banks are faced with technology risks, which may arise due to the outsourcing of their various activities, fast unplanned computerisation and IT-related factors such as errors in the computer programming, lack of security, backup and disaster recovery systems and so on. Operational risk can also arise due to use of obsolete or untested technology which is not fully in line with the business needs, lack of trained staff or their negative response to new technology and so on.

Group Risk Such a risk may arise when a bank has other domestic/overseas subsidiaries dealing in various activities such as merchant banking, mutual fund, insurance, gilt securities, hire-purchase/leasing, which are not doing well and are incurring losses this may affect their bank's profitability.

Control Related Risks

Control related risks arise out of an absence/lack of control and supervisory systems. Banks have designed their own control systems. For loans, they have in place appraisal, monitoring/follow, surveillance, inspection/audit systems. They are also evolving credit risk evaluation, rating and management systems. For ensuring proper house keeping, they have set guidelines, as also a system of concurrent audit of the branches, in place. Banks are going in a big way to computerise their offices and have evolved some control systems, which may include security checks, backup and disaster recovery, testing of softwares/programmes at periodical intervals and so on. However, in practice, it is seen that there are many weaknesses in the control systems, which may be due to organisational bottlenecks in the form of inadequate or inappropriate structure. The organisation structure may lack flexibility and dynamism to meet the frequent and fast changing banking scenario.

In view of the growing complexities in the banking sector, particularly the speed of their operation and development of new financial products and services, leading to various risks, it is imperative for them to articulate their risk management philosophy and put in place appropriate risk management policies. Banks should define in detail, the various types of risks, indicating the tolerance levels. As regards the measurement of the various types of risks, banks should design tools and rating models. In addition, banks should evolve clear policy guidelines indicating the actions to be initiated to mitigate the risk and to effectively monitor the progress for reporting the same to the top management. For an effective and efficient handling of the various types of risks, banks should create a proper organisational setup, maintained by qualified/trained personnel with a positive outlook and put in place effective corporate governance practices.

Our focus in this Chapter is on three types of risks: liquidity risk, credit risk, and operational risk. These are discussed in the following Sections, in the framework of RBI guidelines relating to ALM, credit risk management and operational risk management. **Market risks are illustrated in Chapter 12 as a part of the capital Adequacy Norms for banks (Basel II framework).**

ASSET-LIABILITY MANAGEMENT PRACTICES

Following the recommendations of the Narasimham Committee II, the banks were required by the RBI to introduce effective risk management systems to cover credit risk, market risk and operational risk on priority basis. To this end, a comprehensive risk measurement approach should be adopted and a detailed structure of operating limits, guidelines and other parameters should be kept in place. The banks were also advised to address market risks in a structured manner by adopting a more comprehensive Asset-Liability Management Practices with effect from April 1, 1999. The RBI has issued guidelines for the introduction of Asset-Liability Management (ALM) System as a part of the risk management and control systems in banks. They are intended to form the basis of initiating collection, compilation and analysis of data required to support the ALM system. This Section discusses the RBI guidelines in respect of interest rate and liquidity risk management systems in banks which form part of the ALM functions.

Over the last few years, the Indian financial markets have witnessed wide ranging changes at a fast pace. Intense competition for business involving both the assets and liabilities, together with increasing volatility in the domestic interest rates as well as foreign exchange rates, has brought pressure on the bank management to maintain a good balance among spreads, profitability and long-term viability. These pressure call for structured comprehensive measures. The bank management have to base their business decision on a dynamic and integrated risk management system and process, driven by corporate strategy. The banks are exposed to several major risks in the course of their business – credit risk, interest rate risk, foreign exchange risk, equity/commodity price risk, liquidity risk and operational risks. It is against this background that the RBI guidelines relating to ALM focus on interest rate and liquidity risk management systems in banks which form part of the ALM function. The initial thrust of the ALM function would be to enforce the risk management discipline, that is, managing business after assessing the risks involved. The objective of good risk management programmes should be that these programmes evolve into a strategic tool for bank management. The main elements of the ALM system are:

- ALM information system,
- ALM organisation, and
- ALM Process are discussed below.

ALM Information Systems

The ALM has to be supported by a management philosophy which clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with necessary information system as back up. Thus, information is the key to the ALM process. However, varied business profiles of banks in the public and private sectors as well as those of foreign banks do not make the adoption of a uniform ALM system for all banks feasible. There are various methods prevalent worldwide for measuring risks. These range from the simple Gap Statement to extremely sophisticated and data intensive Risk Adjusted Profitability Measurement (RAPM) methods. The central element for the entire ALM exercise is the availability of adequate and accurate information. However, the existing systems in many Indian banks do not generate information in the manner required for the ALM. Collecting accurate data in a timely manner is the biggest challenge before the banks, particularly those having wide network of branches, but lacking full scale computerisation. However, the introduction of these information system for risk measurement and monitoring has to be addressed urgently. As banks are aware, internationally, regulators have prescribed or are in the process of prescribing capital adequacy for market risks. As a prerequisite banks must have in place an efficient information system.

Considering the large network of branches and the lack of (an adequate) support system to collect information required for the ALM which analyses information on the basis of residual maturity and behavioural pattern, it would take time for banks in the present state to get the requisite information. The problem of ALM needs to be addressed by following an ABC approach, that is, analysing the behaviour of asset and liability products in the sample branches accounting for significant business, and then making rational assumptions about the way in which assets and liabilities would behave in other branches. In respect of foreign exchange, investment portfolio and money-market operations, in view of the centralised nature of the functions, it would be much easier to collect reliable information. The data and assumptions can then be refined over time, as the bank management gain experience of conducting business within an ALM framework. The spread of computerisation would also help banks in accessing data.

ALM Organisation

Successful implementation of the risk management process requires strong commitment on the part of senior management in the bank to integrate basic operations and strategic decision making with risk management. The Board of Directors should have overall responsibility for management of risk and should decide the risk management policy of the bank, besides setting limits for liquidity, interest rate, foreign exchange and equity/price risk.

The Asset-Liability Management Committee (ALCO) consisting of the bank's senior management, including CEO/CMD should be responsible for ensuring adherence to the limits set by the Board of Directors as well as for deciding the business strategy of the bank (on the assets and liabilities sides) in line with the bank's budget and decided risk management objectives.

The ALM Support Groups consisting of operating staff should be responsible for analysing, monitoring and reporting the risk profiles to the ALCO. The staff should also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to bank's internal limits.

The ALCO is a decision making unit responsible for balance sheet planning from a risk-return perspective including the strategic management of interest rate and liquidity risks. Each bank has to decide on the role of its ALCO, its responsibility as also the decision to be taken by it. The business and risk management strategy of the bank should ensure that the bank operates within the limits/parameters set by its Board of Directors. The business issues that an ALCO would consider, *inter alia*, should include product pricing for both deposits and advances, desired maturity profile and mix of the incremental assets and liabilities, and so on. In addition to monitoring the risk levels of the bank, the ALCO should review the results of, and progress in, implementation of the decision made in the previous meetings. The ALCO should also articulate the current interest rate view of the bank and base its decisions for future business strategy on this view. In respect of the funding policy, for instance, its responsibility would be to decide on source and mix of liabilities or sale of assets. Towards this end, it should develop a view on future direction of interest rate movements and decide on funding mixes between fixed vs floating rate funds, wholesale vs retail deposits, money market vs capital market funding, domestic vs foreign currency funding, and so on. Individual banks should decide the frequency for holding their ALCO meetings.

Composition of ALCO The size (number of members) of ALCO depends on the size of each institution, business mix and organisational complexity. To ensure commitment of the top management and timely response to market dynamics, the CEO/CMD or the ED should head the Committee. The Chiefs of Investment, Credit, Resources Management or Planning, Funds Management/Treasury (forex and domestic), International Banking and Economic Research can be members of the ALCO. In addition, the Head of the Technology Division should also be an invitee for building up of MIS and related computerisation. Some banks may even have sub-committees and support groups.

Committee of Directors The Management Committee of the Board of Directors or any other specific committee constituted by it should oversee the implementation of the system and review its functioning periodically.

ALM Process

The scope of ALM function can be described as follows: **(i)** Liquidity risk management, **(ii)** Management of market risks, **(iii)** Trading risk management, **(iv)** Funding and capital planning; and **(v)** Profit planning and growth protection. The RBI guidelines mainly address liquidity and interest rate risks.

Liquidity Risk Management Measuring and managing liquidity needs are vital for effective operation of commercial banks. By assuring a bank's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. Bank management should measure not only the liquidity positions of banks on an ongoing basis, but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets, commonly considered liquid like Government securities and other money market instruments, could also become illiquid when the market and players are unidirectional. Therefore, liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool. The format of the Statement of Structural Liquidity is given in **Appendix 13-A**. **A-I on the website. The website address is http:/www.mhhe.com/khanifs10e.**

Maturity Profiles The maturity profiles as given in **Appendix-13-A on the website** could be used for measuring the future cash flows of banks in different time buckets. The time buckets, given the statutory reserve cycle of 14 days may be distributed as under: **(i)** 1 to 14 days, **(ii)** 15 to 28 days, **(iii)** 29 days and up to 3 months, **(iv)** over 3 months and up to 6 months, **(v)** over 6 months and up to 1 year, **(vi)** over 1 year and up to 3 years, **(vii)** over 3 years and up to 5 years, and **(viii)** over 5 years.

The investments in SLR securities and other investments are assumed as illiquid due to lack of depth in the secondary market and are, therefore, required to be shown under respective maturity buckets, corresponding to the residual maturity. However, some of the banks may be maintaining securities in the 'trading book', which are kept distinct from other investments made for complying with the statutory reserve requirements and for retaining relationship with customers. The securities held in the 'trading book' are subject to certain preconditions like: **(i)** The composition and volume are clearly defined; **(ii)** Maximum maturity/duration of the portfolio is restricted; **(iii)** The holding period is not to exceed 90 days; **(iv)** Cut-loss limit is prescribed; **(v)** Defeasance periods (product-wise), that is, time taken to liquidate the position on the basis of liquidity in the secondary market are prescribed; and **(vi)** Marking to market on a daily/weekly basis and the revaluation gain/loss charged to the profit and loss account; and so on. Banks which maintain such 'trading books' and comply with the above standards are permitted to show the trading securities under 1–14 days, 15–28 days and 29–90 days buckets on the basis of the defeasance periods. The Board of Directors/ALCO of the banks should approve the volume, composition, holding/defeasance period, cut loss and so on of the 'trading book'.

Within each time bucket, there could be mismatches depending on cash inflows and outflows. While the mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems, the main focus should be on the short-term mismatches, namely, 1–14 days and 15–28 days. Banks, however, are expected to monitor their cumulative mismatches (running total) across all time buckets by establishing internal prudential limits with the approval of the Board of Directors/Management Committee. The mismatches (**negative gap**) during 1–14 days and 15-28 days in normal course may not exceed 20 per cent of the cash outflows in each time bucket.

The Statement of Structural Liquidity (**Appendix 13-A-I**) may be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability would be a cash outflow while a maturing asset would be a cash inflow. It would also be necessary to take into account the rupee inflows and outflows on account of forex operations. While determining the likely cash inflows/outflows, banks have to make a number of assumptions according to their asset-liability profiles. For instance, Indian banks with large branch network can (on the stability of their deposit base as most deposits are rolled-over) afford to have larger tolerance levels in mismatches in the long-term if their term deposit base is quite high. While determining the tolerance levels, the banks may take into account all relevant factors based on their asset-liability base, nature of business, future strategy, and so on. The tolerance levels should be determined keeping all necessary factors in view and further refined with experience gained in liquidity management.

In order to enable the banks to monitor their short-term liquidity on a dynamic basis over a time horizon spanning from 1-90 days, banks may estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes. The short-term dynamic liquidity may be estimated according to the format given in **Appendix 13-A**. **A-III on the website**. **The website address is http:/www.mhhe.com/khanifs10e**.

Currency Risk Floating exchange rate arrangement has brought in its wake pronounced volatility adding a new dimension to the risk profile of banks' balance sheets. The increased capital flows across free economies following deregulation have contributed to increase in the volume of transactions. Large cross-border flows together with the volatility has rendered the banks' balance sheets vulnerable to exchange rate movements.

Dealing in different currencies brings opportunities as also risks. If the liabilities in one currency exceed the level of assets in the same currency, then the currency mismatch can add/erode value depending upon the currency movements. The simplest way to avoid currency risk is to ensure that mismatches, if any, are reduced to zero or near zero. Banks undertake operations in foreign exchange like accepting deposits, making loans and advances and quoting prices for foreign exchange transactions. Irrespective of the strategies adopted, it may not be possible to eliminate currency mismatches altogether. Besides, some of the institutions may take proprietary trading positions as a conscious business strategy.

Managing currency risk is one more dimension of asset-liability management. Mismatched currency position, besides exposing the balance sheet to movements in exchange rate, also exposes it to country risk and settlement risk. Ever since the RBI introduced the concept of end of the day near square position in 1978, banks have been setting up overnight limits and selectively undertaking active day time trading. Following the introduction of 'Guidelines for Internal Control Over Foreign Exchange Business', maturity mismatches (gaps) are also subject to control. The calculation of exchange position has been redefined and banks have been given the discretion to set up overnight limits linked to maintenance of capital to risk-weighted assets ratio at 8 per cent of open position limit.

Presently, banks are also free to set gap limits with RBI's approval but are required to adopt Value at Risk (VaR) approach to measure the risk associated with forward exposures. Thus, the open position limits together with the gap limits form the risk management approach to forex operations.

Interest Rate Risk (IRR) The phased deregulation of interest rates and the operational flexibility given to banks in pricing most of the assets and liabilities imply the need for the banking system to hedge the interest rate risk, defined as the risk where changes in market interest rates might adversely affect a bank's financial condition. The changes in interest rates affect banks in a larger way. The immediate impact of change in interest rates is on bank's earnings (that is, reported profits) by changing its net interest income (NII). A long-term impact of changing interest rates is on bank's market value of equity (MVE) or net worth as the economic value of bank's assets, liabilities and off-balance sheet positions get affected due to variation in market interest rates. The interest rate risk when viewed from these two perspective is known as 'earnings perspective' and 'economic value' perspective respectively. The risk from the earnings perspective can be measured as changes in the net interest income (NII) or net interest margin (NIM). There are many analytical techniques for measurement and management of interest rate risk. In the context of poor MIS, slow pace of computerisation in banks and the absence of total deregulation, the traditional Gap Analysis is considered as a suitable method to measure the interest rate risk in the first place. The banks should move over to the modern techniques of interest rate risk measurement like duration gap analysis, simulation and value at risk (VaR) over time when banks acquire sufficient expertise and sophistication in acquiring and handling MIS.

The Gap or Mismatch risk can be measured by calculating Gaps over different time intervals as at a given date. Gap analysis measures mismatches between rate sensitive liabilities and rate sensitive assets (including off-balance sheet position). An asset or liability is normally classified as rate sensitive if: **(i)** within the time interval under consideration, there is a cash flow; **(ii)** the interest rate resets/reprices contractually during the interval; **(iii)** RBI changes the interest rates (that is, interest rates on savings bank deposits, DRI advances, export credit, refinance, CRR balance and so on) in cases where interest rates are administered; and **(iv)** it is contractually pre-payable or withdrawable before the stated maturities.

The Gap Report should be generated by grouping rate sensitive liabilities, assets and off-balance sheet positions into time buckets according to residual maturity or next repricing period, whichever is earlier. The difficult task in Gap Analysis is determining rate sensitivity. All investments, advances, deposits, borrowings, purchased funds, and so on that mature/reprice within a specified timeframe are interest rate sensitive. Similarly, any principal repayment of loan is also rate sensitive if the bank expects to receive it within the time horizon. This includes final principal payment and interim instalments. Certain assets and liabilities receive/pay rates that vary with a reference rate. These assets and liabilities are repriced at predetermined intervals and are rate sensitive at the time of repricing. While the interest rates on term deposits are fixed during their currency, the advances portfolio of the banking system is basically floating. The interest rates on advances could be repriced any number of occasions, corresponding to the changes in PLR (prime lending rate). The Gaps may be identified in the following time buckets: **(i)** 1-28 days, **(ii)** 29 days and up to 3 months, **(iii)** over 3 months and up to 6 months, **(iv)** over 6 months and up to 1 year, **(v)** over 1 year and up to 3 year, **(vi)** over 3 years and up to 5 years, **(vii)** over 5 years, and **(viii)** non-sensitive.

The various items of rate sensitive assets and liabilities and off-balance sheet items may be classified as explained in **Appendix13-B on the website** and the reporting format for interest rate sensitive assets and liabilities is given in **Appendix 13-A-II (on the website**). The address is **http://www.mhhe.com/khanifs10e.**

The Gap is the difference between Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) for each time bucket. The positive Gap indicates that it has more RSAs than RSLs whereas the negative Gap indicates that it has more RSLs. The Gap reports indicate whether the institution is in a position to benefit from rising interest rates by a Gap (RSA > RSL), or whether it is in a position to benefit from declining interest rates by a negative Gap (RSL > RSA). The Gap can, therefore, be used as a measure of interest rate sensitivity.

Each bank should set prudential limits on individual Gaps with the approval of the Board of Directors/Management Committee. The prudential limits should have a bearing on the total assets, earning assets or equity. The banks may work out Earnings at Risk (EaR) or Net Interest Margin (NIM) based on their views on interest rate movements and fix a prudent level with the approval of the Board of Directors/Management Committee.

The classification of various components of assets and liabilities into different time buckets for preparation of Gap reports (liquidity and interest rate sensitivity) as indicated in **Appendices 13-A and 13-B (on the website)**. **The address is http://www.mhhe.com/khanifs10e** is the benchmark. Banks which are better equipped to reasonably estimate the behavioural pattern, embedded options, rolls-in and rolls-out and so on of various components of assets and liabilities on the basis of past data/empirical studies could classify them in the appropriate time buckets, subject to approval from the ALCO/Board of Directors.

The present framework does not capture the impact of embedded options, that is, the customers exercising their options (premature closure of deposits and prepayment of loans and advances) on the liquidity and interest rate risks profile of banks. The magnitude of embedded option risk at times of volatility in market interest rates is quite substantial. Banks should, therefore, evolve suitable mechanism, supported by empirical studies and behavioural analysis, to estimate the future behaviour of assets, liabilities and off-balance sheet items to changes in market variables and estimate the embedded options.

A scientifically evolved internal transfer pricing model by assigning values on the basis of current market rates to funds provided and funds used is an important component for effective implementation of ALM System. The transfer price mechanism can enhance the management of margin, that is, lending or credit spread, the funding or liability spread and mismatch spread. It also helps centralising interest rate risk at one place which facilitate effective control and management of interest rate risk. A well-defined transfer pricing system also provide a rational framework for pricing of assets and liabilities.

An actual case relating to a public sector bank in India is given in **Appendices 13-C to 13-E on the website. The website address is http:/www.mhhe.com/khanifs10e.**

CREDIT RISK MANAGEMENT

As a step towards enhancing and fine-tuning their existing risk management practices, the RBI has prescribed effective 2001, a comprehensive risk management framework for banks. This Section focuses on the three main elements of the framework: **(i)** credit risk policies and procedures; **(ii)** organisational structure for effective credit administration and risk management functions; and **(iii)** credit risk rating framework. The Section also illustrates credit risk scoring and rating models. Risk scoring and rating models of two Indian banks are given in the **Appendices 13-F and 13-G on the website. The website address is http:/www/com/khanifs10e.**

Credit Policies and Procedures

As per RBI guidelines, banks should prepare a comprehensive and well articulated, written credit policy document, with the approval of their Boards of Directors, highlighting the strategy, policies and procedures for effective management of credit and mitigation of credit risks. The credit policies and procedures should have the following features:

- Based on studies of industries/business activities, banks should identify those which are doing well and have encouraging outlook/potential for growth. Such activities should be placed under target/preferred credits while others which are not doing well and have uncertain prospects/default risk may be kept under a watch list wherein exposures are increased-contained/reduced.
- Delegation of loan approving/sanctioning powers of officials, linking the same with the risk rating of the borrowers. The level of the loan sanctioning authority may increase as the risk rating worsens.
- Linking credit risk scoring and rating system and risk acceptance criteria with the risk rating of the borrowers so that no loan proposal below a certain cutoff level is entertained. The conditions under which deviations can be made by the sanctioning authority and the level of authority required to ratify the deviations should also be specified.
- The credit policies and procedures should lay down prudential exposure limits for loans to individuals and groups of borrowers, as also for different industries/sensitive sectors, as a proportion of the bank's capital funds.
- They should discuss concentration risks in terms of industry, sector exposures or regional exposures as also the steps that need to be taken for credit dispersions as to mitigate concentration risk. Banks should lay down a system to conduct a regular analysis of the credit portfolio for an ongoing control of risk concentration.
- They should discuss the loan review mechanism and renewal systems and may relate their frequency with the risk rating of the borrowers; Loans under high-risk categories need to be reviewed more frequently.
- Banks should evolve effective systems of monitoring the operational/financial performance of the borrowers, as also the conduct of their bank accounts so that the outstandings remain within limits. The monitoring system may vary depending upon the type of borrower, namely, normal borrower, NPA/sick/rehabilitated unit, suit file/decreed account, one with whom the bank has entered into a compromise settlement for the recovery of its dues and so on.

- The policies and procedures should discuss the system/procedure for judging the credit quality on an on-going basis and any migration of credit from low to high-risk categories and *vice-versa*.
- They should lay down clear guidelines for pre-sanction appraisal and monitoring of funded and non-funded exposures, which can get converted into funded liabilities in case the customer does not meet his commitment.
- They should discuss Forex risks, which may comprise of transfer risk, currency risk, cross border risk, sovereign risks, non-sovereign risk or political risk and so on and lay down countrywise exposure limits based on an analytical review and guidelines so as to mitigate such risk.
- They should lay down policies and fix limits for inter-bank exposures based on internal/external ratings or any other prudential parameters.
- They should lay down guidelines on multiple credit approver, making financial sanctions subject to approvals at various stages, namely, credit risk rating, risk approvals, credit approval grid and so on.
- They should lay down policies to control exposures in high-risk sectors, depending upon the bank's own experience, such as capital markets, gold and bullion, commercial properties development, loans against shares/debentures and so on.
- They should evolve a consistent approach towards an early recognition of a problem, exposures and remedial actions, by using appropriate rehabilitating, restructuring schemes.
- Establish proactive policies like periodical industry studies, plant visits, periodical credit calls that are documented, system of review of troubled/weak exposures and so on.
- Banks can evolve their own policies, but still, there may be some areas like maximum prudential exposure limits, financing against shares/debentures of companies, advances against gold/bullion and so on, where RBI guidelines may still be mandatory. The bank's policy document should include all mandatory instructions of the RBI, so as to ensure their compliance.
- Evolve mechanism of loan pricing (interest rates fixation) for borrowers, linking it with their risk categorisation. A higher interest rate maybe charged from in the borrowers higher risk category.
- To create an independent set-up for credit risk management, credit risk audit and loan review mechanism, in line with RBI guidelines and depending upon the type/size of the banking institutions.

Each bank should also develop, with the approval of its Board of Directors, its own strategy or plan that could guide the bank's credit granting activities and spell out the bank's credit appetite and acceptable level of risk reward trade-off for its activities. The strategy should include a statement of the bank's willingness to grant loans based on the type of economic activity, geographical location, currency, market maturity and anticipated profitability. This would necessarily translate into an the identification of the target markets and business sectors, preferred levels of diversification and concentration, the cost of capital in granting credit and the cost of bad debts.

It is not only important to evolve policies and procedures for the management of credit risk, but also to ensure that these are properly communicated to the various functionaries and are implemented in right earnest. Further, there has to be a system of periodic review of these policies/procedures at the top management/Board level, so that necessary amends are made wherever required, for their better implementation.

Organisational Structure for Effective Credit Administration and Risk Management Function

As per the RBI guidelines, for a successful implementation of effective credit administration and risk management system, banks should create a sound organisational structure, with the following basic features:

Functions of Board of Directors Relating to Risk Management The functions of the Board of Directors relating to risk management are listed below.

- The Board of Directors should have the overall responsibility for the management of credit and other risks. Banks may set-up a Board level sub-committee which should effectively coordinate between the various committees, namely, the Credit Risk Management Committee (CRMC), the Asset Liability Management Committee (ALCO) and the Operational Risk Management Committee (ORMC).
- The Credit Risk Management Committee (CRMC) should be headed by the bank's Chairman/Chief Executive Officer (CEO) or Executive Director (ED) and should comprise of heads of the Credit Administration Department (CAD), Credit Risk Management Department (CRMD), Treasury Department and the Chief Economist. The size of the committee may depend upon the size of the bank and its loan book.
- The CRMC may undertake the following broad functions:
- Be responsible for the implementation of the credit risk policy/strategy, approved by the Board of Directors (Board),
- Monitor credit risk on a bank-wide basis and ensure compliance with limits approved by the Board,
- Recommend to the Board, for their approval, a clear policy on the standards for presentation of credit proposals, financial covenants, rating standards and benchmarks,
- Decide on the delegation of credit approving powers, prudential limits on large credit exposures, standards for loan collaterals, portfolio management, loan review mechanism, risk concentration, risk monitoring and evaluation, pricing of loans, provisioning, regulatory/legal compliances. The Credit Risk Management Department (CRMD) should be independent of the Credit Administration Department (CAD). The broad functions of the CRMD and CAD are listed below:

Functions of CRMD The functions of CRMD would, *inter alia*, include the following:

- Laying down risk assessment systems, developing the MIS, monitoring the quality of or loan, or investment portfolio, identifying problems and correcting deficiencies.
- Enforcing compliance with the risk parameters and prudential limits set up by the CRMC/Board.
- Measuring, controlling and managing credit risk on a bank-wide basis, within the limits set up by the Board/CRMC.
- Being accountable for protecting the quality of the entire loan/investment portfolio. The department should undertake portfolio evaluations and conduct comprehensive studies on the environment.
- Undertaking loan review/audit to determine the resilience of the loan portfolio. Large banks may have a separate set-up for loan review/audit.

Functions of CAD The functions of the CAD would, *inter alia,* include the following:

- To be responsible for business development and customer relationship management.

- Transaction management, i.e., risk assessment, loan pricing, loan approvals and structuring the facilities, to be offered, documentation, loan administration, ongoing monitoring and risk measurement.
- The portfolio management phase may entail monitoring of the portfolio at a macro level and management of problem loans.

In addition, banks should have independent set-ups to perform functions like risk rating of borrowers, monitoring/review of loans and for credit risk audit. **The organisational chart recommended by the RBI is depicted in *Figure 13.1*.**

Credit Risk Rating Framework

The RBI credit risk rating framework is discussed below, with reference to (a) definition of credit risk, (b) factors causing credit risk, and (c) guidelines.

Definition Credit risk is the possibility of losses associated with a diminution in the credit quality of borrowers/counterparties. In a bank's credit portfolio, losses stem from outright default due to inability or unwillingness of a customer/counterparty to meet his commitments in relation to lending, trading, settlement and other financial transactions. Alternatively, losses result from a reduction in the portfolio value arising from actual or perceived deterioration in credit quality.

Credit risk emanates from the bank's dealings with an individual, corporate, bank, financial institution or a sovereign and may take any of the following forms:

- In the case of direct lending: the principal and/or interest amount may not be repaid;
- In the case of guarantees or letter of credits: funds may not be coming from the constituents upon crystallisation of the liability;
- In the case of treasury operations: payment(s) due from the counterparties under the respective contacts may not be forthcoming or ceases;
- In the case of security trading business: funds/securities settlement may not be effected; and
- In the case of cross-border exposure: availability and free transfer of foreign currency funds may either be frozen or restrictions imposed by the action of, or because of political/economic conditions in the country where the borrower is located.

Factors The factors which cause credit risk and have an adverse impact on the credit quality, *inter-alia*, include:

(i) Deficiencies in the appraisal of loan proposals and in the assessment of the creditworthiness/ financial strength of the borrowers;
(ii) Inadequately defined lending policies and procedures;
(iii) High prudential exposure limits for an individual and a group of borrowers;
(iv) Absence of credit concentration limits for various industries/business segments;
(v) Inadequate value of collaterals obtained by the banks to secure the loan facilities;
(vi) Overoptimistic assessment of thrust/potential areas of credit;
(vii) Liberal loan sanctioning powers for bank executives without checks and balances;
(viii) Liberal sanctioning of non-fund based limits without proper scrutiny of borrowers' activity, financial strength, cash flows and so on;
(ix) Lack of knowledge and skills in officials processing loan proposals and subjectivity in credit decisions;
(x) Lack of effective monitoring and consistent approach towards early recognition of problem accounts for initiation of timely remedial actions;

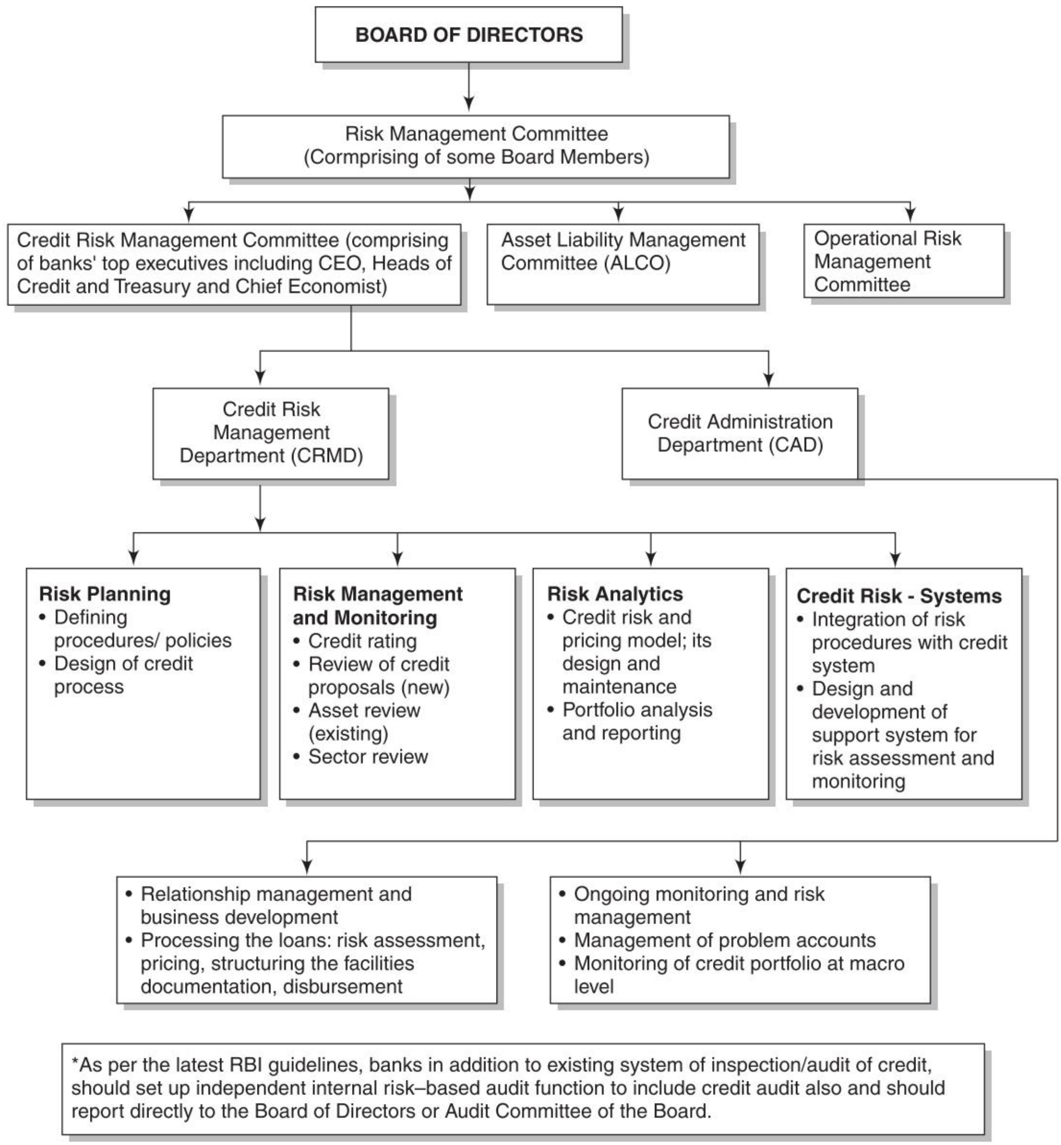


Figure 13.1 Organisational Structure for Credit Risk Management Function

(xi) Lack of information on the functioning of various industries and performance of economy;

(xii) Lack of proper coordination between the various departments of banks looking into credit functions;

(xiii) Lack of a well-defined organisational structure and clarity with regard to responsibilities, authorities and communication channels;

(xiv) Lack of a proper system of credit risk rating, quantifying and managing across geographical and product lines;

(xv) Lack of effectiveness of the existing credit inspection and audit system and slow progress in removal of the deficiencies as revealed during inspection/audit of branches and controlling offices;

(xvi) Lack of reliability and integrity of data being used for managing credit and risks associated with lending; and

(xvii) Too much harping on staff accountability and as a result, demotivating the staff and not looking at the credit decisions from hindsight.

The above illustrative factors which may have an adverse impact on the quality of a bank's credit portfolio, can be remedied only if the banks evolve efficient credit administration and risk management systems which may include formulation of well articulated policies/procedures, creating an effective organisational structure manned by well trained and committed personnel and so on.

RBI Guidelines According to RBI Guidelines, banks should evolve a comprehensive risk scoring/rating framework that serves as a single point indicator of the diverse risk factors of a borrower/counterparty, to help in taking credit decisions in a consistent manner. The rating system should be designed to have a substantial degree of standardisation so that it helps in revealing the overall risk of lending, setting pricing and non-price terms of loans as also present meaningful information for the review and management of the loan portfolio. The risk rating should reflect the credit risk and the quality of the loan portfolio.

The risk rating framework should be drawn in a structured manner and banks may use any number of operational parameters, financial ratios and collaterals, as also qualitative aspects of management and industry characteristics that may have a bearing on the creditworthiness of borrowers. They should also examine their foreign exposures, particularly those which are unhedged, and factor these in their rating models, as such exposures can alter their risk profile. They should have a separate rating framework for large corporates, small borrowers, traders, agriculturalists and so on and may prescribe certain level of standards or critical parameters, beyond which no loan proposals should be entertained. Further, banks as a matter of prudent risk management policy, should also prescribe the minimum rating below which no exposures would be undertaken and any flexibility in the minimum standards and conditions for relaxation and authority should be articulated and documented in its loan policy.

Banks should undertake the credit risk assessment exercise normally, at quarterly intervals or at least at half-yearly intervals, to gauge the quality of their credit portfolio. Any variations in the rating of the borrowers over a period of time would indicate changes in the credit quality. In order to ensure the consistency and accuracy of ratings, the responsibility of setting and confirming such ratings should vest with the loan review function and it should be examined by an independent Loan Review Group.

The indicative parameters for credit risk rating should include: Debt-Equity Ratio, Debt-Service Coverage Ratio (DSCR), Return on Capital Employed (ROCE), Operating Profit Margin, Gross Revenue and so on. Further, the rating scale may consist of 9 levels, of which 1 to 5 may represent acceptable credit risk, while 6 to 9 would be unacceptable. Each level of rating may be allotted a suitable alphabetic prefix, which may make their individual ratings scale distinct and unique.

Structure The risk rating structure should serve the following purposes:

Taking Credit Decision This is the decision as to whether to lend to a borrower or not. A borrower with a high rating would be financed.

Pricing of Loans (fixation of interest rates). A borrower falling in a higher risk category would be priced higher.

Mitigation of Risk The extent of borrower's contribution in the form of margin and collaterals can be demanded on the basis of the borrower's risk-rating category.

Nature of Facilities Whether to sanction cash credit, term loan or demand loan to a borrower may depend upon its risk categorisation. A demand loan or a term loan for a shorter period, may be considered where the risk involved is high.

Delegation of Loaning Power Higher loaning powers may be vested to the field functionaries for sanction of loans to borrowers who are rated high, with practically no risk. For borrowers falling under high-risk categories, approval of loans should be considered at higher levels of authority.

Selective Monitoring It is difficult for banks to pay the same degree of attention to all loan accounts due to fast expansion of credit. Borrowers who fall under high risk rating categories can be kept under closer monitoring, that is, they should be monitored more frequently than the low risk borrowers.

Ensuring Quality The banks need to judge the quality of the total credit portfolio, as also under various segments, that is, industry, trade, transport, agriculture and so on (large/medium/small). They also have to identify the problem accounts and determine the risk concentration of the credit portfolio.

Migration of Credit This involves effectively monitoring the overall credit portfolio by looking at the movement and migration of the portfolio, from higher to lower risk categories and vice vesa.

Management of Credit Risk Effective management of credit risk by evolving effective and robust credit policies and procedures which are sensitive and responsive to changes needs to be undertaken by the banks.

Identification of the Thrust Areas of credit which are looking up and safe as also those which are risky, having a high default rate.

Credit Risk in Non-Fund Based Exposures Credit risk in non-fund based businesses need to be assessed in a manner similar to the assessment of a fund-based business since it has the potential to become a funded liability in case the customer is not able to meet his commitments. Financial guarantees are generally long-term in nature and assessment of these requirements should be similar to the evaluation of requests for term loans. As contracts are generally for a term of 2-3 years, banks must obtain cashflows over this time horizon, arising from the specific contract they intend to support and determine the viability of financing the contract.

For reducing the credit risk on account of non-fund based businesses/exposures, banks may adopt measures including, *inter-alia*, the following:

(i) Banks must ensure that the security, which is available to the funded limits, also covers the letter of credits limits and the guarantee facilities. On some occasions, it will be appropriate to also take a charge over the fixed assets, especially in the case of long-term guarantees.

(ii) In the case of guarantees covering contracts, banks must ensure that the clients have the requisite technical skills and experience to execute the contracts. The value of the contracts must be determined on a case by case basis, and separate limits should be set up for each contract. The physical progress of contracts and financial indicators should be monitored regularly, and any slippages should be highlighted in the credit review.

(iii) The strategy to sanction non-fund facilities with a view to increase earnings should be properly balanced *vis-à-vis* the risk involved and extended only after a thorough assessment of the credit risk has been undertaken.

Risk-based Audit System Banks should put in place a risk-based internal audit system which should play an important role in an effective 'Credit Risk Management and Control System', as also help in ensuring regulatory compliances by providing high quality counsel to the top management of banks. So far, banks' internal audit systems have been concentrating on transaction testing, ensuring accuracy and reliability of accounting records and reliability and timely submission of control returns and so on. However, in the changing scenario, particularly when the RBI is also moving towards risk-based supervision, banks should widen and redirect the scope of their internal audit so that it also helps in evaluating the adequacy and effectiveness of risk management policies and procedures and internal control systems. Further, the internal risk-based audit function should be independent and entrusted to officials who are welltrained and can perform the job objectively and impartially. Banks should determine the scope of risk-based internal audit for low, medium, high and extremely high-risk areas. They should at the minimum, cover in the audit reports, the following:

(i) Reliability of the process by which risks are identified and managed in various areas.

(ii) Gaps, if any, in the control mechanism, which might lead to frauds; identification of fraud prone areas.

(iii) Verify compliance of laid down policies/procedures and regulatory compliance with regard to sanction of loans.

(iv) Examine the effectiveness of the control system which picks up early warning signals and suggest remedial measures.

(v) Assess integrity and reliability of data and its timely preparation and submission by the offices.

(vi) Position of budgetary control and performance reviews.

(vii) Testing/verification of transactions related to assets, to the extent considered necessary.

(viii) Monitoring compliances with risk-based internal audit reports.

(ix) Review of systems in place for ensuring compliances with money laundering controls; for identifying potential inherent business risks and control risks, if any; for suggesting various corrective measures and undertaking follow-up reviews to monitor the actions taken thereon.

Risk-based audit is expected to be an aid to the ongoing risk management in banks by providing the necessary checks and balances in the system. For the effectiveness of a risk-based audit, banks should establish a proper set-up clearly, indicating the roles responsibilities and the communication channels between the risk-based internal audit staff and management, which would encourage reporting of negative and sensitive findings, which would, in turn, help in initiating corrective actions to remedy the ills.

In brief, a well designed credit risk scoring/rating framework can aid banks in identifying, quantifying, aggregating and managing risk across geographical and product lines. The rating framework can be of immense use in taking credit decisions, pricing, evolving effective credit policies/procedures, avoiding credit concentration, taking capital structure decisions and so on. For designing an effective risk rating structure and its implementation, banks should create a proper organisational set-up, manned by a staff who is not only qualified and experienced, but also has a positive outlook. The staff identified for the purpose should also be provided with intensive training, which is structured and designed after considering the best international procedures/practices that have been tried out successfully.

Credit Risk Scoring and Rating Models

To comply with the RBI guidelines on scoring/rating systems, most of the banks have developed models to classify their large/medium sized industrial borrowers under various risk categories. Though the parameters used by the banks have a lot of commonalities, their scores and number of risk categories widely vary, depending upon their own risk perception. The evaluation of the parameters also vary as some banks judge them against certain benchmarks on a stand-alone basis, while others use the moving average method and allot scores by comparing the same with those of peer units.

Parameters The parameters used in the risk scoring and rating systems can broadly be grouped under the following four main heads:

(i) Operational/functional performance of the unit,
(ii) Bank accounts and securities available,
(iii) Business/industry outlook, and
(iv) Promoters/management.

Some parameters particularly related to the evaluation of the management, are qualitative in nature.

Operational/Financial Performance of the Unit The parameters generally used by the banks under this head are listed below:

(i) Plant capacity utilisation in relation to installed capacity;
(ii) Breakeven point in relation to installed plant capacity;
(iii) Sales trend during the last 3 years;
(iv) Profit trend during the last 3 years;
(v) Achievement of sales projections;
(vi) Achievement of profit projections;
(vii) Net profit to net sales ratio;
(viii) Return on capital employed;
(ix) Ratio of current assets to current liabilities;
(x) Debt-equity ratio (DER);
(xi) Debt service coverage ratio (DSCR);
(xii) Ratio of net sales per annum to working capital;
(xiii) Ratio of net sales per annum to fixed/total assets;
(xiv) Inventory turnover ratio;
(xv) Average collection period of receivables;
(xvi) Average payment period of accounts payable; etc.

Bank Accounts and Securities Available The parameters generally included are:

- **(i)** Conduct of fund and non-fund based accounts with banks/financial institutions: whether these are regular/irregular;
- **(ii)** Compliance of terms/conditions stipulated by banks/financial institutions while sanctioning the loans;
- **(iii)** Position of annual renewal/review of the loan facilities;
- **(iv)** Position with regard to submission of balance sheet and profit/loss accounts, monitoring data and inventory statement and so on;
- **(v)** Nature and value of securities (primary/collateral) offered to cover the loan facilities;
- **(vi)** Validity of creation of charge on the securities;
- **(vii)** Interest and other income being earned by the banks;
- **(viii)** Tenability of loan documents in the court of law;
- **(ix)** Position of contingent liabilities, if any;
- **(x)** Transparency and disclosures in audited annual accounts;
- **(xi)** Diversion of short-term funds for long-term users;
- **(xii)** Unauthorised withdrawals of funds for personal use or diversion of funds for investments in allied/associate and other firms;
- **(xiii)** Utilisation of loans sanctioned by banks/financial institutions (FIs) for purposes other than those for which these have been lent;
- **(xiv)** Auditor's comments on the quality and valuation of current/fixed assets.

Business and Industry Outlook The relevant parameters are:

- **(i)** Intensity of market competition faced by the industry;
- **(ii)** Technology used and whether it is successfully implemented and chances of its obsolescence;
- **(iii)** Market-demand and growth potential for the products;
- **(iv)** Quality of product(s) and their market acceptability;
- **(v)** Threats of substitutes available and likely to come in the market;
- **(vi)** Export potential of the products;
- **(vii)** Position with regard to availability of raw material;
- **(viii)** Import barriers, if any, imposed by the Government;
- **(ix)** Units' locational advantages and disadvantages;
- **(x)** Geeral outlook and capital market perception of the industry;
- **(xi)** Threat of dumping products by foreign companies;
- **(xii)** Type of product(s)—whether customised or for general use;
- **(xiii)** Foreign exchange component (risk) in the total business, covering both exports/imports;
- **(xiv)** Nture of product(s), their applications and shelf life;
- **(xv)** Volatility of prices of finished goods and basic inputs/material used; and
- **(xvi)** Fluctuations in demand/supply of products, both present and expected in the future.

Promoters/Management The important parameters are the following:

- **(i)** Ownership pattern of the unit, that is, whether public/private limited, proprietorship and so on;
- **(ii)** Qualifications, experience and knowledge of industry/business;
- **(iii)** Integrity, commitment and sincerity;

(iv) Market reputation and credibility;
(v) Track record of debt repayment;
(vi) Financial strength and their capacity to raise more funds;
(vii) Pending statutory dues and litigations, if any;
(viii) Functioning of and support from other group companies;
(ix) Turnover of top management personnel;
(x) History of dividends/bonus issues declared; and
(xi) Future succession plan.

Suggested Credit Risk Scoring and Rating Model Using the parameters identified in the RBI guidelines in terms of the four broad heads, a typical scoring/rating model is illustrated below.

Operational and Financial Performance (Maximum score: 80) The operational and financial performance of the unit being rated may be judged from certain parameters such as plant capacity utilisation, achievement of sales and profit projections; financial ratios such as current, debt-equity, debt service coverage, return on capital employed, cash flow positions and so on. All these parameters, as well as these are to be evaluated, indicating the scores to be allotted thereagainst, are discussed below.

Plant Capacity Utilisation (Maximum score: 10) It is an important parameter which can tell a lot about the unit's functioning. Low plant capacity utilisation is a disturbing feature which can be due to various reasons, such as, lack of demand, imbalance in plant/machinery, frequent breakdowns due to plant being old and so on. Whatever may be the reason, it would have an adverse effect on the unit's functioning and ultimately, on its profitability. It would be desirable to compare this parameter with the average capacity utilisation of peer units engaged in similar activity and having plant/machinery more or less of the same installed capacity. In case the average capacity utilisation of a peer is X, then scores allotted for the various levels of plant capacity utilisation may be as under:

Plant capacity utilisation	*> 1.25X*	*1.10X to 1.25X*	*X to < 1.10X*	*0.9X to < X*	*0.8X to 0.9X*	*.70X to 0.80X*	*<0.70X*
Score	10	9	8	6	4	2	0

In case data about units is not available, the score may be allotted on the basis of a comparison of the actual utilisation of plant capacity with the projections accepted by the bank while sanctioning the loan:

Plant capacity utilisation (% usage of projections	*100% or more*	*95-99%*	*90-94%*	*85-89%*	*80-84%*	*75-79%*	*<75%*
Score	10	9	8	6	4	2	0

Current Ratio (Maximum score: 10) This ratio helps in measuring the liquidity and solvency of a company. A higher current ratio may be good for the creditors, but a very high ratio may have an impact on the company's profitability. The distribution of score for various levels of the current ratio is indicated below:

Current ratio	*1.50 or ore*	*1.30 < 1.50*	*1.15 to < 1.30*	*1.0 to <1.15*	*<1.0*
Score	10	8	6	3	0

Return on Capital Employed (Maximum score: 10) [Profit before interest and tax × Capital Employed] The percentage of return on capital employed is a good indicator of a company's earning capacity. Any company having a return on capital employed that is lower than they cost of capital employed is undesirable. The score distribution covering various returns in percentage terms, is given below:

Return on capital employed	*>20%*	*17 to 20%*	*14 to < 17%*	*12 to < 14%*	*10 to < 12%*	*<10%*
Score	10	8	6	4	2	0

Debt Service Coverage Ratio (DSCR) (Maximum Score: 10) [Net Profit + depreciation + interest on term loan × Annual repayment of term loan + interest on term loan] This ratio measures the capacity of the company to service its debt, that is, repaying the term liabilities and interest thereon. The score to be allotted for ratios at various levels are given below:

DSCR	*>2.0*	*1.8 to 2.0*	*1.6 to < 1.8*	*1.2 to < 1.6*	*1.0 to < 1.3*	*<1.0*
Score	10	9	7	5	3	0

Debt Equity Ratio (Maximum Score: 10) [Total Debts × Tangible net worth] This ratio is an indicator of the promoters'/shareholders' stake in the business, when compared to the total debts. A lower debt-equity ratio means, high or long-term stability in case the ratio is gradually coming down.

Debt equity	*Upto 1.0 ratio*	*>1.0 to 1.5*	*>1.50 to 2.0*	*>2.0 to 2.50*	*>2.50 to 3.0*	*>3.0*
Score	10	9	7	5	3	0

Achievement of Net Sales Projections (Maximum Score: 10) The level of achievement of net sales when compared to projections, is an important indicator of a unit's efficient functioning.

Percentage achievement of net sales projection	*95% and more*	*90% to < 95%*	*85% to < 90%*	*80% to < 85%*	*75% to < 80%*	*Below 75%*
Score	10	9	7	5	3	0

Achievement of Net Projections (Maximum Score: 10) The level of achievement of net profit when compared to projections, is an important indicator of a unit's efficient functioning and control on its expenditure.

Percentage achievement of net profit projection	*95% and more*	*90% to < 95%*	*85% to < 90%*	*80% to < 85%*	*75% to < 80%*	*Below 75%*
Score	10	9	7	5	3	0

Future Cash Flow Position (Maximum Score: 10) Banks should obtain the cash flow statement of the borrowing companies to assess as to whether they would have enough profit generation and surplus funds to repay their term loan instalments or to meet their capital expenditures, as envisaged in the projections given by the company. The various situations and score to be allotted are given below:

Future cash flows	Company would have enough profit and surplus generation of funds to meet its obligations including payment of interest and loan instalments	Company would have enough profit and surplus funds after taking into account the loans already sanctioned, to be released shortly.	Company would have enough profit and surplus funds after taking into account only the applied for, which are yet to be sanctioned/released.	Company may not have enough profit and surplus funds to meet its loan repayments obligations and may default.
Score	10	7	4	0

Conduct of Bank Accounts and Availability of Collaterals (Maximum score: 45) The conduct of bank accounts with banks/FIs is to be evaluated in the context of regularity in accounts, which may depend on timely payments of interest and instalments of the loans. In addition, the conduct of accounts can be gauged from the compliance of terms/conditions related to the loan, timely submission of data/information to the bank and securities offered by the borrower to secure bank loans. Other aspects related to this head may include operations in non-fund based limits and diversion of funds. The parameters and scores allotted to them are given below:

Conduct of Bank Accounts (Regular/Irregular) (Maximum score: 10)

Accounts running regular and their conduct satisfactory	Accounts remained irregular for 15 days	Accounts remained irregular for 16-30 days	Accounts remained irregular for 31-45 days	Accounts remained irregular for more than 45 days
Score 10	8	6	3	0

Compliance of Terms and Conditions of Sanction (Maximum score: 10)

All conditions complied with	Conditions related to security creation complied with while others still remain to be complied with	Conditions of security creation are yet to be complied with, while other conditions complied with	Conditions have not been complied with
Score 5	4	2	0

Discipline in Timely Submission of Financial Data/Stock Statements (Maximum score: 10)

Timely submission	Delayed submission upto 15 days	Delayed submission 16 – 30 days	Delayed submission 31 – 45 days	Delayed submission more than 45 days
Score 5	4	3	2	0

Security Coverage (Primary and Collateral) (Maximum score: 10)

Percentage to total sanctioned limits, both fund and non fund based	>200%	175 to 200%	150 to <175%	125 to <150%	100 to <125%	<100%
Score	10	8	6	4	2	0

Operations in Non-Fund Based Loan Limits (Maximum score: 10) Non-fund based loans limits generally include the letter of guarantee and the letter of credit limits. These are called non-fund based limits as these do not involve extending any funds or money. These, however, involve commitment by banks on behalf of their customers to pay in the event of default by the customers. The various situations and scores allotted under each of the situation is given below:

Operations in non-fund based loan limits	Borrower honours his commitment and arranges funds whenever L/G or L/C liability falls due	Borrower generally arranges funds whenever liabilities devolve/or takes maximum 15 days in meting his liabilities	Borrower generally delays in arranging the funds whenever the liabilities devolve The period of delay goes upto 30 days.	Borrower generally delays in arranging the funds whenever non-fund based limits devolve. The delay is generally more than 30 days.
Score	5	4	2	0

Diversion of Funds (Maximum score: 10) Banks take a serious view whenever they observe that the borrowers are diverting funds to their allied and associated concerns, particularly when they are themselves not doing well. The diversion may affect the company's liquidity and operations. This parameter is important and the scores allotted for the various types of situations are given below:

Diversion of funds	Company is not diverting any funds	Company has diverted funds, may be from short terms, to long terms, to be utilised in the company itself, to meet emergent norms.	Company has diverted funds to its allied associated concerns by maintaining current ratio (CR) and debt-equity ratio (DER) within bank's acceptable norms	Company has diverted funds to its allied/ associated concerns and for repayment of unsecured loans by affecting its CR and/or DER beyond norms acceptable to banks.
Score	10	7	4	0

Industry/Business Outlook (Maximum score: 40) The future outlook of any unit can be gauged from certain parameters such as expected growth rate, intensity of competition from existing/

new entrants in the field-as well as threat from substitutes, technology used and threat of its obsolescence, general outlook based on capital market perceptions and so on. The scores allotted for the above parameters are given below:

Growth Rate (Maximum score: 10) (Growth in terms of percentage during last two years)

>20%	**15-20%**	**10-<15%**	**5-<10%**	**<5%**	**Decline**
Score 10	8	7	5	3	0

Threat of Competition (Maximum score: 10) From existing and new entrants and substitutes.

Minimum threat	*Modest threat*	*Marginal threat*	*High threat*	*Very high threat*
Score 10	8	5	2	0

Reliability of Technology (Maximum score: 10) **Used and Threat of Its Obsolescence.**

Minimum threat	*Modest threat*	*Marginal threat*	*High threat*	*Very high threat*
Score 10	8	5	2	0

General Outlook of Industry Based on Market Study and Capital Market Perception (Maximum score: 10)

Bright outlook	*Good outlook*	*Average outlook*	*Below Average outlook*	*Dismal outlook*
Score 10	8	6	3	0

Promoters/Management (Maximum score: 35) Evaluating and rating of management is always difficult as most of the parameters available for this purpose are generally qualitative in nature and difficult to quantify for the purpose of assigning scores/ratings. Nevertheless, it is important to evaluate the management since the single most important reason for sickness of companies has been inefficient management and their lack of integrity and commitment. The various parameters, how these are to be evaluated and scores allotted are discussed as under:

Integrity/Commitment would be reflected in:

- Market and banker's report;
- Willingness to offer securities to bank's loan;
- Willingness to increase their stake in the business;
- Commitment towards business and taking steps for faster implementation of the project; and
- Past track record in honouring their commitments.

Financial Strength/Risk Bearing Capacity and Technical Knowledge: The parameters are:

- Financial position (net worth) of the promoter(s);
- Position with regard to availability of funds/liquid assets;
- Means of financing and their stake in the business;
- Technical/financial qualifications/experience of the promoter(s);

- Knowledge of product(s) and process of manufacture;
- Knowledge of financial/banking related aspects; and
- Support from group companies.

Organisational Structure and Succession Plan: This to be examined in relation to:

- Type of organisational structure and hierarchy;
- Qualifications/experience of persons holding key positions;
- Employee turnover in the organisation;
- Coordination between the various executives/departments;
- Position of delegation of powers and responsibilities; and
- Succession plan for 'Top Managements'.

Market Reputation and Past Track Record: This should be examined in the light of:

- Dealing in the market and their reputation;
- Price of the share and earnings per share;
- Market capitalisation and volume of stocks traded in the market; and
- History of payment of dividends/bonus issues.

The allotted scores to each of the above parameters are listed below:

Management Integrity/Commitment, Financial Strength (Maximum score: 20)

Parameter and rating	*Maximum score*	*Of high order*	*Good*	*Satisfactory*	*Marginal*	*Unsatisfactory*
Integrity/commitment	5	5	4	3	2	0
Financial strength/technical knowledge and risk bearing capacity	5	5	4	3	2	0
Organisational structure and succession plan	5	5	4	3	2	0
Market reputation and past track record	5	5	4	3	2	0

Management of Inventory and Receivables in Relation to Net Sales in Months (Maximum Score: 5) [Average Inventory + Receivables × Net Sales per month] This measure indicates as to how efficiently the inventory and receivables are being managed. The shorter the period, the more efficient is the management.

Ratio value score	*Maximum*	*<3 months months*	*3 to <4 months*	*4 to <5 months*	*5 to <6 and above*	*6 month*
	5	5	4	3	2	0

Realisability of Receivables and Valuation of Inventory (Maximum score: 5)

Realisability of receivables and valuation of inventory	Maximum score	Comments given by bank's inspectors/stock auditors are satisfactory	Comments given raised more doubts but no shortfall in value is indicated	Comments given indicate some shortfall in value, say, maximum upto 5%	Comments given are adverse, which are indicative of poor quality of receivables/inventory
Score	5	5	4	2	0

Transparency in Account Statements (Maximum score: 5)

Transparency in accounting statements (related to disclosures by management and qualifications by auditors)	Maximum score	Standard accounting practices are being followed which are consistent; management has made disclosures and there are no qualifications from the auditors	Standard accounting practices are being followed which are consistent; management has made disclosures and auditors have given qualifications which are not damaging	Accounts lack transparency as disclosures are not adequate; Auditors have given qualifications which are damaging and may erode company's net worth.
Score	5	5	3	0

Summary of Various Parameters The various parameters and the associated scores are summarised below.

A.	**Operational/Financial Performance: (Maximum score)**	**80**
1	Plant capacity utilisation	10
2	Current ratio	10
3	Return on capital employed	10
4	Debt equity ratio	10
5	Debt service coverage ratio	10
6	Achievement of net sales projections	10
7	Achievement of net profit projections	10
8	Future cash flows	10
B.	**Conduct of Bank Accounts and Availability of Securities: (Maximum Score)**	**45**
1	Accounts running regular/irregular	10
2	Compliance in terms/conditions of sanction	5
3	Discipline in timely/submission of data/information	5
4	Primary and collateral securities	10
5	Operations in non-fund based loan limits	5
6	Diversion of funds	10

(*Contd*)

(*Contd*)

C. Industry/Business Outlook: (Maximum Score)	**40**
1 Expected growth rate	10
2 Threat of competition from existing and new entrants and substitutes	10
3 Technology development and threat of obsolescence	10
4 General outlook/capital market perception	10
D. Management-Rating and Evaluation: (Maximum Score)	**35**
1 Management integrity/commitment and financial strength	20
2 Management of inventory and receivables in relation to its sales	5
3 Realisability of receivables and valuation of inventory	5
4 Transparency in accounting statements	5
Grand Total (A+B+C+D):	**200**

The borrowers are to be rated on the basis of their score received out of 100 and, therefore, the score received is reduced to 50 per cent as the total score of all the parameters under A+B+C+D works out to be 200.

Risk Categorisation of Borrowers Based on the score achieved by borrowing units, out of a total score of 100, they may be allotted grades and risk categories as given below:

The risk rating of individual borrowers can also help in evaluating/rating the credit portfolio and evolving policies which can help in checking the migration of borrowers from a low risk category to a high-risk category.

Score	*Rating/Grade*	*Risk categorisation*	
90% or more	AAA	Practically no risk	
80–89%	AA	Minimal risk	
70–79%	A+	Modest risk	
60–69%	A	Marginal risk	
50–59%	B+	Medium risk	(Generally border line/likely NPAs)
40–49%	B	High risk	(Generally sub-standard category of NPAs)
30–39%	C	Very high risk	(Generally doubtful category of NPAs)
Below 30%	D	Caution	(Generally loss category of NPAs)

Two credit risk rating models developed by two Indian banks are given in **Appendix 13-F and 13-G on the website. The website address is http:/www.mhhe.com/khanifs10e.**

OPERATIONAL RISK MANAGEMENT

The New Capital Adequacy (Basel II) Framework requires banks to hold capital explicitly towards operational risk. The growing number of high-profile operational loss events worldwide have led banks and regulatory/supervisory authorities to increasingly view operational risk management as an integral part of the risk management activity. Management of specific operational risks is not a new practice; it has always been important for banks to try to prevent fraud, maintain the integrity of internal controls, reduce errors in transaction processing and so on. However, what is relatively new is the view that **operational risk management is a comprehensive practice comparable to the management of credit and market risks.**

Operational risk differs from other banking risks in that it is typically not directly taken in return for an expected reward but is implicit in the ordinary course of corporate activity and has the potential to effect the risk management process. Failure to properly manage operational risk can result in a mis-statement of risk profile and expose the bank to significant loss. **Management of operational risk means the identification assessment and/or measurement, monitoring and control/mitigation of this risk**.

Operational risk has been defined by the Basel Committee **as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events**. This definition includes legal risk, but excludes strategic and reputational risk. It is based on the underlying causes of operational risk. It seeks to identify why a loss happened and at the broadest level includes the breakdown by four causes: **people, processes, systems and external factors**.

The Basel Committee has identified the following types of operational risk events as having the potential to result in substantial losses:

- **Internal Fraud**. For example, intentional misreporting of positions, employee theft, and insider trading on an employee's own account.
- **External Fraud**. For example, robbery, forgery, cheque kiting, and damage from computer hacking.
- **Employment Practices and Workplace Safety**. For example, workers compensation claims, violation of employee health and safety rules, organised labour activities, discrimination claims, and general liability.
- **Clients, Products and Business Practices**. For example, fiduciary breaches, misuse of confidential customer information, improper trading activities on the bank's account, money laundering, and sale of unauthorised products.
- **Damage to Physical Assets**. For example, terrorism, vandalism, earthquakes, fires and floods.
- **Business Disruption and System Failures**. For example, hardware and software failures, telecommunication problems, and utility outages.
- **Execution, Delivery and Process Management**. For example: data entry errors, collateral management failures, incomplete legal documentation, and unauthorised access given to client accounts, non-client counterparty misperformance, and vendor disputes.

As a step towards enhancing and fine-tuning the operational risk management practices as also to serve as a benchmark to banks, on the pattern of credit and market risks, the RBI has issued Guidance Note 2007 on management of operational risk in the context of the Basel II Framework. This Section discusses the major elements of the Guidance Note, namely, **(i)** organisational set up and key responsibilities for operational risk management **and the key elements in the operational risk management process in terms of (a)** policy requirements, **(b)** identification and assessment of operational risk, **(c)** monitoring of operational risk, **(d)** control/mitigation of operational risk, **(e)** independent valuation of operational risk management functions, and **(f)** capital allocation of operational risk.

Organisational Set-up and Key Responsibilities for Operations Risk Management

Operational risk is intrinsic to a bank and should, hence, be an important component of its enterprise wide risk management systems. The Board of Directors and senior management should create an enabling organisational culture placing high priority on effective operational risk management and adherence to sound operating procedures. Successful implementation of risk management process has to emanate from the top management with the demonstration of strong commitment to integrate the same into the basic operations and strategic decision making processes. Therefore, the Board of Directors and senior management should promote an organisational culture for management of operational risk.

The approach for operational risk management that may be chosen by an individual bank will depend on a range of factors, including size and sophistication, nature and complexity of its activities. However, despite these differences, clear strategies and oversight by the Board of Directors and senior management; a strong operational risk culture, that is, the combined set of individual and corporate values, attitudes, competencies and behaviour that determine a bank's commitment to and style of operational risk management; internal control culture (including clear lines of responsibility and segregation of duties); effective internal reporting; and contingency planning are all crucial elements of an effective operational risk management framework. Ideally, the organisational set-up for operational risk management should include the following: **(i)** Board of Directors, **(ii)** Risk Management Committee of the Board of Directors, **(iii)** Operational Risk Management Committee, **(iv)** Operational Risk Management Department, **(v)** Operational Risk Managers, and **(vi)** Support Group for Operational Risk Management. A typical organisation chart for supporting operational risk management function is portrayed in Figure 13.2.

It has to be ensured that each type of major risk, namely, credit risk, market risk and operational risk, is managed as an independent function. Hence, banks should have corresponding risk management committees, which are assigned the specific responsibilities. They may structure the risk management department(s) as appropriate without compromising on the above principles.

Board Responsibilities Board of Directors (Board) of a bank is primarily responsible for ensuring effective management of operational risks. The Board would include Committee of the Board to which it may delegate specific operational risk management responsibilities:

- It should be aware of the major aspects of the bank's operational risks as a distinct risk category that should be managed, and it should approve an appropriate operational risk management framework for the bank and review it periodically.
- It should provide senior management with clear guidance and direction.
- The framework should be based on appropriate definition of operational risk which clearly articulates what constitutes operational risk in the bank and covers the bank's appetite and tolerance for operational risk. The framework should also articulate the key processes the bank needs to have in place to manage operational risk.
- It should be responsible for establishing a management structure capable of implementing the bank's operational risk management framework. Since a significant aspect of managing operational risk relates to the establishment of strong internal controls, it is particularly important that the Board establishes clear lines of management responsibility, accountability and reporting. In addition, there should be separation of responsibilities and reporting lines between operational risk control functions, business lines and support functions in order to avoid conflicts of interest.
- It should review the framework regularly to ensure that the bank is managing the operational risks arising from external market changes and other environmental factors, as well as those operational risks associated with new products, activities or systems. This review process should also aim to assess industry best practice in operational risk management

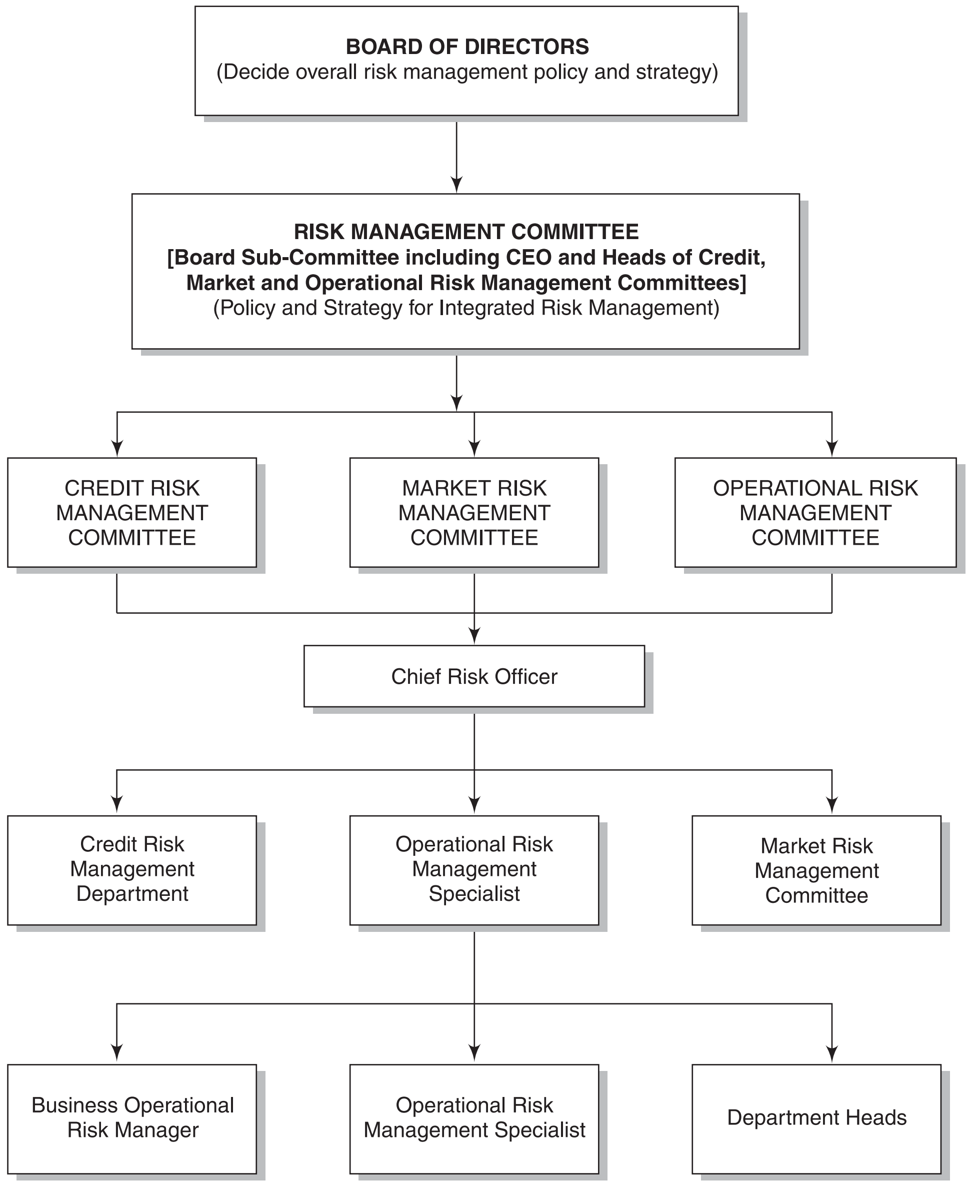


Figure 13.2 Organisation Chart for Supporting Operational Risk Management Function

appropriate for the bank's activities, systems and processes. If necessary, the Board should ensure that the operational risk management framework is revised in light of this analysis, so that material operational risks are captured within.

- The Board should ensure that the bank has in place adequate internal audit coverage to satisfy itself that policies and procedures have been implemented effectively. The operational risk management framework should be subjected to an effective and comprehensive internal audit by operationally independent, appropriately trained and competent staff. The internal audit function should not be directly involved in the operational risk management process. Though, in smaller banks, the internal audit function may be responsible for developing the operational risk management programme, responsibility for day-to-day operational risk management should be transferred elsewhere.

Senior Management Responsibilities Senior management should have responsibility for implementing the operational risk management framework approved by the Board of Directors (Board). The framework should be consistently implemented throughout the whole banking organisation, and all levels of staff should understand their responsibilities with respect to operational risk management. The additional responsibilities that devolve on the senior management include the following:

- To translate operational risk management framework established by the Board of Directors into specific policies, processes and procedures that can be implemented and verified within the different business units.
- To clearly assign authority, responsibility and reporting relationships to encourage and maintain this accountability, and ensure that the necessary resources are available to manage operational risk effectively.
- To assess the appropriateness of the management oversight process in light of the risks inherent in a business unit's policy.
- To ensure bank's activities are conducted by qualified staff with the necessary experience, technical capabilities and access to resources, and that staff responsible for monitoring and enforcing compliance with the institution's risk policy have authority independent from the units they oversee.
- To ensure that the bank's operational risk management policy has been clearly communicated to staff at all levels in the units that incur material operational risk.
- To ensure that staff responsible for managing operational risk communicate effectively with staff responsible for managing credit, market, and other risks as well as with those in the bank who are responsible for the procurement of external services such as insurance purchasing and outsourcing agreements. Failure to do so could result in significant gaps or overlaps in a bank's overall risk management programme.
- To give particular attention to the quality of documentation controls and transaction-handling practices. Policies, processes and procedures related to advanced technologies supporting high transaction volumes, in particular, should be well documented and disseminated to all relevant personnel.
- To ensure that the bank's HR policies are consistent with its appetite for risk and are not aligned to rewarding staff who deviate from policies.

The broad indicative role of each organisational arm of the risk management structure both at the corporate level and at the functional level is indicated in brief in **Appendix 13-H on the website. The website address is http://www.mhhe.com/khanifs10e**. These can be customised to the actual requirements of each bank depending upon the size, risk profile, risk appetite and level of sophistication.

Policy Requirements and Strategic Approach

The operational risk management framework provides the strategic direction and ensures that an effective operational risk management and measurement process is adopted throughout the bank. Each bank's operational risk profile is unique and requires a tailored risk management approach appropriate for the scale and materiality of the risk present, and the size of the bank. There is no single framework that would suit every bank; different approaches will be needed for different banks. In fact, many operational risk management techniques continue to evolve rapidly to keep pace with new technologies, business models and applications. **Operation risk is more a risk management than measurement issue.**

Policy Requirement Each bank must have policies and procedures that clearly describe the major elements of the operational risk management framework including identifying, assessing, monitoring and controlling/mitigating operational risk.

The operational risk management policies, processes, and procedures should be documented and communicated to appropriate staff, that is, the personnel at all levels in units that incur material operational risks. The policies and procedures should outline all aspects of the institution's operational risk management framework, including:

- The roles and responsibilities of the independent bank-wide operational risk management function and line of business management.
- A definition for operational risk, including the loss event types that will be monitored.
- The capture and use of internal and external operational risk loss data including data potential events (including the use of scenario analysis).
- The development and incorporation of business environment and internal control factor assessments into the operational risk framework.
- A description of the internally derived analytical framework that quantifies the operational risk exposure of the institution.
- A discussion of qualitative factors and risk mitigants and how they are incorporated into the operational risk framework.
- A discussion of the testing and verification processes and procedures.
- A discussion of other factors that affect the measurement of operational risk.
- Provisions for the review and approval of significant policy and procedural exceptions.
- Regular reporting of critical risk issues facing the banks and its control/mitigations to senior management and Board of Directors.
- Top-level reviews of the bank's progress towards the stated objectives.
- Checking for compliance with management controls.
- Provisions for review, treatment and resolution of non-compliance issues.
- A system of documented approvals and authorisations to ensure accountability at an appropriate level of management.
- Define the risk tolerance level for the bank, break it down to appropriate sublimits and prescribe reporting levels and breach of limits.
- Indicate the process to be adopted for immediate corrective action.

Given the vast advantages associated with effective operational risk management, it is imperative that the strategic approach of the risk management function should be oriented towards:

- An emphasis on minimising and eventually eliminating losses and customer dissatisfaction due to failures in processes.

- Focus on flaws in products and their design that can expose the institution to losses due to fraud etc.
- Align business structures and incentive systems to minimise conflicts between employees and the institution.
- Analyse the impact of failures in technology / systems and develop mitigants to minimise the impact.
- Develop plans for external shocks that can adversely impact the continuity in the institution's operations.

The bank can decide upon the mitigants for minimising operational risks rationally, by looking at the costs of putting in mitigants as against the benefit of reducing the operational losses.

Identification and Assessment of Operational Risk

In the past, banks relied almost exclusively upon internal control mechanisms within business lines, supplemented by the audit function, to manage operational risk. While these remain important, there is need to adopt specific structures and processes aimed at managing operational risk. Several recent cases demonstrate that inadequate internal controls can lead to significant losses for banks. The types of control break-downs may be grouped into five categories:

- **Lack of Control Culture** Management's inattention and laxity in control culture, insufficient guidance and lack of clear management accountability.
- **Inadequate Recognition and Assessment of the Risk of Certain Banking Activities, Whether On-or-Off-balance Sheet**. Failure to recognise and assess the risks of new products and activities or update the risk assessment when significant changes occur in business conditions or environment. Many recent cases highlight the fact that control systems that function well for traditional or simple products are unable to handle more sophisticated or complex products.
- **Absence/Failure of Key Control Structures and Activities**, such as segregation of duties, approvals, verifications, reconciliations and reviews of operating performance.
- **Inadequate Communication** of information between levels of management within the bank – upward, downward or cross-functional.
- **Inadequate/Ineffective Audit/Monitoring Programmes**.

Managing operational risk is emerging as an important feature of sound risk management practice in modern financial markets in the wake of phenomenal increase in volume of transactions, high degree of structural changes and complex technological support systems. Some of the guiding principles for banks to mange operational risks are identification, assessment, monitoring and control of these risks. These principles are elaborated below:

Identification of Operational Risk Banks should identify and assess the operational risk inherent in all material products, activities, processes and systems. They should also ensure that before new products, activities, processes and systems are introduced or undertaken, the operational risk inherent in them is identified clearly and subjected to adequate assessment procedures.

Risk identification is paramount for the subsequent development of a viable operational risk monitoring and control system. Effective risk identification should consider both internal factors (such as the bank's structure, the nature of the bank's activities, the quality of the bank's human resources, organisational changes and employee turnover) and external factors (such as changes in the industry and technological advances) that could adversely affect the achievement of the bank's objectives.

The first step towards identifying risk events is to list out all the activities that are susceptible to operational risk. Usually, this is carried out at several stages. To begin with, we can list:

- The main business groups, namely, corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage.
- The analysis can be further carried out at the level of the product teams in these business groups, for example, transaction banking, trade finance, general banking, cash management and securities markets.
- Thereafter the product offered within these business groups by each product team can be analysed, for example, import bills, letter of credit, bank guarantee under trade finance.

After the products are listed, the various operational risk events associated with these products are recorded. **An operational risk event is an incident/experience that has caused or has the potential to cause material loss to the bank either directly or indirectly with other incidents**. Risk events are associated with the people, process and technology involved with the product. They can be recognised by:

(i) **Experience** The event has occurred in the past;
(ii) **Judgment** Business logic suggests that the bank is exposed to a risk event;
(iii) **Intuition** Events where appropriate measures saved the bank in the nick of time;
(iv) **Linked Events** This event resulted in a loss resulting from other risk type (credit, market etc.);
(v) **Regulatory Requirement** Regulator requires recognition of specified events.

These risk events can be catalogued under the last tier for each of the products.

Assessment of Operational Risk In addition to identifying the risk events, banks should assess their vulnerability to these risk events. Effective risk assessment allows a bank to better understand its risk profile and most effectively target risk management resources. Amongst the possible tools that may be used by banks for assessing operational risk are:

Self Risk Assessment A bank assesses its operations and activities against a menu of potential operational risk vulnerabilities. This process is internally driven and often incorporates checklists and/or workshops to identify the strengths and weaknesses of the operational risk environment. Scorecards, for example, provide a means of translating qualitative assessments into quantitative metrics that give a relative ranking of different types of operational risk exposures. Some scores may relate to risks unique to a specific business line while others may rank risks that cut across business lines. Scores may address inherent risks, as well as the controls to mitigate them.

Risk Mapping In this process, various business units, organisational functions or process flows are mapped by risk type. This exercise can reveal areas of weakness and help prioritise subsequent management action.

Key Risk Indicators The key risk indicators are statistics and/or metrics, often financial, which can provide insight into a bank's risk position. These indicators should be reviewed on a periodic basis (such as monthly or quarterly) to alert banks to changes that may be indicative of risk concerns. Such indicators may include the number of failed trades, staff turnover rates and the frequency and/or severity of errors and omissions.

Measurement A key component of risk management is measuring the size and scope of the bank's risk exposures. As yet, however, there is no clearly established, single way to measure operational risk on a bank-wide basis. Banks may develop risk assessment techniques that are appropriate to the size and complexities of their portfolio, their resources and data availability. A good assessment model must cover certain standard features. An example is the "matrix" approach in which losses are categorised according to the type of event and the business line in which the event occurred. Banks may quantify their exposure to operational risk using a variety of approaches. For example, data on a bank's historical loss experience could provide meaningful information for assessing the bank's exposure to operational risk and developing a policy to mitigate/control the risk. An effective way of making good use of this information is to establish a framework for systematically tracking and recording the frequency and severity of each loss event along with other relevant information on individual loss events. In this way, a bank can hope to identify events which have the most impact across the entire bank and business practices which are most susceptible to operational risk. Once loss events and actual losses are defined, a bank can analyse and perhaps even model their occurrence. Doing so requires constructing databases for monitoring such losses and creating risk indicators that summarise these data. Examples of such indicators are the number of failed transactions over a period of time and the frequency of staff turnover within a division.

Every risk event in the risk matrix is then classified according to its frequency and severity. By frequency, the reference is to the number/ potential number (proportion) of error events that the product type/risk type point is exposed to. By severity, the reference is to the loss amount/ potential loss amount that the operational risk event is exposed to when the risk event materialises. The classification can be on any predefined scale (say, **1-10**, **Low**, **Medium**, **High** etc.). All risk events will thus be under one of the four categories, **namely, (i) high frequency-high severity, (ii) high frequency-low severity, (iii) low frequency high severity, and (i) low frequency-low severity in the decreasing order of the risk exposure.**

Potential losses can be categorised broadly as arising from "**high frequency, low severity" (HFLS) events**, such as minor accounting errors or bank teller mistakes, and "**low frequency, high severity" (LFHS) events**, such as terrorist attacks or major fraud. Data on losses arising from HFLS events are generally available from a bank's internal auditing systems. Hence, modeling and budgeting these expected future losses due to operational risk potentially could be done very accurately. However, LFHS events are uncommon and thus limit a single bank from having sufficient data for modeling purposes. Scenario analysis can be used for filling up scarce data. Scenarios can be treated as potential future events which need to be captured in terms of their potential frequency and potential loss severity. Scenarios should be generated for all material operational risks faced by all the organisational units of the bank. An assessment of the generated scenarios is carried out by the business experts based on the information such as historical losses, key risk indicators, insurance coverage, risk factors and the control environment, etc. The above assessments are subjected to data quality check which may be based on a peer review of the estimates made by the business expert, internal audit, etc. The data can be fed into an internal model for generating economic capital requirements for operational risk.

Risk assessment should also identify and evaluate the internal and external factors that could adversely affect the bank's performance, information and compliance by covering all risks faced by the bank that operate at all levels within the bank. Assessment should take account of both historical and potential risk events. The historical risk events are assessed based on: **(i)** Total number of risk events, **(ii)** Total financial reversals, **(iii)** Net financial impact, **(iv)** Exposure: based on expected increase in volumes, **(v)** Total number of customer claims paid out, **(vi)** IT indices: Uptime etc., and **(vii)** Office accounts status. The factors for assessing potential risks include: **(i)** Staff related factors such as productivity, expertise, turnover, **(ii)** Extent of activity outsourced, **(iii)** Process clarity, complexity, changes, **(iv)** IT Indices, **(v)** Audit scores, and **(vi)** Expected changes or spurts in volumes.

Monitoring of Operational Risk

An effective monitoring process is essential for adequately managing operational risk. Regular monitoring activities can offer the advantage of quickly detecting and correcting deficiencies in the policies, processes and procedures for managing operational risk. Promptly detecting and addressing these deficiencies can substantially reduce the potential frequency and/or severity of a loss event.

In addition to monitoring operational loss events, banks should identify appropriate indicators that provide early warning of an increased risk of future losses. Such indicators (often referred to as early warning indicators) should be forward-looking and could reflect potential sources of operational risk such as rapid growth, the introduction of new products, employee turnover, transaction breaks, system downtime, and so on. When thresholds are directly linked to these indicators, an effective monitoring process can help identify key material risks in a transparent manner and enable the bank to act upon these risks appropriately.

The frequency of monitoring should reflect the risks involved and the frequency and nature of changes in the operating environment. Monitoring should be an integrated part of a bank's activities. The results of these monitoring activities should be included in regular management and Board reports, as should compliance reviews performed by the internal audit and/or risk management functions. Reports generated by (and/or for) intermediary supervisory authorities may also inform the corporate monitoring unit which should likewise be reported internally to the senior management and the Board, where appropriate.

The senior management should receive regular reports from appropriate areas such as business units, group functions, operational risk management unit and internal audit. The operational risk reports should contain internal financial, operational, and compliance data, as well as external market information about events and conditions that are relevant to decision making. Reports should be distributed to appropriate levels of management and to areas of the bank on which areas of concern may have an impact. Reports should fully reflect any identified problem areas and should motivate timely corrective action on outstanding issues. To ensure the usefulness and reliability of these risk reports and audit reports, the management should regularly verify the timeliness, accuracy, and relevance of reporting systems and internal controls in general. The management may also use reports prepared by external sources (auditors, supervisors) to assess the usefulness and reliability of internal reports. Reports should be analysed with a view to improving existing risk management performance as well as developing new risk management policies, procedures and practices.

Management Information Systems Banks should implement a process to regularly monitor operational risk profiles and material exposures to losses. There should be regular reporting of pertinent information to senior management and the Board of Directors that supports the proactive management of operational risk. In general, the Board of Directors should receive sufficient higher-level information to enable them to understand the bank's overall operational risk profile and focus on the material and strategic implications for the business. Towards this end, it would be relevant to identify all activities and all loss events in a bank under well defined business lines.

Business Line Identification Banks have different business mixes and risk profiles. Hence, the most intractable problem banks face in assessing operational risk capital is due to this diversity. The best way to get around this intractable problem in computation is by specifying a range of operational risk multipliers for specified distinct business lines. The following benefits are expected to accrue by specifying business lines:

- Banks will be able to crystallise the assessment processes to the underlying operational risk and the regulatory framework;
- The line managers will be aware of operational risk in their line of business;
- Confusion and territorial overlap which may be linked to subsets of the overall risk profile of a bank can be avoided.

For the purpose of operational risk management, the activities of a bank may be mapped into eight business lines identified in the new capital adequacy framework. The various products launched by the banks are also to be mapped to the relevant business line. They must develop specific policies for mapping a product or an activity to a business line and have the same documented to indicate the criteria. The following are the eight recommended business lines: **(1)** Corporate finance, **(2)** Trading and sales, **(3)** Retail banking, **(4)** Commercial banking, **(5)** Payment and settlement, **(6)** Agency services, **(7)** Asset management, and **(8)** Retail brokerage **Details and methodologies for mapping of these business lines are furnished in Appendix 13-I on the website. The website address is http://www.mhhe.com/khanifs10e.**

The following are the principles to be followed for business line mapping:

(i) All activities must be mapped into the eight level - 1 business lines in a mutually exclusive and jointly exhaustive manner.

(ii) Any banking or non banking activity which cannot be readily mapped into the business line framework, but which represents an ancillary function to an activity included in the framework, must be allocated to the business line it supports. If more than one business line is supported through the ancillary activity, an objective mapping criteria must be used.

(iii) The mapping of activities into business lines for operational risk management must be consistent with the definitions of business lines used for management of other risk categories, that is, credit and market risk. Any deviations from this principle must be clearly motivated and documented.

(iv) The mapping process used must be clearly documented. In particular, written business line definitions must be clear and detailed enough to allow third parties to replicate the business line mapping. Documentation must, among other things, clearly motivate any exceptions or overrides and be kept on record.

(v) Processes must be in place to define the mapping of any new activities or products.

(vi) Senior management is responsible for the mapping policy (which is subject to approval by the Board of Directors).

(vii) The mapping process to business lines must be subject to independent review.

The following principles might be relevant for determining mapping of activities into appropriate business lines:

(i) Activities that constitute compound activities may be broken up into their components which might be related to the level 2 activities under the eight business lines and these components of the complex activity may be assigned to the most suitable business lines, in accordance with their nature and characteristics.

(ii) Activities that refer to more than a business line may be assigned to the most predominant business line and if no predominant business line exist, then it may be mapped to the most suitable business lines, in accordance with their nature and characteristics.

Operational Risk Loss Events Banks must meet the following data requirement for internally generating operational risk measures:

- The tracking of individual internal event data is an essential prerequisite to the development and functioning of operational risk measurement system. Internal loss data is crucial for tying a bank's risk estimates to its actual loss experience.
- Internal loss data is most relevant when it is clearly linked to a bank's current business activities, technological process and risk management procedures. Therefore, a bank must have documented procedures for assessing on-going relevance of historical loss data, including those situations in which judgement overrides, scaling, or other adjustments may be used, to what extent it may used and who is authorised to make such decisions.
- Bank's internal loss data must be comprehensive in that it captures all material activities and exposures from all appropriate sub-systems and geographic locations. A bank must be able to justify that any activities and exposures excluded would not have a significant impact on the overall risk estimates. Bank may have appropriate *de minimis* gross loss threshold for internal loss data collection, say ₹10,000. The appropriate threshold may vary somewhat between banks and within a bank across business lines and/or event types. However, particular thresholds may be broadly consistent with those used by the peer banks. Measuring operational risk requires both estimating the probability of an operational loss event and the severity of the loss.
- Banks must track actual loss data (i.e., where losses have actually materialised) and map the same into the relevant level 1 category defined in **Appendix 13-J on the website. (The website address is http://www.mhhe.com/khanifs10e)**. They must endeavour to map the actual loss events to level 3. Operational risk loss would be the financial impact associated with the operational event that is recorded in the financial statement and would include for example, **(a)** loss incurred, and **(b)** expenditure incurred to resume normal functioning, but would not include opportunity costs and foregone revenue etc. However, the banks must also track the potential loss (i.e. extent to which further loss may be incurred due to the same operational risk event), near misses, attempted frauds, etc where no loss has actually been incurred by the bank, from the point of view of strengthening the internal systems and controls and avoiding the possibility of such events turning into actual operational risk losses in future.
- Aside from information on gross loss amounts, bank should collect information about the data of the event, any recoveries, as well as some descriptive information about the cause/drivers of the loss event. The level of descriptive information should be commensurate with the size of the gross loss amount.
- A bank must develop specific criteria for assigning loss data arising from an event in a centralised function (e.g. information technology, administration department etc.) or any activity that spans more than one business line.
- A bank may also collect external loss data to the extent possible. External loss data should include data on actual loss amounts, information on scale of business operations where the event occurred, information on causes and circumstances of the loss events or any other relevant information. A bank must develop a systematic process for determining the situations for which external data should be used and the methodologies used to incorporate the data.
- The loss data collected must be analysed loss-event category and business line-wise. Banks should look into the process and plug any deficiencies in the process and take remedial steps to reduce such events.

Controls/Mitigation of Operational Risk

Risk management is the process of mitigating the risks faced by a bank. With regard to operational risk, several methods may be adopted for mitigating the risk. For example, losses that might arise on account of natural disasters can be insured against. Losses that might arise from business disruptions due to telecommunication or electrical failures can be mitigated by establishing redundant backup facilities. Loss due to internal factors, like employee fraud or product flaws, which may be difficult to identify and insure against, can be mitigated through strong internal auditing procedures.

Although a framework of formal, written policies and procedures is critical, it needs to be reinforced through a strong control culture that promotes sound risk management practices. Both the Board of Directors and senior management are responsible for establishing a strong internal control culture in which control activities are an integral part of the regular activities of a bank, since such integration enables quick responses to changing conditions and avoids unnecessary costs.

A system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations. Such a system can also help to ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures, and decrease the risk of unexpected losses or damage to the bank's reputation. Internal control is a process effected by the Board of Directors, senior management and all levels of personnel. It is not solely a procedure or policy that is performed at a certain point in time, but rather it is continually operating at all levels within the bank.

The internal control process, which historically has been a mechanism for reducing instances of fraud, misappropriation and errors, has become more extensive, addressing all the various risks faced by banking organisations. It is now recognised that a sound internal control process is critical to a bank's ability to meet its established goals, and to maintain its financial viability.

In varying degrees, internal control is the responsibility of everyone in a bank. Almost all employees produce information used in the internal control system or take other actions needed to effect control. An essential element of a strong internal control system is the recognition by all employees of the need to carry out their responsibilities effectively and to communicate to the appropriate level of management any problems in operations, instances of non-compliance with the code of conduct, or other policy violations or illegal actions that are noticed. It is essential that all personnel within the bank understand the importance of internal control and are actively engaged in the process. While having a strong internal control culture does not guarantee that an organisation will reach its goals, the lack of such a culture provides greater opportunities for errors to go undetected or for improprieties to occur.

An effective internal control system requires that:

- An appropriate control structure is set up, with control activities defined at every business level. These should include: top level reviews; appropriate activity controls for different departments or divisions; physical controls; checking for compliance with exposure limits and follow-up on noncompliance; a system of approvals and authorisations; and, a system of verification and reconciliation.
- There is appropriate segregation of duties and personnel are not assigned conflicting responsibilities. Areas of potential conflicts of interest should be identified, minimised, and subjected to careful, independent monitoring.
- There are adequate and comprehensive internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant

to decision making. Information should be reliable, timely, accessible, and provided in a consistent format.

- There are reliable information systems in place that cover all significant activities of the bank. These systems, including those that hold and use data in an electronic form, must be secure, monitored independently and supported by adequate contingency arrangements.
- Effective channels of communication to ensure that all staff fully understand and adhere to policies and procedures affecting their duties and responsibilities and that other relevant information is reaching the appropriate personnel.

Adequate internal controls within banking organisations must be supplemented by an effective internal audit function that independently evaluates the control systems within the organisation. Internal audit is part of the ongoing monitoring of the bank's system of internal controls and of its internal capital assessment procedure, because internal audit provides an independent assessment of the adequacy of, and compliance with, the bank's established policies and procedures.

Operational risk can be more pronounced where banks engage in new activities or develop new products (particularly where these activities or products are not consistent with the bank's core business strategies), enter unfamiliar markets, and/or engage in businesses that are geographically distant from the head office. It is incumbent upon banks to ensure that special attention is paid to internal control activities where such conditions exist.

In some instances, banks may decide to either retain a certain level of operational risk or self-insure against that risk. Where this is the case and the risk is material, the decision to retain or self-insure the risk should be transparent within the organisation and should be consistent with the bank's overall business strategy and appetite for risk. The bank's appetite as specified through the policies for managing this risk and the bank's prioritisation of operational risk management activities, including the extent of, and manner in which, operational risk is transferred outside the bank. The degree of formaity and sophistication of the bank's operational risk management framework should be commensurate with the bank's risk profile.

Banks should have policies, processes and procedures to control and/or mitigate material operational risks. They should periodically review their risk limitation and control strategies and should adjust their operational risk profile accordingly using appropriate strategies, in light of their overall risk appetite and profile:

- For all material operational risks that have been identified, the bank should decide whether to use appropriate procedures to control and/or mitigate the risks, or bear the risks. For those risks that cannot be controlled, the bank should decide whether to accept these risks, reduce the level of business activity involved, or withdraw from this activity completely. Control processes and procedures should be established and banks should have a system in place for ensuring compliance with a documented set of internal policies.
- Some significant operational risks have low probabilities but potentially very large financial impact. Classification of operational loss event into various risk categories based on frequency and severity matrix prioritise the events to be controlled and tracked. Audit benchmarks can be set for high loss events. Moreover, not all risk events can be controlled (e.g., natural disasters). Risk mitigation tools or programmes can be used to reduce the exposure to, or frequency and/or severity of, such events. For example, insurance policies, particularly those with prompt and certain pay-out features, can be used to externalise the risk of "low frequency, high severity" losses which may occur as a result of events such as third-party claims resulting from errors and omissions, physical loss of securities, employee or third-party fraud, and natural disasters.

- However, banks should view risk mitigation tools as complementary to, rather than a replacement for, internal operational risk control. Having mechanisms in place to quickly recognise and rectify legitimate operational risk errors can greatly reduce exposures. Careful consideration also needs to be given to the extent to which risk mitigation tools, such as insurance, truly reduce risk, or transfer the risk to another business sector or area, or even create a new risk (e.g. legal or counterparty risk).
- Investment in appropriate processing technology and information technology security are also important for risk mitigation. However, banks should be aware that increased automation could transform high-frequency low-severity losses into low-frequency high-severity losses. The latter may be associated with loss or extended disruption of services caused by internal factors or by factors beyond the bank's immediate control (e.g., external events). Such problems may cause serious difficulties for banks and could jeopardise an institution's ability to conduct key business activities. Banks should establish disaster recovery and business continuity plans that address this risk.
- Banks should also establish policies for managing risks associated with outsourcing activities. Outsourcing of activities can reduce the institution's risk profile by transferring activities to others with greater expertise and scale to manage the risks associated with specialised business activities. However, a bank's use of third parties does not diminish the responsibility of management to ensure that the third-party activity is conducted in a safe and sound manner and in compliance with applicable laws. Outsourcing arrangements should be based on robust contracts and/or service level agreements that ensure a clear allocation of responsibilities between external service providers and the outsourcing bank. Furthermore, banks need to manage residual risks associated with outsourcing arrangements, including disruption of services.
- Depending on the scale and nature of the activity, banks should understand the potential impact on their operations and their customers, of any potential deficiencies in services provided by vendors and other third-party or intra-group service providers, including both operational breakdowns and the potential business failure or default of the external parties. Banks should ensure that the expectations and obligations of each party are clearly defined, understood and enforceable. The extent of the external party's liability and financial ability to compensate the bank for errors, negligence, and other operational failures should be explicitly considered as part of the risk assessment. Banks should carry out an initial due diligence test and monitor the activities of third party providers, especially those lacking experience of the banking industry's regulated environment, and review this process (including re-evaluations of due diligence) on a regular basis. For critical activities, the bank may need to consider contingency plans, including the availability of alternative external parties and the costs and resources required to switch external parties, potentially on very short notice.
- Banks should have in place, contingency and business continuity plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption. These plans needs to be stress tested annually and may be revised to appropriately address any new or previously unaddressed parameters for them. For reasons that may be beyond a bank's control, a severe event may result in the inability of the bank to fulfil some or all of its business obligations, particularly where the bank's physical, telecommunication, or information technology infrastructures have been damaged or made inaccessible. This can, in turn, result in significant financial losses to the bank, as well as broader disruptions to the financial system through channels such as the payments system. This potential requires

that banks establish disaster recovery and business continuity plans that take into account different types of plausible scenarios to which the bank may be vulnerable, commensurate with the size and complexity of the bank's operations.

- Banks should periodically review their disaster recovery and business continuity plans so that they are consistent with the bank's current operations and business strategies. Moreover, these plans should be tested periodically to ensure that the bank would be able to execute the plans in the unlikely event of a severe business disruption.

Independent Evaluation of Operational Risk Management Function

The bank's Board of Directors has the ultimate responsibility for ensuring that the senior management establishes and maintains an adequate and effective system of internal controls, a measurement system for assessing the various risks of the bank's activities, a system for relating risks to the bank's capital level, and appropriate methods for monitoring compliance with laws, regulations, and supervisory and internal policies.

Internal audit is part of the ongoing monitoring of the bank's system of internal controls because internal audit provides an independent assessment of the adequacy of, and compliance with, the bank's established policies and procedures. As such, the internal audit function assists senior management and the Board of Directors in the efficient and effective discharge of their responsibilities as described above. Banks should have in place adequate internal audit coverage to verify that operating policies and procedures have been implemented effectively. The Board (either directly or indirectly through its Audit Committee) should ensure that the scope and frequency of the audit programme is appropriate to the risk exposures.

The scope of internal audit should broadly cover:

- The examination and evaluation of the adequacy and effectiveness of the internal control systems and the functioning of specific internal control procedures;
- The review of the application and effectiveness of operational risk management procedures and risk assessment methodologies;
- The review of the management and financial information systems, including the electronic information system and electronic banking services;
- The review of the means of safeguarding assets;
- The review of the bank's system of assessing its capital in relation to its estimate of operational risk;
- The review of the systems established to ensure compliance with legal and regulatory requirements, codes of conduct and the implementation of policies and procedures;
- The testing of the reliability and timeliness of the regulatory reporting;
- Mitigating risks through risk based audit.

All functional departments should ensure that the operational risk management department is kept fully informed of new developments, initiatives, products and operational changes to ensure that all associated risks are identified at an early stage.

- Operational risk groups are likely to focus on regulatory liaison, operational risk measures, best practice in areas involving risk quantification such as model risk, new products approval and optimising operations and processes. Audit should periodically validate that the bank's operational risk management framework is being implemented effectively across the bank. To the extent that the audit function is involved in oversight of the operational risk management framework, the Board should ensure that the independence of the audit function is maintained. This independence may be compromised if the audit function is directly involved in the operational risk management process. The audit function may provide valuable input to those responsible for operational risk management, but should not itself have direct operational risk management responsibilities.

- Examples of what an independent evaluation of operational risk should review include the following:
- The effectiveness of the bank's risk management process and overall control environment with respect to operational risk;
- The bank's methods for monitoring and reporting its operational risk profile, including data on operational losses and other indicators of potential operational risk;
- The bank's procedures for the timely and effective resolution of operational risk events and vulnerabilities;
- The effectiveness of the bank's operational risk mitigation efforts, such as the use of insurance;
- The quality and comprehensiveness of the bank's disaster recovery and business continuity plans;
- To ensure that, where banks are part of a financial group, there are procedures in place to ensure that operational risk is managed in an appropriate and integrated manner across the group. In performing this assessment, cooperation and exchange of information with other supervisors, in accordance with established procedures, may be necessary.

Capital Allocation for Operational Risk

The Basel Committee has put forward a framework consisting of three options for calculating operational risk capital charges in a 'continuum' of increasing sophistication and risk sensitivity. These are, in the order of their increasing complexity: **(i)** the Basic Indicator Approach **(ii)** the Standardised Approach and **(iii)** Advanced Measurement Approaches. Though the RBI has initially allowed banks to use the Basic Indicator Approach for computing regulatory capital for operational risk, some banks can move along the range toward more sophisticated approaches as they develop more sophisticated operational risk management systems and practices which meet the prescribed qualifying criteria. The qualifying criteria for Standardised Approach and Advanced Measurement Approaches are given in the **in Appendix 13-K on the website. The website address is http://www.mhhe.com/khanifs10e.**

The Basic Indicator Approach The RBI has proposed that, at the minimum, all banks in India should adopt this approach while computing capital for operational risk while implementing Basel II. Under the Basic Indicator Approach, banks have to hold capital for operational risk equal to a fixed percentage (**alpha**) of a single indicator which has currently been proposed to be "gross income". This approach is available for all banks irrespective of their level of sophistication. The charge may be expressed as follows:

$$K_{BIA} = [\ \Sigma\ (GI^{*}\ \alpha)\ ]/n,$$

Where

$\mathbf{K_{BIA}}$ = the capital charge under the Basic Indicator Approach.
GI = annual gross income, where positive, over the previous three years
α = 15% set by the Committee, relating the industry-wide level of required capital to the industry-wide level of the indicator.
n = number of the previous three years for which gross income is positive.

The Basel Committee has defined gross income as net interest income and has allowed each relevant national supervisor to define gross income in accordance with the prevailing accounting practices. Accordingly, gross income will be computed for this purpose as defined by the RBI for implementation of the new capital adequacy framework.

STRESS TESTING

Improvement in risk management practices has been in focus since the introduction of the financial sector liberalisation process in the mid nineties. The process gained momentum with the issue of regulatory guidelines and guidance notes on asset liability management and management of credit risk, market risk and operational risk by the RBI since 1999. Further, the implementation of the revised capital adequacy framework in India has brought the risk management capabilities of banks into greater focus.

Globally, banks are increasingly relying on statistical models to measure and manage the financial risks to which they are exposed. These models are gaining credibility because they provide a framework for identifying, analysing, measuring, communicating and managing these risks. Since models cannot incorporate all possible risk outcomes, and are generally not capable of capturing sudden and dramatic changes, banks supplement models with '**stress tests**'. Internationally, stress testing has become an integral part of banks' risk management systems and is used to evaluate the potential vulnerability to some unlikely but plausible events or movements in financial variables. There are broadly two categories of stress tests used in banks, namely, **sensitivity tests** and **scenario tests**. These may be used either separately or in conjunction with each other.

Sensitivity tests are normally used to assess the impact of change in *one variable* (for example, a high magnitude parallel shift in the yield curve, a significant movement in the foreign exchange rates, a large movement in the equity index etc.) on the bank's financial position.

Scenario tests include **simultaneous** moves in a *number of variables* (for example, equity prices, oil prices, foreign exchange rates, interest rates, liquidity etc.) based on a single event experienced in the past (i.e., *historical scenario* – for example, natural disasters, stock market crash, depletion of a country's foreign exchange reserves) or a plausible market event that has not yet happened (i.e., *hypothetical scenario* - for example, collapse of communication systems across the entire region/country, sudden or prolonged severe economic downturn) and the assessment of their impact on the bank's financial position.

Banks in India are beginning to use statistical models to measure and manage risks. Stress tests are, therefore, relevant for these banks. Notwithstanding the use of statistical models, stress tests are a relevant and integral part of banks' risk management frameworks. Further, the supervisory review process under **Pillar 2 of Basel II framework** is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. In the above background, the need for banks in India to adopt 'stress tests' as a risk management tool had been emphasised upon by the RBI in the Annual Policy Statement for 2006-07. Accordingly, guidelines on stress testing were prepared and issued by the RBI in June 2007. Banks were required to put in place appropriate stress test policies and the relevant stress test framework for the various risk factors by September 30, 2007. As banks needed to undertake the stress tests on a trial basis and use the results of these trial tests as a feedback to further refine the framework, they were allowed some time to refine the stress testing frameworks. Banks were required to ensure that their formal stress testing frameworks, which were in accordance with the guidelines were operational from March 31, 2008. This Section discusses the major elements of the RBI guidelines.

Utility

Internationally, stress testing has become an integral part of a bank's risk management system and is used to evaluate its potential vulnerability to certain unlikely but plausible events or movements in financial variables. The vulnerability is usually measured with reference to the bank's profitability or / and capital adequacy. This brings to fore the inadequacies of managing risks on the basis of 'normal' business conditions and emphasises the importance of robust risk management systems which factor in a forward looking element anhd recognise the need to manage risks 'over the economic cycle'.

A well designed and implemented stress testing framework would supplement banks' risk management systems and help in making these systems more robust. The stress testing framework also helps banks to be better equipped to meet the stress situations as and when they arise and also overcome them such that they do not become a serious threat to themselves or to the banking systems in which they operate.

Stress tests should, as far as possible, be conducted on a bank-wide basis. While applying the stress tests on a bank-wide basis, due consideration should be given to country or market or portfolio specific factors. Stress tests should be adequately tailored to capture these factors. Stress tests undertaken on a bank-wide basis enable the Board of Directors and senior management to assess the potential impact of the stress situations on the bank's earnings and capital position, and enable them to develop or choose appropriate strategies for mitigating and managing the impact of those situations. The framework also helps bank managements in understanding the bank's risk profile and adjusting it in accordance with their risk appetites. The stress test results should be considered while establishing and reviewing various policies and limits.

The stress testing frameworks perform the dual role of being a diagnostic tool for improving a bank's understanding of its risk profile, for assessing the adequacy of internal capital, for supplementing the internal capital models where paucity of historical data limits the predictive power of the models, **and for introducing a forward looking element in the capital assessment process**. Banks need to understand the likely impact of the stress situations and relate it to the capacity of the bank's profitability to absorb the shocks and the consequent impact on the bank's capital.

Considering the range of possible options to tackle the stress situations, banks may decide to hold a capital buffer that would be aligned to the exceptional but plausible stress situations. The stress testing framework will serve as an important component of banks' Internal Capital Adequacy Process (ICAAP) under the Basel II framework. **Guidelines on stress testing, as relevant for the Basel II framework, will be issued separately**.

Framework Requirements

Banks should put in place a Board approved 'Stress Testing Framework' to suit their individual requirements which would integrate into their risk management systems. The framework should satisfy the following essential requirements:

(i) The Board approved '**stress testing policy**' should detail **(a)** the frequency and procedure for identifying the principal risk factors which affect the bank's portfolio and should be stressed; **(b)** the methodology for constructing appropriate and plausible single factor and multi factor stress tests; **(c)** the procedure for setting the stress tolerance limits; **(d)** the process for monitoring the stress loss limits; **(e)** the remedial actions required to be taken at the relevant stages; **(f)** the authorities designated to activate the remedial actions; **(g)** the need for identification of the responsibilities assigned to various levels/ functional units; and **(h)** the need for specification of reporting lines.

(ii) The senior management should be actively involved in identifying the principal risk factors; designing appropriate single factor/ multi factor stress tests; setting the stress tolerance limits; reviewing the stress test results and monitoring the stress loss limits; activating the appropriate remedial actions; periodically communicating the stress test results and the actions taken, if any, to the Board; reviewing the need to modify the stress testing framework with reference to certain elements like the risk factors, stress scenarios, levels of stress to be applied, the underlying assumptions, stress tolerance levels, remedial actions etc.; designing an appropriate MIS to support the stress tests to be conducted; and ensuring an appropriate and effective internal control mechanism to validate the stress tests and their findings;

(iii) The Board of Directors and senior management should regularly review the results of scenario analyses and stress tests, including the major assumptions that underpin them. Stress test results may be used for setting risk limits; allocating capital for various risks; managing risk exposures; and putting in place appropriate contingency plans for meeting the situations that may arise under adverse circumstances.

(iv) The stress testing framework should be calibrated according to the complexity of each bank's business activities. The number of risk factors to be stressed would depend on the complexity of the portfolio and the risks the bank is exposed to. The banks should be able to justify their choice of stress tests and the choice of risk factors that are stressed. Banks which have foreign operations, or/ and are active in derivatives markets, or/ and are operating an active trading portfolio should use a combination of scenario analysis and sensitivity tests. Other banks may confine themselves to sensitivity tests run relatively more frequently to assess the impact of the relevant principal risk factors on their financial condition.

(v) Banks are free to choose the various assumptions underlying the stress tests and the basis for their assumptions. However, these should be well documented and available for verification by the supervisor/auditors. The assumptions underlying the stress tests should be reviewed periodically for assessing their validity. Banks should undertake fresh stress tests when there are significant modifications in the underlying assumptions. Such periodic reviews are necessary to ensure the integrity, accuracy, and reasonableness of the stress testing framework.

(vi) Banks should use appropriate, accurate and complete data when performing stress tests. The IT resources should be commensurate with the complexity of the techniques and the coverage of the stress tests. They should have adequate MIS in place to support the stress testing framework. The systems should be able to support the conduct of stress tests on different risks at relevant levels (portfolios, regions, business units) and also aggregate the results for the bank as a whole.

(vii) As the environment in which banks are operating is quite dynamic, there are changes in macroeconomic environment, banks' instruments, trading strategies and regulatory policies. The risk measurement methodologies and stress testing techniques in banks should, therefore, evolve to accommodate these changes. The stress testing framework should, therefore, be reviewed periodically to determine its efficacy and to consider the need for modifying any of the elements. The framework should be subjected to at least annual reviews which should cover, among others, the following aspects:

- **(a)** Adequacy of the documentation for various elements of the stress testing framework;
- **(b)** Integration of the stress testing framework in the day-to-day risk management processes;
- **(c)** Scope of coverage of the framework and the levels of stress applied;
- **(d)** Integrity of MIS and data feeding into the stress tests; and
- **(e)** Adequacy of the remedial actions and the efficiency of the systems for their activation.

Identification of Risks

While traditionally stress tests are used in the context of managing *market risks*, these may also be employed in the management of *credit risks, operational risks and liquidity funding risk*. Banks should identify their major risks that should be subjected to stress tests. While identifying the major risks, they should understand their exposures and the risks to which these are exposed as well as the correlation between these risks. An indicative list of the risks that banks, in general, are exposed to are credit risk, credit concentration risk, interest rate risk, price risk, foreign currency risk, impact of market movements on contingent credit risk, liquidity risk, operational risks, prepayment risk, model risk, macro economic risk and political risk. The above is only an indicative list and banks should identify the risks to which they are exposed to with regard to their bank specific circumstances and portfolio.

Stress Scenarios/Levels

Banks should stress the relevant parameters at, at least three levels of increasing adversity **(i)** minor, **(ii)** medium, and **(iii)** major with reference to the normal situation and estimate the financial resources needed by it under each of the circumstances to **(a)** meet the risk as it arises and for mitigating the impact of manifestation of that risk; **(b)** meet the liabilities as they fall due; and **(c)** meet the minimum CRAR requirements.

A scenario analysis measures the combined effect of adverse movements in more than one risk factor. Banks should determine the various risks that should be included in a scenario, take into account the linkages among the various risks without looking at each of them in isolation and assess the extent to which the stress would impact their financial position. Stress scenarios may be designed on the basis of either historical events or hypothetical events. An important element of scenario development will be the assessment and incorporation of the linkages between the various risk factors.

A few examples of stress factors/scenarios are as follows: **(i) domestic economic downturn, economic downturn of major economies to which the bank is directly exposed or to which the domestic economy is related; (ii) decline in the prospects of sectors to which the banks are having significant exposures; (iii) increase in level of NPAs and provisioning levels; (iv) increase in level of rating downgrades; (v) failure of major counterparties; (vi) timing difference in interest rate changes (repricing risk); (vii) unfavourable**

differential changes in key interest rates (basis risk); (viii) parallel/non parallel yield curve shifts (yield curve risk); (ix) changes in the values of standalone and embedded options (option risk); (x) adverse changes in exchange rates of major currencies; (xi) decline in market liquidity for financial instruments; (xii) stock market declines; (xiii) tightening of market liquidity; and (xiv) significant operational risk events.

Frequency of Stress Testing

Banks may apply stress tests at varying frequencies dictated by their respective business requirements, relevance and cost. While some stress tests may be conducted daily or weekly – for example: trading book items for the various market risks; some others may be conducted at monthly or quarterly intervals – for example: those items which are less volatile in nature like credit risk in loans or HTM (hold till maturity) securities; interest rate risk in the banking book; and liquidity risk. Further, ad-hoc stress tests may be warranted when there are any special circumstances – for example: a rapidly deteriorating political / economic conditions in a country may warrant a quick assessment of the likely impact on the bank on account of its exposures to that country.

Interpretation of Stress Test Results

The results of the various stress tests should be reviewed by the senior management and reported to the Board of Directors. These results should be an essential ingredient of bank's risk management systems.

Banks should be conscious of the fact that the stress tests indicate only the likely impact and do not indicate the likelihood of the occurrence of the stress events. Since stress testing is influenced by the judgment and experience of the people who design the stress tests, the effectiveness of the stress tests will depend upon whether banks have identified their major risks, whether they have chosen the right level of stress / stress scenarios, whether they have understood and interpreted the stress test results properly and whether they have initiated the necessary steps to address the situation presented by the stress test results. Hence, each of the above aspects need to be assigned their due importance.

Banks should document the stress tests undertaken by them, the underlying assumptions, the results and the outcomes. The documentation should be preserved *at least* for five years.

Remedial Actions

The remedial actions that banks may consider necessary to activate when the various stress tolerance levels are breached may include: **(a)** Reduction of risk limits; **(b)** Reduction of risks by enhancing collateral requirements, seeking higher level of risk mitigants, undertaking securitisation, and hedging; **(c)** Amend pricing policies to reflect enhanced risks or previously unidentified risks; **(d)** Augmenting the capital levels to enhance the buffer to absorb shocks; and **(e)** Enhancing sources of funds through credit lines, managing the liability structure, altering the liquid asset profile, and so on.

Banks should clearly identify the principles that they would be guided by while they decide on activation of the various remedial actions as appropriate to the stress event/level that may be reflected in the stress test results. The triggers for remedial actions may be identified clearly, for example: with reference to the size of the potential loss or the impact on earnings and/or capital.

In addition, the level of authority for determining the remedial action to be initiated should be clearly identified. The triggers, the remedial actions, the guiding principles for activation and the designated authorities should be properly documented and adopted/ applied as and when relevant.

As stress testing is an evolving area, a few ***illustrative*** examples of typical stress tests are presented in the **Appendix 13-L on the website** purely with a view to aid in better perception of stress tests. **The website address is: http://www.mhhe.com/khanifs10e**. Therefore, it would **not** be appropriate **(i)** to conclude that the levels of stress or the impacts mentioned in the illustrations are as perceived by the RBI or are recommended by the RBI and **(ii)** for banks to apply the illustrative stress tests as they are. Each bank should ensure that the assumptions and the levels of stress are as determined by them and that the stress tests are suitably modified while designing their respective stress testing frameworks. The stress testing framework and methodology in each bank should be tailored to suit the size, complexity, risk philosophy, risk perceptions and skills in each bank.

CONCLUDING OBSERVATIONS

- Banking risks can be categorised into business-related risks and control-related risks.
- Business-related risks are associated with the operational activities and market environment ofbanks. There are six types of such risks: credit risk; market risk; country risk; business environment risk; operational risk; and group risk.
- Credit risk is the possibility of losses associated with a diminution in the credit quality of borrowers/counterparties. Losses may arise from outright default due to inability/unwillingness of borrowers/counterparties to meet commitments, as also due to risk inherent in the nature of business activity and environment in terms of obsolescence of technology/product(s) design, competition, inadequate supply of inputs, lack of infrastructure and so on.
- Market risk is caused due to a change in the market variables having an adverse impact on the earnings/capital of a bank. The market risk comprises of interest rate risk, foreign exchange risk, equity price risk, commodity price risk and liquidity risk.
- Interest rate risk may be on account of changes in interest rates, both of assets and liabilities (basis risk), mismatch between assets and liabilities (mismatch/gap risk), depreciation in the assets portfolio due to an increase in the market interest rate (price risk). Forex risk is caused by the effect of an adverse exchange rate movement on the foreign currency exposure of banks and includes transaction exposure, translation exposure and economic exposure. Equity price risk relates to capital market exposures which arise due to an adverse movement in the equity prices. Liquidity risk is caused by a mismatch in the maturity of assets and liabilities.
- Country risk arises when a foreign country is unable to repay its debts. It includes currency transfer risk, political risk, cross-border risk and sovereign risk.
- Business environment risk arises due to lending policies relating to identification of target markets, products/customer base, formulated without prior planning.
- Operational risk is caused by deficient internal processes/systems/procedures, non-conducive work environment, demotivated/untrained/incompetent staff, obsolete/ untested technology and so on.
- Group risk may arise from subsidiaries of banks engaged in merchant banking, mutual funds, insurance and so on.

- Control-related risks are associated with the weaknesses in the control systems of banks due to organisational bottlenecks in the form of inadequate/inappropriate structure.
- The RBI guidelines relating to ALM focus on interest rate and liquidity risk management systems in banks, which form a part of the ALM function. The main elements of the ALM system are: ALM information system, ALM organisation and ALM process.
- The ALM system should be built up on a sound methodology, with the necessary information system as a back up. Information is key to the ALM process. A uniform system is not feasible for all banks. The ALM system analyses information on the basis of residual maturity and behavioural pattern. Banks should initially follow the ABC approach, that is, analyse the behaviour of the asset and liability products in the sample branches that account for significant business and make rational assumptions about the behaviour of the assets and liabilities in other branches. The data and assumptions can be refined over time in the light of experience of conducting business within the ALM framework. The spread of computerisation would facilitate accessing of data.
- The Board of Directors should have the overall responsibility for the management of risk and of deciding the risk management policy of the bank, besides setting limits for liquidity, interest rate, forex and equity price risk. The ALCO should ensure adherence to the limits set by the Board and decide the business strategy of the bank on the assets and liability side, in line with the budget and risk management objectives. A sub-committee of the Board should oversee the implementation of the system and review its functioning periodically.
- The ALM process mainly addresses liquidity and interest rate risks.
- Bank management should not only measure the liquidity position of banks on an ongoing basis, but also examine how liquidity requirements are likely to evolve under different assumptions. Liquidity should be tracked through maturity/cashflow estimates. The use of the maturity ladder and calculation of cumulative surplus/deficit of funds at selected maturity dates may be used to measure/manage the net funding requirements. The maturity profile of the various heads of accounts should be used for measuring the future cashflows in different time brackets: 1-14 days; 15-28 days; 29 days upto 3 months; 3-6 months; 6 months – 1 year; 1 – 3 years; 3 – 5 years; and over 5 years. Within each time bracket, there could be mismatches between cash-inflows and outflows. The main focus should be on short-term mismatches, namely, 1-14 days and 15-28 days. The mismatches (negative gap) in the normal course should not exceed 20 per cent of the cashoutflows in each time bracket.
- A statement of structural liquidity may be prepared by placing all cash inflows (i.e., maturing assets) and cash outflows (i.e., maturing liabilities) in the maturity ladder, according to the timing of the cashflows. While determining the tolerance level in mismatches, banks should take into account all the relevant factors, based on their asset liability base, nature of business, future strategy and so on and further refined with experience gained in liquidity management. To monitor their short-term liquidity on a dynamic basis, over a time horizon spanning from 1–90 days, banks may estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.
- Interest rate risk has two dimensions. The immediate effect of a change in the interest rate is on its net interest income (NII) or net interest margin (NIM). The long-term impact is on the market value of equity (MVE)/networth.
- Initially, banks should use the traditional gap analysis to measure the interest rate risk and move over to modern techniques of interest risk measurement, such as duration gap analysis, simulation and VaR overtime, when they acquire sufficient expertise and sophistication in acquiring and handling MIS.

- Gap analysis measures mismatches between rate sensitive liabilities and assets. Such assets and liabilities should be grouped into time brackets according to the residual maturity or next repricing period, whichever is earlier. The gaps may be classified into the following time-brackets: 1–28 days; 29 days to 3 months; 3–6 months; 6 months – 1 year; 1–3 years; 3–5 years; over 5 years; and non-sensitive.
- The gap is the difference between rate sensitive assets (RSAs) and rate sensitive liabilities (RSLs) for each time bracket. RSAs > RSLs = positive gap; RSAs < RSLs = negative gap. The gap report indicates whether the bank can benefit from rising interest rates (positive gap) or from a declining interest rate (negative gap).
- The main elements of the RBI credit risk management framework are: credit risk policies and procedures; organisational structure for effective credit administration; and credit rating framework.
- The credit risk is the possibility of losses associated with a diminution in the credit quality of the borrowers/counterparties. Losses may stem from outright default due to inability/unwillingness of a customer/counterparty to meet commitments in relation to lending/settlement/other financial transaction. Losses may also result from a reduction in the portfolio value arising from actual/perceived deterioration in the credit quality.
- Banks should prepare a comprehensive and well articulated/written credit policy document, highlighting the strategy, policies and procedures for effective management of credit and mitigation of credit risks. The main features of the policies/procedures, *inter alia*, should include identification of activities/industries doing well, delegation of approving/sanctioning powers, linking credit risk scoring/rating system and risk acceptance criteria with risk rating of borrowers, laying down prudential exposure limits for loans, discussion of concentration risk/loan review mechanism and renewal systems, evolution of effective systems of monitoring operational/financial performance of borrowers, laying down guidelines on pre-sanction appraisal and monitoring, discussion of forex risk, fixation of limits for inter-bank exposures, laying down guidelines on multiple credit approval/policies on exposure to high-risk sectors, evolving consistent approach towards early recognition of problem-exposures and remedial action, mechanism of loan pricing and creation of independent set up for credit risk management and audit and loan review mechanism in line with RBI guidelines.
- For the successful implementation of effective credit administration and risk management systems, a sound organisational structure should be created by each bank. The Board of Directors should have the overall responsibility for management of credit and other risks. The CRMC of the Board should be responsible for the implementation of the credit risk policy/strategy decided upon by the Board of Directors. The CRMD of the CRMC should be independent of the CAD. Banks should also have an independent setup to perform functions like risk rating of borrowers, monitoring/review of loan and for credit risk audit.
- Banks should evolve a comprehensive risk scoring/rating framework to serve as a single point indicator of diverse risk factors of borrowers/counterparties. The risk rating structure should serve the following purposes: taking credit decisions, pricing of loans, mitigation of risk, nature of facilitating delegation of loaning power, selective monitoring, ensuring quality, migration of credit, management of credit risk and identification of thrust areas.
- A well-structured credit rating framework should be developed by using a number of operational parameters, financial ratios, collaterals, qualitative aspects of management and industry characteristics. The scores allotted to each parameter may depend upon their risk predicting capacity. An illustrative list of parameters has also been given.

- The risk rating framework for larger, medium and small enterprises and traders may vary. Normally, it should have nine grades of which, the first five may represent acceptable credit while the remaining four may represent unacceptable credit. It should have some minimum cut-off score below which no credit proposal should be entertained. For any relaxation, there should be clear guidelines in the loan policy, especially indicating the authority who can permit such relaxation.
- The rating exercise should be undertaken normally, at quarterly intervals or at least on a half yearly basis, to assess the migration in the credit quality.
- Credit risk in non-fund based businesses should be assessed on the same lines as the assessment of fund-based business. Financial guarantees should be evaluated in the same manner as term loans.
- Banks should put in place a risk-based internal audit system. They should determine the scope of such audit for low, medium, high and extremely high-risk areas. The minimum coverage of the audit report should, *inter alia*, include, reliability of process of identification/management of various risk areas, gaps in control mechanism, verification of compliance of policies/procedures, examination of effectiveness of control system, assessment of integrity/reliability of data and its timely preparation, position by budgetary control/performance review, verification of asset-related transactions, monitoring compliances with risk-based internal audit reports and so on.· The parameters used by banks in designing a scoring/rating system fall into four broad categories: operational/financial performance of the unit; bank accounts and securities available; business/industry outlook; and promoters/management.
- The important parameters generally used by banks under the head operational/financial performance include plant capacity, break-even point, sales/profit trend/projections, profit margin, ROCE, DER, DSCR, ratio of sales to working capital/assets, inventory turnover, average collection/payment period and so on.
- The important parameters relevant to bank accounts and securities available are: regularity in the conduct of accounts, compliance with the terms of sanction of loan, annual review/renewal of loan facility, submission of data, nature/volume of security, validity of charge, transparency/disclosure in accounts, diversion of funds, unauthorised withdrawal of funds, utilisation of loans, auditors' comment on quality/valuation of assets and so on.
- The business and industry outlook would be reflected in factors such as competition, technology, market demand and growth potential, quality of products, exports-potential, import barriers, foreign exchange component, volatility of prices of the product, and so on.
- The major components of promoters/management assessment are ownership pattern of the unit, qualifications, integrity/commitment/sincerity, market reputation/credibility, financial strength, functioning/support of other group companies, turnover of top management, succession plan and so on.
- Management of operational risk means the identification assessment and/or measurement, monitoring and control/mitigation of the risk. Operational risk is the risk of loss resulting form inadequate or failed processes, people and systems or from external events/factors. The operational risks events having the potential to result in substantial losses include **(i)** internal frauds, **(ii)** external fraud, **(iii)** employment practices and workplace safety, **(iv)** clients, products and business practices, **(v)** damage to physical assets, **(vi)** business disruptions and system failure and **(vii)** execution, delivery and process management.
- The main elements of the RBI Guidelines Notes on management of operational risk are: **(a)** organisational setup and key responsibilities, **(b)** policy requirements, **(c)** identification

and assessment of operational risk, **(d)** monitoring of risk, **(e)** control/mitigation of risk, **(f)** independent evaluation and **(g)** capital allocation.

- The Board of Directors/senior management should promote an organisational culture for management of operational risk in terms of corporate values, attitudes, competencies and behaviour that determine a bank's commitment to and style of operational risk management; clear lines of responsibility and segregation of duties; effective internal reporting and contingency planning. The organisational setup for operational risk management should include the Board of Directors, Risk Management Committee of the Board, Operational Risk Management Committee, Operational Risk Management Department, Operational Risk Managers and Support Groups for Operational Risk Management.
- The operational risk management framework provides the strategic direction to ensure that an effective process is adopted throughout the bank. The policies/procedures should clearly describe the major elements of the framework including identifying assessing, monitoring and controlling/mitigating risk.
- There is need to adopt specific structures and processes for managing operational risk. Inadequate internal controls can lead to significant loses for banks. The major control break-downs may be **(1)** lack of control culture, **(2)** inadequate recognition and assessment of risk of certain activities, **(3)** absence of key control structure and activities, **(4)** inadequate communication and **(5)** inadequate/ ineffective audit/monitoring programmes. The guiding principles for banks to manage operational risk are identification, assessment, measurement, monitoring and control of these risks.
- An effective monitoring process is essential for adequately managing operational risk. Banks should identify appropriate indicators that provide early warning of an increased risk of future losses. The elements of the monitoring mechanism should be **(1)** management information system, **(2)** business line identification, and **(3)** operational risk loss events.
- Risk management is the process of mitigating risks faced by a bank. Several methods may be adopted for mitigating the operational risk, such as, insurance for natural disasters, back up facilities for business disruption and strong internal auditing procedures for loss due to internal factors. A system of effective internal control is a critical component of operational risk management. Banks should have policies, processes and procedures to control and/or mitigate material operational risks. They should periodically review their risk limitation and control strategies and adjust their operational risk profiles accordingly, using appropriate strategies in the light of their overall risk appetite and profile.
- Internal audit is part of the ongoing monitoring of the bank's system of internal control as it provides an independent assessment of the adequacy of, and compliance with, the bank's establishment policies and procedures. Banks should have in place adequate internal audit coverage to verify that operating policies and procedures have been implemented effectively. The Board of Directors should ensure that the scope and frequency of the audit programme is appropriate to the risk exposures.
- There are three approaches for calculating operational risk capital charges: **(1)** Basic Indicator Approach, **(2)** Standard Approach, and **(3)** Advanced Measurement Approach. The RBI has proposed that all banks in India should, to begin with, adopt the Basic Indicator Approach. Under this approach, banks have to hold capital for operational risk equal to a fixed percentage (alpha) of a single indicator, that is, gross income. The charge may be expressed as follows:

  $[KB_{IA} = \{(SGia)\}/n]$

  Where

  $\mathbf{KB_{IA}}$ = Capital charge under the Basic Indicator Approach

GI = Gross income over the previous three years

a = 15%

n = number of 3 years

- Stress testing is used to evaluate the potential vulnerability to some unlikely but plausible events/movements in financial variables and the assessment of their impact on the financial position of a bank. There are two broad categories of stress tests, namely, sensitivity tests and scenario tests. The sensitivity tests are normally used to assess the impact of change in one variable, say, a large movement in the equity index, on the financial position of the bank. The scenario tests include simultaneous moves in a number of variables such as equity prices, oil prices, interest rates and so on. The historical scenario is based on a single event experienced in the past, for instance, a stock market crash. The hypothetical scenario is based on a plausible market event that has yet not happened, for example, sudden severe economic downturn.
- The major elements of the RBI guidelines on stress testing are **(1)** utility, **(2)** framework requirements, **(3)** identification of risks, **(4)** stress scenarios/levels, **(5)** frequency of testing, and **(6)** remedial action.
- The stress testing framework performs the dual role of being a diagnostic tool for improving a bank's understanding of its risk profile, for assessing the adequacy of internal capital, for supplementing the internal capital models and for improving a forward looking element in the capital assessment process.
- The stress testing framework should satisfy the following essential requirements: **(1)** the frequency and procedure for identifying the principal risk factors, methodology for constructing stress tests, monitoring, remedial action and so on, **(2)** active involvement of the senior management in the process, **(3)** regular review of the results of scenario analysis and stress tests, **(4)** calibration of the framework according to the complexity of business activities, **(5)** freedom to banks to choose the various assumptions underlying the stress tests and, **(6)** use of appropriate, accurate and complete data.
- Banks should identify all the risks to which they are exposed to with regard to their specific circumstances and portfolio such as market risks, credit risks, operational risks and liquidity risk and so on.
- Banks should stress the relevant parameters at least at three levels of increasing adversity: **(a)** minor, **(b)** medium and **(c)** major with reference to the normal situation and estimate the financial resources needed by it under each of the circumstances to meet the **(i)** risks as it arises, **(ii)** liabilities as they fall due and **(iii)** meet the minimum CRAR requirements.
- Banks may apply stress tests at various frequencies dictated by their respective business requirements, relevance and cost, for instance, daily, weekly, monthly, quarterly and so on.
- The remedial action that banks may consider may include reduction of risk limits, reduction of risk by enhancing collateral requirements, amend pricing policies, augment capital levels and enhance sources of funding.

CHAPTER 14

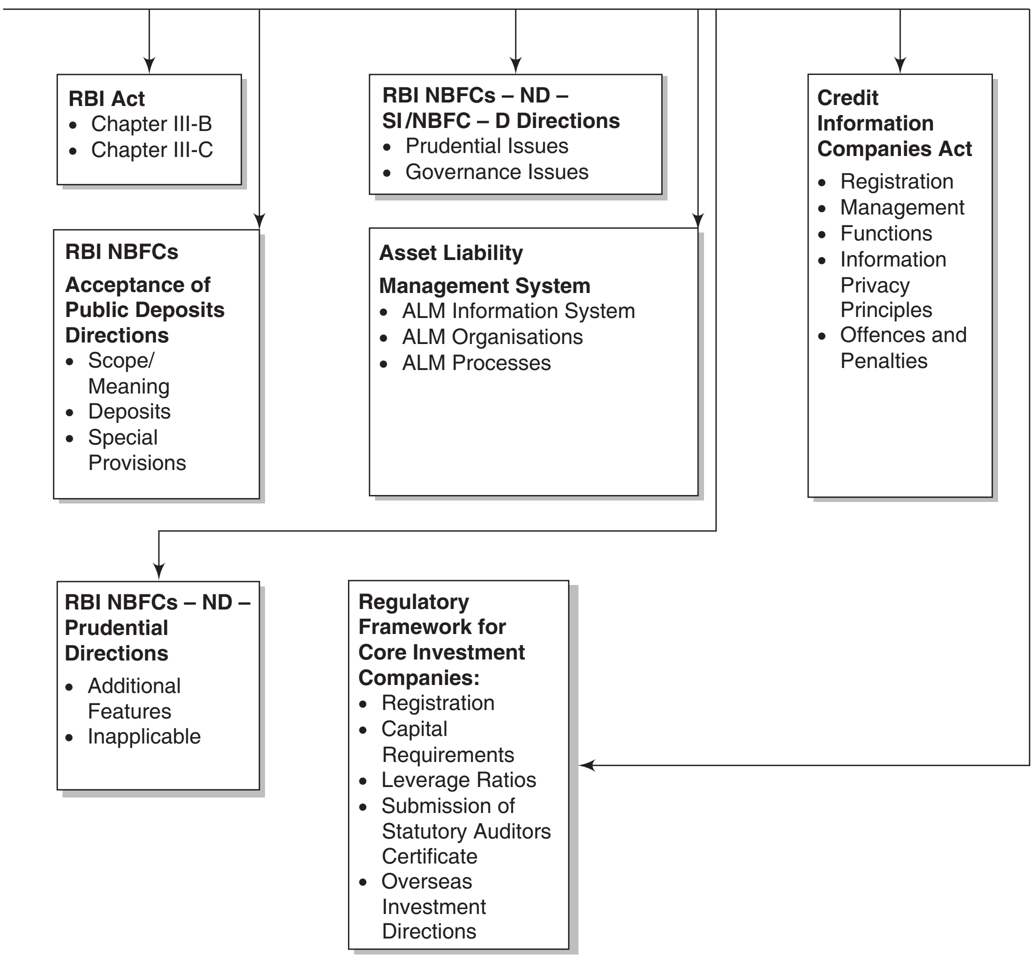
Non-Banking Financial Companies

INTRODUCTION

Reflecting the imperative of the evolution of a vibrant, competitive and articulate financial system, the non-banking financial sector in India has recorded marked growth in the recent years, in terms of the number of Non-Banking Financial Companies (NBFCs), their deposits and so on. Keeping in view the growing importance of the NBFCs, the Banking Laws (Miscellaneous Provisions) Act, 1963 was introduced to regulate them. To enable the regulatory authorities to frame suitable policy measures, several committees have been appointed from time to time to conduct an indepth study of these institutions and make suitable recommendations for their healthy growth, within a given regulatory framework. The suggestions/recommendations made, by them in the context of the contemporary financial scenario, formed the basis of the formulation of policy measures by the regulatory authorities/Reserve Bank of India (RBI). The committees that deserve specific mention in this regard are the: Bhabatosh Datta Study Group (1971), James Raj Study Group (1975), Chakravarty Committee (1985), Vaghul Committee (1987), Narsimham Committee on Financial Systems (1991) and Shah Committee (1992). The Shah Committee, as a follow-up to the Narsimham Committee, was the first to suggest a comprehensive regulatory framework for the NBFCs. While, in principle, endorsing the Shah Committee's framework of regulations for NBFCs, the RBI had implemented a number of its recommendations and incorporated them in the RBI Directions that regulate and supervise the working and operations of such companies. The Khanna Group, 1996, had suggested a supervisory framework for NBFCs. In pursuance of its recommendations, the RBI Act was amended in January 1997. As a further follow-up, the RBI Acceptance of Public Deposits Directions, the RBI NBFCs Prudential Norms Directions and the RBI NBFCs Auditors Report Directions were modified/issued in January 1998. The RBI Acceptance of Public Deposits Directions were modified in December 1998, as recommended by the Vasudev Task Force Group. To strengthen the regulatory framework, the RBI has issued several other directions also.

The purpose of this chapter is to outline the scheme/system of regulation of the working and operations of NBFCs regulated by the RBI. **It is portrayed in Exhibit 14.1.**

Exhibit 14.1 System of Regulation of Non-Banking Finance Companies



The provisions of the (amended) RBI Act and the RBI Acceptance of Public Deposit Direction to different categories of NBFCs are examined in Sections 1 and 2, respectively. Sections 3-4 describe the prudential norms applicable to the NBFCs accepting deposits and those not accepting deposits respectively. The Auditor's Reports Directions for NBFCs are discussed in Section 5. The RBI's Asset Liability Management (ALM) framework applicable to them is examined in Section 6. While the framework of regulation of credit information companies in terms of the Credit Information Companies Act, 2005 is outlined in Section 7, the guidelines on fair practices by NBFCs are outlined in Section 8. Section 9 discusses the regulatory framework for core investment companies. Some concluding observations are given in the last Section.

RBI ACT FRAMEWORK

The RBI regulates different types of NBFCs under the provisions of Chapter III-B and Chapter III-C of the RBI Act. It was amended in 1997 incorporating **(i)** amendment of the existing Sections (45I, 45MA, and 58B), **(ii)** insertion of new Sections (45A/B/C, 45JA, 45MB/C, 45NB/C, 45QA/B and 4/58G) and **(iii)** substitution by new Section (45S).

Salient Features of Chapter III-B

The chapter contains provisions relating to Non-Banking Institutions (NBIs) receiving deposits, and Financial Institutions (FIs).

Deposits The term deposit is defined in a broad sense to include any receipt of money by way of deposit or loan or in any other form. However, certain receipts are excluded:

(i) Amount received from banks,
(ii) Amount received from development finance corporations/State Financial Corporations or any other financial institution;
(iii) Amount received in the ordinary course of business, by way of security deposit, dealership deposit, earnest money, advance against order for goods/ properties/services;
(iv) Amount received from an individual/firm/association related to money lending;
(iv) Amount received by way of subscription in respect of a chit
(v) Loans from mutual funds.

Financial Institutions These mean any non-banking institutions/financial companies engaged in any of the following activities:

(i) Financing by way of loans, advances, and so on, any activity except its own;
(ii) Acquisition of shares/stocks/bonds/debentures/securities;
(iii) Hire-purchase;
(iv) Any class of insurance, stockbroking etc;
(v) Chit funds and
(vi) Collection of money by way of subscription/sale of units or other instruments/any other manner, and their disbursement.

Non-banking Financial Company (NBFC) It means **(i)** a financial institution that is a company, **(ii)** a non-banking institution that is a company whose principal business is the receiving of deposits under any scheme/arrangement/in any other manner or lending in any manner and **(iii)** such other non-banking institutions/class of institutions as the RBI may specify, with the prior approval of the Government and by notification in the official gazette.

Registration and Net Owned Funds (NOFs) With effect from January 1997, in order to commence (new company)/carry on (existing company) the business of a Non-Banking Financial Institution (NBFI), an NBFC must obtain a certificate of registration from the RBI. Moreover, its minimum net owned funds (NOFs) must be ₹25 lakh or such other amount not exceeding ₹200 lakh, as specified by the RBI. The **NOFs** mean **(a)** paid-up capital and free reserves, as per the latest balance sheet, minus the accumulated losses, if any, deferred revenue expenditure and other intangible assets and **(b) (i)** less investments in shares of subsidiaries/companies in the same group/all other NBFCs and **(ii)** the book value of debentures/bonds/outstanding loans and advances—including hire-purchase and lease finance made to, and deposits with, subsidiaries/companies in the same group—in excess of 10 per cent of (a) above.

While considering an application for registration, the RBI would consider that the NBFC fulfils the following conditions:

- The NBFC is/would be in a position to pay its present/future depositors in full, as and when their claims accrue.
- Its affairs are not being/likely to be conducted in a manner detrimental to the interests of its present/future depositors.
- The general character of the management/proposed management would not be prejudicial to the public interest/interest of the depositors.
- It has adequate capital structure and earning prospects.
- The public interest would be served by the grant of the certificate to commence/carry on business in India.
- The grant of the certificate would not be prejudicial to the operation/consolidation of the financial sector, consistent with the monetary stability and economic growth considering such other relevant factors specified by the RBI.
- Any other condition, the fulfillment of which, in the opinion of the RBI, would be necessary to ensure that the commencement/carrying on business in India would not be prejudicial to the public interest or the interest of the depositors.
- The RBI may impose conditions while granting registration. It may cancel a certificate of registration if the NBFC:
  (i) Ceases to carry on the business in India;
  (ii) Has failed to comply with any condition subject to which the certificate was issued;
  (iii) At any time fails to fulfil any of the above conditions, which the RBI considered while granting registration;
  (iv) Fails to **(a)** comply with any directions issued by the RBI under the provisions relating to registration, **(b)** maintains accounts in accordance with the requirements of any law/direction/order issued by the RBI under these provisions and **(c)** submit/offer for inspection its books of accounts/other relevant documents, when so demanded by an inspecting authority of the RBI and
  (v) Has been prohibited from accepting deposits by an order of the RBI, under the provisions that have been in force for a period of at least three months.

Maintenance of Assets NBFCs are required to invest, in unencumbered approved Indian securities, at least 5 per cent or more of their outstanding deposits at the close of business on the last working day of the second preceding quarter as specified by the RBI from time to time. The RBI may, however, specify different percentages of investment in respect of different classes of NBFCs. Approved securities mean the securities of any State Government/Central Government and bonds unconditionally guaranteed by them as regards the payment of interest as well as the repayment of principal. Included in unencumbered approved securities are approved securities lodged by NBFCs with other institutions, for an advance/any other arrangement, to the extent to which such securities have not been drawn against or availed of or encumbered in any manner. The basis of valuation of such securities would be the cost or current market price. To ensure compliance of the maintenance of the percentage of assets, the NBFCs may be required to furnish a return in such form/manner and for such periods as specified by the RBI.

In case the amount invested at the close of business on any day falls below the specified rate, the NBFCs would have to pay the RBI, a penal interest at a rate of 3 per cent per annum above the bank rate to compensate the shortfall. If the shortfall continues in subsequent quarters, the rate of panel interest would be 5 per cent per annum above the bank rate. The penal interest must be paid within 14 days from the date of the issue or serving the payment notice by the RBI, failing which the RBI can approach an appropriate court for a direction for payment. The certificate/direction issued by the court would be enforceable like a decree in a suit. However, if the RBI is satisfied that the defaulting NBFC had sufficient cause for its failure, it may not demand the payment of the penal interest.

Reserve Fund Every NBFC must create a reserve fund to which at least 20 per cent of its net profits must be transferred before the declaration of any dividend. The reserve fund can be used/appropriated only for purposes specified by the RBI from time to time. Every appropriation should be reported to it within 21 days from the date of withdrawal. However, the RBI, for sufficient cause in any particular case, may extend the period or condone any delay. The Central Government may, on the recommendation of the RBI, exempt, by an order in writing, any NBFC for a specified period from the above requirements, taking into consideration the adequacy of its paid-up capital and reserves in relation to deposit liabilities. But such an exemption can be granted only if the reserve fund together with the share premium account of the NBFC is not less than its paid-up capital.

Power of Regulation/Prohibition The RBI can by general/special order regulate or prohibit the issue, by any Non-Banking Institution (NBI), of any prospectus or advertisement soliciting deposits of money from the public and also specify conditions subject to which they can be issued.

In public interest, to regulate the financial system or to prevent the affairs of a NBFC being conducted in a manner detrimental to the interests of the depositors, or prejudicial to the interest of the company, the RBI can determine policy and give directions to all or any of the NBFC(s) relating to: **(a)** income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy based on risk weights for assets and credit conversion factors for off-balance sheet items and **(b)** deployment of funds. They would be bound to follow the policy determined/directions issued. In addition, the RBI may give directions to NBFC(s), in particular, regarding:

(i) The purpose for which advances/other funds-based/non-fund-based accommodation may not be made and

(ii) The maximum amount of advances/other financial accommodation/ investment in shares/ other securities, having taken into account the paid-up capital, reserves and deposits of the NBFC and other relevant considerations.

Power to Collect Information from NBIs The RBI can issue direction to the NBIs to furnish information relating to, or concerned with, deposits. The information may relate to aspects such as amount of deposits, its period and purpose, rates of interest and other terms and conditions on which deposits are received. It may also issue directions to the NBIs with respect to these matters. Non-compliance of these directions may lead to the prohibition of acceptance of deposits by the NBI. Any NBI can also be required to furnish depositors with a copy of its balance sheet, profit and loss account or other annual accounts.

Power to Call for Information from FIs and Issue Directions To regulate the credit system, the RBI can ask for information from the FIs relating to, as well as issue directions for the conduct of, their business. The information sought may cover matters such as paid-up capital, reserves or other liabilities, investments, persons/purpose and periods for which finance was provided, terms and conditions, including the rate of interest, and so on. While issuing directions, the RBI has to give due regard to the conditions in which and the objects for which the FI has been established, its statutory responsibilities and the effect its business would have on trends in the money and capital markets.

Duty of NBIs and Auditors It is mandatory for every NBI to furnish the statements/information/particulars called for and comply with any direction given by the RBI. The auditors of a NBI have an obligation to enquire into the status of compliance with the requirements relating to deposits and report it to the RBI. In public interest/in the interest of the depositors or for the purpose of assessment of the books of accounts, the RBI may issue directions to NBFCs/their auditors relating to balance sheet, profit and loss account, disclosure of liabilities in the books of accounts or any other related matter. The auditor should include in his statutory report, under the Companies Act, the contents of the report submitted to the RBI regarding the compliance status. The RBI can, in public interest/in the interest of the NBFC(s)/depositors, also order for a special audit of the accounts in relation to any specified transaction(s)/period(s). It can also appoint an auditor(s) to conduct the specific audit and report to it. The remuneration of the auditors, fixed by the RBI, having regard to the nature and volume of work involved, and the expenses incidental to the audit would be borne by the concerned NBFC.

A NBFC which violates any of the provisions or fails to comply with any direction(s), may be prohibited from accepting any deposit. If necessary, in public interest or in the interest of the depositors, the RBI may further direct such a company not to sell/transfer/create, charge, mortgage or deal in any manner with its properties/assets for a period not exceeding six months from the date of the order, without its prior written permission.

On being satisfied that the NBFC: **(a)** is unable to pay its debt, that is, has refused/failed to meet within five days any lawful demand, **(b)** has been disqualified to carry on business, **(c)** has been prohibited from receiving any deposit by order in force for not less than three months, **(d)** its continuance is detrimental to public interest or in the interest of the depositors. The RBI may file an application under the Companies Act for its winding-up, a copy of which must be sent to the Registrar of Companies. All the provisions of the Companies Act would be applicable to the winding-up process.

Inspection The RBI has the power to order inspection by its officers/employees or any other person (inspecting authority) of any NBI/FI **(a)** for the purpose of verifying the correctness/completeness of any statement/information/particulars furnished to it or obtaining any information/particulars which the NBI/FI has failed to furnish and **(b)** if it is necessary or expedient to inspect that NBI/FI. The management/ directors/ officers/employees of the NBI/FI must produce all books of accounts/documents and furnish all information/statements relating to its business to the inspection authority, which may also examine them on oath.

Soliciting Deposits, Disclosure of Information and Exemption Nobody is allowed to solicit deposits on behalf of NBFCs by publishing a prospectus or advertisement or through any other manner, unless he is authorised in writing to do so, and the advertisement/prospectus conforms to the RBI stipulations and the other provisions of law.

Any information relating to a NBFC, contained in any statement/return submitted by it/obtained through audit/inspection by the RBI, would be treated confidential and would not be disclosed. This restriction, however, does not apply to the following:

- Disclosures of information submitted by a NBFC with the previous permission of the RBI.
- Publication of any information collected by the RBI, in public interest, in a consolidated form, without disclosing the name of the NBFC or its borrowers.
- Disclosure/publication by the NBFC/RBI of any such information to another NBFC or in accordance with practice and usage, customary amongst such companies, or as permitted/required under any other law.

However, in public interest, or in the interest of the depositors/NBFC, or to prevent the affairs of the NBFC being conducted in a manner detrimental to the interest of the depositors, the RBI may, on its own or on request, furnish/communicate any information relating to the conduct of business of a NBFC to any authority constituted under any law. Nevertheless, no court/tribunal/authority can compel it to produce/give information or any statement/other material obtained by it from the NBFCs.

The RBI is empowered to exempt the NBIs/NBFCs from the application of any/all provision(s), either generally or for specified period, subject to any conditions/limitations/restrictions imposed by it.

Repayment of Deposit/Nomination by Depositors These provisions override all other laws in force. The deposits accepted by the NBFCs should be repaid in accordance with the relevant terms and conditions or renewed. If a NBFC fails to repay any deposit, the Company Law Board (CLB) is empowered to order the repayment of deposit immediately/within a specified time and subject to the specified conditions. The CLB would have to satisfy itself, either on its own motion or an application of the depositor(s), that it is necessary to do so to safeguard the interests of the company/depositors or the public.

The depositor(s) can nominate one person to whom, in the event of his/their death, the deposit money would be returned by the NBFC. The nominee-depositor would become entitled to all the rights of the depositor(s), unless the nomination is varied/cancelled in the prescribed manner. If the nominee is a minor, the depositor(s) can appoint any person to receive the amount of deposit in the event of his death, during the minority of the nominee. Payment to the nominee would constitute a full discharge, to the NBFC, of its liability, with respect to the deposit. The NBFC would neither receive any notice of claim from any person other than those in whose name(s) a deposit is held nor would it be bound by any such notice, even though expressly given to it. However, it would have to take note of any decree/order/certificate/other authority from a court of competent jurisdiction relating to such a deposit produced before it.

Penalties In case any prospectus/advertisement inviting deposit from the public, knowingly makes a false statement in any material particular knowing it to be false or omits to make a material statement, the person responsible would be punishable with imprisonment for a term up to three years and would also be liable to a fine. Failure by a person to produce any book/account/other document or to furnish any statement/information/particulars is punishable with fine up to ₹2,000 for each offence and refusal to comply or persistence in such failure with fine extending to ₹100 for every day after the first, during which the offence continues.

The penalties for the contravention of the provisions of the RBI Act are as listed below.

- Relating to the requirement of registration and net owned funds of NBFCs (Section 45IA), imprisonment for a term of not less than one year, but may extend up to five years; and fine of not less than ₹1 lakh, which may extend to ₹5 lakh.
- Failure of auditors to comply with any direction/order of the REI (Section 45MA), a fine not exceeding ₹5,000.
- Non-compliance with any order of the Company Law Board, relating to the repayment of deposit (Section 45QA), imprisonment for a term of up to three years and a fine of not less than ₹50 for every day during which non-compliance continues.

If any person, other than an auditor, receives any deposit in contravention of, or fails to comply with, any direction given/order made by the RBI under Chapter III-B, he can be punished with imprisonment up to three years and fine up to a maximum of twice the amount of deposit received.

In case of issue of any prospectus/advertisement by an unauthorised person or violation of orders pertaining to the condition, subject to which any prospectus/advertisement can be issued, the penalty would be imprisonment extending to three years and a fine that may extend to twice the amount of deposit called for.

Power of RBI to Impose Fine Where the above contraventions/defaults are committed by a NBFC, the RBI is authorised to impose:

(i) A penalty not exceeding ₹5,000 and

(ii) Where the contravention relates to the requirement of registration and net owned funds or receipts of any deposit/compliance with any direction given/order made, a penalty of ₹5 lakh or twice the amount involved in such contravention/default. In case of continuation of the violation, a further penalty up to ₹25,000 for every day, after the first, during which the default continues.

The penalty imposed by the RBI is payable within 30 days from the date on which the notice demanding payment is served on the NBFC. In the event of the non-payment, the RBI may obtain a direction from a court specifying, in a certificate, the sum payable by the NBFC. The certificate would be enforceable in the same manner as if it were a decree made by the court in a civil suit.

Provisions of Chapter III-C

Subject to the provisions of Chapter III-B, non-corporates are not permitted to accept deposits after April 1, 1997. However, individuals can accept deposits from: **(i)** relatives, **(ii)** any other individual, for his personal use but not for lending or business purposes. Non-corporate entities that hold deposits should repay it immediately after such deposit becomes due for repayment or within two years from the date of such commencement, whichever is earlier. They are prohibited from issuing, or causing to be used, any advertisement, in any form, for soliciting deposit.

If certain documents related to the acceptance of deposits, in contravention of the requirements, are secreted in any place, a court, on application by an authorised officer of the RBI/State Government, may issue a warrant to search for the documents. Such warrants would have the same effect as one issued under the Code of Criminal Procedure.

If a person contravenes any of the above provisions, he wold be punishable with imprisonment for a term that may extend to two years or with a fine up to twice the amount of deposit received or ₹2,000, whichever is more, or with both. Generally, the imprisonment and the fine would not be less than one year and ₹1,000, respectively. A fine exceeding ₹2,000 may be imposed in special circumstances.

RBI NBFCs ACCEPTANCE OF PUBLIC DEPOSITS DIRECTIONS, 2016

In pursuance of its powers, under the provisions of Chapters III-B and III-C, the RBI has issued directions to regulate acceptance of deposits by NBIs/FIs. These directions contain provisions regulating the amount/period of deposits, rates of interest, brokerage and so on. They also exempt from their purview certain types of borrowings/money received by these companies. The directions issued by the RBI so far are: **(i)** NBFCs Directions, 1977, **(ii)** MNBCs Directions, 1977 and **(iii)** RNBCs Directions, 1987. They also pertain to advertisement, namely, NBFCs/MNBCs/RNBCs Advertisement Rules, 1977. In the public interest and to regulate the credit system to the advantage of the country, exercising the powers conferred by Section 45J/K/L/MA of the amended RBI Act, the RBI issued the NBFC's Acceptance of Public Deposits (RBI) Directions, 1998, in place of NBFC Directions, 1977. The main elements of RBI Directions, 2016 are discussed below.

Scope and Meaning of NBFCs/MNBCs/RNBCs

Meaning of NBFCs The directions supply to a NBFC which means only the non-banking institution, which is any asset finance, investment, loan or mutual benefit financial company but excludes an insurance company/stock exchange/stockbroking company/merchant banking company. A mutual benefit company/financial company is not covered. The directions are also not applicable to NBFCs that do not accept/hold public deposits. Such NBFCs have to pass a resolution in a meeting of the Board of Directors, within 30 days of the commencement of the financial year, to the effect that they have neither accepted nor would accept any public deposit during the year. Investment companies that have acquired shares/securities of their own group/holding/subsidiary companies only—of not less than 90 per cent of their total assets—do not trade in these shares/securities and do not accept/hold public deposits are also exempt from these directions. For this purpose, their Board of Directors have to pass a resolution within 30 days of the commencement of each financial year.

The RBI can grant, to avoid any hardship for any just and sufficient reason, extension of time to comply with or exempt any NBFC/class of NBFCs from all or any of these directions, either generally or for any specified period, subject to such conditions as it may impose.

The term company refers to a public/private Indian/foreign company. The NBFCs, for the purpose of these directions, are classified into the following categories.

Asset Finance Company (AFC) This means any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. The principal business means that the aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60 per cent of its total assets and total income respectively.

Investment Company (IC) A company that is a financial institution carrying on, as its principal business, the acquisition of securities.

Loan Company (LC) This means any company that is a financial institution whose principle business is providing finance, whether by making loans or advances or otherwise for any activity other than its own, but does not include an asset finance company.

Mutual Benefit Company (MBC)/Mutual Benefit Finance Company (MBFC) A MBC is a company which is a financial institution that is not notified by the Central Government under Section 620-A of the Companies Act, 1956, but has at least ₹10 net owned funds and preferential share capital and complies with the requirements contained in the relevant provisions of the Directions issued under Section 637-A of the Companies Act to Nidhi Companies by the Government. A MBFC is a financial institution notified by the Government under Section 620-A of the Companies Act.

The question as to whether a company is a financial institution or not would be decided by the RBI in consultation with the Government. Moreover, the question as to whether a financial institution is a company in any of the foregoing five categories would be decided by the RBI, considering the principal business of the company and other relevant factors. The principal business of a financial company engaged in hire-purchase financing and equipment leasing activities will be decided by the RBI, after taking together the volume of both types of business and other related factors. Only such companies as have been specifically notified under Section 620-A of the Companies Act by the Government will be classified as Nidhi Companies.

Meaning of MNBCs A MNBC means a company or a financial institution carrying on all or any of the following types of business:

(a) Collection of money in one lump sum/instalments, by way of **(i)** contributions/subscriptions, **(ii)** sale of units/certificates/other instruments, **(iii)** in any other manner, **(iv)** as membership/admission fee, **(v)** service charges to/or with respect to any savings, mutual benefits, thrift or any other scheme/arrangement and utilisation of the collected money or the income accruing from investment for all/any of the following purposes:
   1. To give/award to subscribers by a draw of lots prizes/gifts in cash/kind.
   2. To refund to the subscribers the subscriptions/contributions/other money collected with/without any bonus/premium/interest rate on the termination of the scheme/arrangement or on/after the expiry of the stipulated period.

(b) Manage/conduct/supervise transaction/arrangement relating to an agreement with the subscribers, each one of whom subscribes a certain sum in instalments over a definite period, and is entitled to a prize amount on the basis of draw of lots or by auction/tender.

(c) Conduct any other form of chit/kuri.

(d) Undertake/carry on/engage in/execute any other business similar to those referred to above.

Meaning of RNBCs The RBI directions, 1987, define RNBCs as companies that are a non-banking institution receiving deposits under any scheme/arrangement in one lump sum/instalments by way of contributions/subscriptions or by sale of units/certificates/other instruments or in any other manner. NBFCs and MNBCs are excluded from the category of RNBCs. In other words, all non-banking companies other than NBFCs and MNBCs fall into the category of RNBCs.

Acceptance of Deposits

The Directions regulate the acceptance of public deposits, as defined under Section 45I(bb) of the RBI Act, excluding the amount received from the following.

- Received from or guaranteed by the Central/State government, local authority, foreign government/citizen, authority or person.
- Received from IDBI/LIC/GIC/SIDBI/UTI/NABARD/Electricity Boards/TIIC/ NIDC/ICICI/ IFCI/IIBI/STC/REC/MMTC/SIDCs/ADB/IFC/ any institution specified by the RBI.
- Received from any other company.
- Received by way of subscription to shares/stock/bonds debentures, or by way of calls in advance on shares.
- Received from directors/shareholders, provided the amount is not given out of borrowed/ acquired funds from others. However, in the case of joint shareholders of a private company, money received from or in the name of the joint shareholders, except the first named shareholder, would not be eligible to be treated as a receipt of money from the shareholders of the company.
- Raised by issue of convertible bonds/secured debentures not exceeding the market value of the security.
- Brought in by promoters by way of unsecured loan—in pursuance of stipulations of lending institutions, in fulfillment of their obligations—provided the loan is brought in by promoters or their relatives, but not from friends/business associates, till the repayment of the institutional loan.
- Received from mutual funds.
- Received as hybrid debt/subordinated debt, with a minimum maturity period of 60 months without option for recall by the issuer.
- Received from a relative of a director of a NBFC.
- Received by issuance of commercial papers.
- Received by a systematically important non-deposit taking NBFC by issuance of perpetual debt instruments.
- Raised by issue of infrastructure bonds by an infrastructure finance company.

Restrictions on Mutual Benefit Financial Companies (MBFCs)/Mutual Benefit Companies (MBCs) Such companies can accept/renew deposits only from their shareholders, provided they are not in the nature of current account deposits. However, they cannot issue advertisements in any form and in any media for inviting deposits from them. They are also not permitted to pay any brokerage/commission/incentive or any other benefit to any person for collecting deposits. The other provisions of these directions are not applicable to MBFCs/MBCs, with the exception of the ceiling on the rate of interest on deposits (specified subsequently).

Restrictions on Non-Banking Financial Companies (NBFCs) Minimum Credit Rating NBFCs that have minimum net owned funds (NOF) of ₹25 lakh can accept public deposits, provided they obtain minimum investment grade or other specified credit rating for their fixed deposits from one of the approved rating agencies, at least once a year. A copy of the rating must be sent to the RBI along with the return, on prudential norms. However, these stipulations do not apply to an asset finance company. The RBI must also be informed, in writing, within 15 days of the upgradation/ downgrading of the ratings, if any. The stipulated minimum credit rating from the various credit rating agencies are as specified below:

	Credit Rating Agency	*Minimum Rating*
1.	Credit Rating Information Services of India Ltd (CRISIL)	FA-(FA Minus)
2.	Investment Information and Credit Rating Agency of India Ltd. (ICRA)	MA-(MA Minus)
3.	Credit Analysis & Research Ltd (CARE)	CARE BBB (FD) (Triple B)
4.	FTICH Rating India Private Ltd	[t_A-(ind) (FD)]
5.	Brickwork Rating India Pvt. Ltd. (Brickwork)	[(BWR) (FA)]
6.	SME Rating Agency of India Ltd (SMERA)	SMERA (A)

Periods of Deposits NBFCs cannot accept deposits payable on demand. They can accept/renew deposits for a minimum period of 12 months to a maximum period of 60 months from the date of acceptance/renewal.

Ceiling on Quantum of Deposit An asset finance/loan/investment company/factor having RBI stipulated NOF and complying with all prudential norms can accept/renew deposits upto one and one-half times of its NOF.

Down Grading of Credit Rating In the event of downgrading of credit rating below the minimum specified investment grade, their excess deposit should be regularised in the manner specified. They must immediately stop accepting deposits and report the position within 15 working days to the RBI. All existing deposits should run-off maturity.

Ceiling on the Rate of Interest There is a ceiling on the rate of interest on deposits. It may be paid or compounded at rests not shorter than monthly rests. The ceiling is currently 12.5 per cent.

Payment of Brokerage The permissible brokerage, commission, incentive or any other benefit on deposits with all NBFCs is 2 per cent of the deposit. The expenses, by way of reimbursement on the basis of related vouchers/bills produced, up to 0.5 per cent of the deposits are also permitted.

Intimation of Maturing of Deposits It is obligatory for a NBFC to intimate the details of maturely of the deposit to the depositor at least two months before the date of its maturity

Renewal of Deposits NBFCs can permit existing depositors to renew their deposits before maturity to avail of the benefit of a higher rate of interest provided: **(i)** the deposit is renewed in accordance with the other provisions of these directions and for a longer duration than the remaining period of the original contract and **(ii)** the interest on the expired period of the deposit is reduced by 1 per cent from the rate that the NBFC would have ordinarily paid had the deposit been accepted for the period for which it has run; any interest paid earlier in excess of such reduced rate is recovered/adjusted. In this context, a depositor means any person who has made a deposit with a company; or a heir, legal representative, administrator or assignee of the depositor.

Payment of Interest on Overdue Deposits The directions permit NBFCs to pay interest, at their discretion, on overdue public deposits/or a portion of it from the date of maturity if:

(i) The total amount/part of the overdue deposit is renewed from the date of maturity till some future date according to the other relevant provisions of these directions and

(ii) The interest should be appropriate rate operative on the date of maturity of such overdue deposits, which would be payable only on the amount of renewed deposits.

If the NBFC fails to repay the deposit along with interest on maturity, following a claim made by the depositor, it would be liable to pay interest from the date of claim till the date of repayment, at the rate as applicable to the deposit.

In regard to the payment of interest on deposits which have been seized by the Government authorities/frozen till further clearance is received from them, the NFCs should follow the following procedure: **(i)** obtain a request letter from the customer on maturity for renewal including the term for renewal failing which the renewal may be for a term equal to the original terms; **(ii)** make a suitable note regarding renewal in the deposit ledger; **(iii)** advise by registered letter/speed post/courier service to the concerned Government department under advice to the depositor mentioning the rate of interest on renewal; and **(iv)** renewal may be done from the date of maturity in case the overdue period does not exceed 14 days on the date of the receipt of the request letter. For overdue period exceeding 14 days, any interest paid should be kept in a separate interest free sub-account and released together with the original deposit. However, the final repayment of the principal and the accrued interest should be made only after clearance from the respective Government agencies.

Joint Deposits Deposits may be accepted by the NBFCs in joint names with/without any of the clauses, that is, either or survivor, number one or survivor(s), anyone or survivor(s).

Particulars in Application Forms All NBFCs are required to accept/renew deposits only on a written application form, to be supplied by them to the depositors. The form should contain all particulars specified in the NBFCs/MNBCs Advertisement Rules, 1977. The application form should also contain the specific category of the deposits, that is, shareholder/director/promoter/member of public. The following additional information should also be included in them.

1. The credit rating assigned for its fixed deposit and the name of the credit rating agency or a statement from the management, if it is AFC that the quantum of public deposit held by it does not exceed 1.5 times of its NOF or not more than rupees ten crore, whichever is less.
2. In case of non-payment of the deposit/a part, as per the terms and condition of such deposits, the depositor may approach the Eastern/Western/ Northern/Southern Bench of the Company Law Board (specify full address) under whose jurisdiction the registered office of the NBFC is located.
3. In case of any deficiency of the NBFC in servicing its deposits, the depositor may approach the National/State/District Level Consumer Research Forum for relief.
4. A statement that the financial position of the NBFC, as disclosed, and the declarations made in the application form are true and correct and the NBFC and its Board of Directors are responsible for their correctness and veracity.
5. The financial activities of the NBFC are regulated by the RBI. It must, however, be distinctly understood that the **RBI does not undertake any responsibility for the financial soundness or for the correctness of any of the statements or the representation made or opinions expressed and for repayment of deposit/discharge of liabilities by the NBFC.**
6. At the end of application form, but before the signature of the depositor, the following verification clause by the depositor should be appended. **"I have gone through the financial and other statements/particulars/declarations made/furnished by the**

NBFC and after careful consideration I am making the deposit with the NBFC at my own risk and volition".

7. The information relating to and the aggregate dues from the facilities, both fund and non-fund based, extended to and the aggregate dues from companies in the same group/other entities/business ventures in which directors/the NBFC are holding substantial interest, and the total amount of exposure to such entities.

Every NBFC should obtain proper introduction of new depositors before opening their accounts and accepting deposits and keep on its records the evidence it has relied upon for the purpose of such introduction.

Advertisement and Statement in Lieu of Advertisement All NBFCs have to mandatorily comply with the provisions of the NBFCs/MNBCs Advertisement Rules, 1977. They also should specify the following in every advertisement:

- **(i)** Actual rate of return by way of interest, premium, bonus and other advantages to depositors;
- **(ii)** Mode of repayment of deposit;
- **(iii)** Maturity period of deposit;
- **(iv)** Interest payable on deposits;
- **(v)** Rate of interest payable on premature withdrawal of the deposits;
- **(vi)** Terms and conditions for the renewal of deposits;
- **(vii)** Any other special features relating to the terms and conditions for the acceptance/renewal of deposits and
- **(viii)** Information relating to the aggregate dues (including the non-fund based facilities provided to) from companies in the same group or other entities/business ventures in which the Directors and/or the NBFC are holding substantial interest, and the total amount of exposure to such companies.
- **(ix)** The deposits are not insured.

Where an NBFC displays any advertisement in electronic media, even without soliciting deposits, it should incorporate a caption/band in such advertisement indicating: **(i)** as regards deposits taking activity of the company, the viewers may refer to the newspaper/information furnished in the application form for soliciting public deposits, **(ii)** the company is having a valid certificate of registration from the RBI. However, the RBI does not accept any responsibility/guarantee about the present position as to the financial soundness of the company or for the correctness of any of the statements/representation made/opinions expressed by the company and for repayment of deposits/discharge for the liabilities by the company.

Where a NBFC intends to accept deposits without inviting such deposits, it has to file a statement in lieu of the advertisement with the RBI containing all the particulars specified above and duly signed in the specified manner. Such a statement is valid for six months. Fresh statements would have to be delivered in each succeeding year before accepting public deposit in that financial year.

General Provisions Regarding Repayment of Public Deposits The provisions are discussed below:

Lock-in Period An NBFC can not grant loan against, or make premature repayment of, a public deposit within the lock-in period of 3 months from the date of its acceptance. However, in the event of the death of a depositor, the NBFC may on request repay it prematurely even within the lock-in period on submission of satisfactory proof of death to the joint depositor/nominee/legal heir of the depositor.

Repayment of Deposits by a Non-Problem NBFC A non-problem NBFC may **(1)** permit premature repayment of a public deposit at its sole direction; it may repay prematurely after three months from the date of deposit at the request of the depositor, **(2)** grant a loan upto 75 per cent of the deposit after 3 months from the date of deposit at a rate of interest 2 percentage points above the rate of interest payable on the deposit.

Repayment by a Problem NBFC **A problem NBFC** means a NBFC which **(i)** has refused/failed to meet within 5 days any lawful demand for repayment of a matured deposit, or **(ii)** intimates the Company Law Board under Section 58-AA of the Companies Act about its default to a depositor in repayment of any deposit/a part of it/any interest on it, or **(iii)** approaches the RBI for withdrawal of liquid asset securities to meet deposit obligations, or for any relief/relaxation/exemption from the provisions of the RBI Public. Deposits Acceptance Prudential Norms Directions, or **(iv)** has been identified by the RBI to be a problem NBFC either **suo motu** or based on complaints from depositors/lenders about non-payment of public deposits/dues. Such a company may, to enable a depositor to meet expenses of an emergent nature, prematurely **(a)** repay a tiny deposit (i.e. aggregate amount not exceeding ₹10,000 in the name of the sole/first named depositor in all the branches of the NBFC) in entirety/upto ₹10,000 in case of any other deposit, **(b)** grant a loan of a similar amount at a rate of interest 2 percentage points above the rate of interest payable on the deposit.

For the purpose of premature repayment, all deposit accounts standing to the credit of sole/first named depositor should be clubbed and treated as one account. Where an NBFC prematurely repays a public deposit for any of the above reasons, it would pay interest at the following rates: **(a)** After 3 months but more than 6 months: not interest, **(b)** After 6 months but before maturity: 2 per cent lower than the interest applicable to a deposit for the period for which the concerned deposit has run. If no rate has been specified for that period, 3 per cent lower than the minimum rate at which public deposits are accepted by the NBFC.

Deposit Receipts All NBFCs/MNBCs/RNBCs have to furnish depositors/joint depositors or their agents with a receipt of the deposit, stating the date of deposit, name of the depositor(s), the amount of deposit (in words and figures), rate of interest and date of maturity. It must be signed by an officer who can act on behalf of the company in this regard.

Register of Deposits All NBFCs/MNBCs/RNBCs have to keep register(s) of deposits, containing each depositor's particular, as detailed below:

(a) Name and address,
(b) Date and amount of each deposit,
(c) Duration and due date of each deposit,
(d) Date and amount of accrued interest/premium on each deposit,
(e) Date of claim made by depositor,
(f) Date and amount of each repayment of principal/interest,
(g) Reason for delay in repayment beyond five working days and
(h) Any other particulars relating to the deposits.

The register of deposits should be kept at respective branches of the NBFC and, a consolidated register for all the branches at its registered office, for at least eight years following the financial year in which the latest entry is made for repayment/renewal of any deposit whose particulars are contained in the register.

Branches and Appointment of Agents to Collect Deposits An NBFC registered with the RBI/otherwise entitled to accept public deposits can open a branch or appoint agents to collect deposits **(i)** within the State where its registered office is situated, **(ii)** anywhere in India if its NOF is more than ₹50 crore with a credit rating above **AA**. The NBFC should notify the RBI of its intention to open the proposed branch. Within 30 days from the date of receipt of such notice/advice, if no advice of rejection of the proposal is communicated by the RBI, the NBFC may proceed with its proposal.

Closure of Branches An NBFC can close its branch(es)/office(s) after publishing its intention in one national level newspaper and in one vernacular newspaper in circulation in the relevant place, and advising the RBI 90 days before the proposed closure. Within 7 days of its publication, and intimation should be sent to the RBI.

Safe Custody of Liquid Assets/Collection of Interest on SLR Securities Every NBFC should open a Constituent's Subsidiary General Ledger (CSGL) account with a bank/Stock Holding Corporation of India (SHCIL) or a demat account with a depository to keep the unencumbered approved securities. It should also designate a bank as its designated banker to entrust in physical form its unencumbered term deposits which are not dematerialised. Such securities would be traded according to the specified procedure and the extent permitted. They can be used only for repayment to depositors with the RBI's prior approval.

Information to be Included in the Board's Report In every report of the Board of Directors of NBFCs under Section 217 of the Companies Act, the following particulars or information must be included:

(i) The total number of accounts of public deposit of the NBFC that have not been claimed by the depositors or not paid by the NBFC after the date on which the deposit became due for repayment and

(ii) The total amounts due to such accounts remaining unclaimed or unpaid beyond the due dates.

These particulars or information should be furnished with reference to the position as on the last day of the financial year to which the report relates and if the amounts remaining unclaimed or undisbursed exceed in the aggregate a sum of ₹5 lakh, the report should also contain a statement on the steps taken or proposed to be taken by the Board of Directors for the payment of the remaining unclaimed or undisbursed amounts due to the depositors.

Employees Security Deposit All NBFCs receiving any amount, in the ordinary course of their business, as security deposit from any of their employees, for due performance of their duties, should keep such amount in an account with a scheduled commercial bank or in the post office in the joint names of the employees and the NBFC on the condition that the amount would not be withdrawn without the written consent of the employee, and it is repayable to the employee along with the interest payable on such deposit account, unless such amount or any part of it is liable to be appropriated by the NBFC for failure on the part of the employee in the due performance of his duties.

Submission of Accounts All NBFCs accepting/holding public deposits have to deliver to the RBI—at the Regional Office of the Department of Non-Banking Supervision, within whose jurisdiction their registered offices are located—an audited balance sheet as on the last date of each financial year and an audited profit and loss account in respect of that year, as passed by the company in general meeting, together with a copy of the report of the Board of Directors, within 15 days of such meeting, as also a copy of the report and notes on the accounts furnished by its auditors.

Cover for Public Deposits To ensure protection of depositors interest, all NBFCs should ensure that there is full cover for all public deposits. They should create a registered floating charge on their statutory liquid assets in their favour through a Trust Deed.

On failure to repay a public deposit, NBFCs are prohibited from granting loan/other credit facility or making any investment creating any other asset as long as the default exists.

Restrictions on Investments The ceiling on investment in land/building, except for own use, by asset finance/loan/investment company is 10 per cent of owned fund. While AFCs can invest upto 10 per cent of owned fund in unquoted shares of a company, other than a subsidiary/same group company, the ceiling for a loan/investment company is 20 per cent. These restrictions would not apply to investment in equity capital of an insurance company.

Provision for Submitting Auditor's Certificate All NBFCs holding/accepting public deposits are required to furnish to the RBI, along with a copy of the audited balance sheet, a copy of the auditor's report to the Board of Directors and a certificate from its auditor to the effect that the full liabilities to the depositors of the company, including the interest payable, are properly reflected in the balance sheet and that the company is in a position to meet the amount of such liabilities to the depositors.

Information to RBI The NBFCs should also intimate to the RBI within one month from the occurrence of any of the following changes:

(i) The complete postal address, telephone number(s) and fax number(s) of the registered/corporate office;
(ii) The names and residential address of the directors of the company;
(iii) The names and the official designation of its principal officers;
(iv) The specimen signatures of the officers authorised to sign on behalf of the company and
(v) The names and office addresses of the auditors of the company.

NON-BANKING FINANCIAL COMPANY—SYSTEMICALLY IMPORTANT NON-DEPOSIT TAKING AND DEPOSIT TAKING COMPANY DIRECTIONS, 2016

The RBI **(i)** in public interest, **(ii)** to regulate the financial system to the advantages of the country and **(iii)** to prevent the affairs of any systematically important non-deposit taking non-banking financial company (**NBFC-ND-SI**) and deposit taking non-banking financial company (**NBFC-ND**) from being conducted in a manner detrimental to the interest of investors/depositors or in any manner prejudicial to the interest of the NBFCs, has been issuing directions in exercise of its powers under the RBI Act and the Factoring Regulation Act since 1998. These were comprehensively revised in 2016. The directions relating to the NBFC-ND-SI and NBFC-D are discussed in this Section. The provisions of the directions relating to the NBFC-Non-systematically important non-deposit taking companies (**NBFC-ND**) are covered in the next Section.

The provisions of these Directions apply to the following: **(i)** systemically important non-deposit taking NBFCs, **(NBFC-ND-SI)**, **(ii)** deposit-taking NBFC **(NBFC-D)**, **(iii) NBFC-factor**, **(iv)** infrastructure debt fund – NBFC **(IDF-NBFC)**, **(v)** NBFC – micro finance institutions **(NBFC-MFIs)** and **(vi)** NBFC - infrastructure finance Company **(NBFC-IFC)** having an asset size of ₹500 crore and above. They are referred to as **applicable NBFCs**. The specific directions applicable to the specific categories of NBFCs registered as NBFC-Factors, IDF-NBFCs and NBFC-MFIs are also discussed in this Section.

A **systematically important** non-deposit taking NBFC means a NBFC not accepting/holding public deposits and having maximum total assets of ₹500 crore. The minimum net owned fund for a NBFC to commence/carry on business is ₹200 lakh, failing which it would not be eligible to hold certificate of registration (CoR) as NBFC from the RBI.

Infrastructure Debt Fund-Non-Banking Financial Company (IDF-NBFC) An IDF-NBFC means a non-deposit taking NBFC that has minimum net owned fund of ₹300 crore or more and which invests only in public private partnerships (PPP) and post-commencement operations date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a tripartite agreement.

An **Infrastructure Finance Company (NBFC-IFC)** means a non-deposit taking NBFC that has: **(a)** a minimum of 75 per cent of its total assets deployed in “infrastructure loans”; **(b)** minimum net owned funds of ₹300 crore; **(c)** minimum credit rating ‘**A**’ or equivalent; **(d)** CRAR of 15 per cent (with a minimum Tier-I capital of 10 per cent).

Infrastructure lending means a credit facility extended by NBFC to a borrower, by way of term/project loan, subscription to bonds/debentures/preference shares/equity shares in a project company acquired as a part of the project finance package such that subscription amount to be “in the nature of advance” or any other form of long term funded facility for exposure in the following infrastructure sub-sectors, namely, transport, energy, water and sanitation, communication and social and commercial infrastructure.

A **Non-Banking Finance Company – Factor (NBFC-Factor)** means a non-banking financial company having at least 50 per cent of **(i)** its total assets in financial assets and **(ii)** gross income from factoring business.

A **Non-Banking Financial Company – Macro Finance Institution (NBFC-MFI)** means a non-deposit taking NBFC having minimum net owned funds of ₹5 crore and not less than 85 per cent of its net assets are in the nature of **qualifying assets**. **Net assets** mean total assets other than cash and bank balances and money market instruments. **Qualifying asset** means a loan which satisfies the following criteria: **(i)** loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹1,00,000 or urban and semi-urban household not exceeding ₹1,60,000; **(b)** loan amount does not exceed ₹60,000 in the first cycle and ₹1,00,000 in subsequent cycles; **(iii)** total indebtedness of the borrower does not exceed ₹1,00,000 and medical expenses should be included while arriving at the total indebtedness of a borrower; **(iv)** tenure of the loan to be not less than 24 months for loan amount in excess of ₹30,000 with prepayment without penalty; **(v)** loan to be extended without collateral; **(vi)** aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs; and **(vii)** loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower. A **Non-Operative Financial Holding Company (NOFHC)** means a non-deposit taking NBFC which holds the shares of the banking company and the shares of all other financial services companies in its group.

The main elements of the NBFC-ND-ST/NBFC-D directions: **(i)** prudential issues and **(ii)** governance issues are discussed below.

Prudential Issues

The prudential issues pertain to **(i)** capital requirements, **(ii)** prudential regulations, **(iii)** fair practices, **(iv)** specific directions applicable to NBFC-Factor, IDF-NBFC and NBFC-MFIs.

Capital Requirements Every applicable NBFC should maintain a minimum capital ratio consisting of Tier-I and Tier-II capital of 15 per cent of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items. The minimum Tier-I capital in respect of applicable NBFCs (other than NBFC-MFI and IDF-NBFC), at any point of time should be 10 per cent. The NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 per cent or more of their financial assets) should maintain a minimum Tier-l capital of 12 per cent. Tier-I capital means **(a)** owned funds as reduced by investment in **(i)** shares of other NBFCs and **(ii)** shares/debentures/bonds/outstanding loans and advance including hire-purchase/lease finance made to, and deposits with, subsidiaries/companies in the same group in excess of 10 per cent of the owned fund and **(b)** perpetual debt instrument issued by the NBFC in each year upto the extent of 15 per cent of its aggregate Tier-I capital. Owned funds means paid-up capital, compulsorily convertible preference share, free reserves, balance in share premium account and capital reserves, excluding revaluation reserves, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure. Group company means an arrangement involving two/more related entities through any of the following relationships: **(i)** subsidiary-parent, **(ii)** joint venture, **(iii)** associate, **(iv)** promoter-promotee for listed companies, **(v)** related party, **(vi)** common brand name and **(vii)** minimum investment in equity shares of 20 per cent. Tier-II capital includes the following:**(a)** preference shares other than those which are compulsorily convertible into equity, **(b)** revaluation reserves at discounted rate of 55 per cent, **(c)** general provisions (including that for standard assets) and loss reserves to the extent not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of 1.25 per cent of risk weighted asset, **(d)** hybrid debt capital instruments (i.e. which passes certain qualities of debt as well equity), **(e)** subordinated debt; and **(f)** perpetual debt instruments in excess of what qualifies for Tier-I capital, to the extent the aggregate does not exceed Tier-I capital. Subordinated debt means an instrument, which is **(i)** fully paid up, **(ii)** unsecured, **(iii)** subordinated to the claims of other creditors and **(iv)** free from restrictive clauses and **(v)** not redeemable at the instance of the holder or without the consent of the supervisory authority of the NBFC. This book value would be subjected to discounting as shown below to the extent such discounted value does not exceed 50 per cent of Tier-I capital.

Remaining maturity of the instruments	*Rate of discount (%)*
(a) Upto one year	100
(b) More than 1 year but upto 2 years	80
(c) More than 2 years but upto 3 years	60
(d) More than 3 years but upto 4 years	40
(e) More than 4 years but upto 5 years	20

I. On-Balance Sheet Assets Degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset/item requires to be multiplied by the relevant risk weight to arrive at risk adjusted value of assets. The aggregate should be taken into account for reckoning the minimum capital ratio. The risk weighted asset should be calculated as the weighted aggregate of funded items as detailed below:

	Weighted Risk Assets – On Balance Sheet Items	*Percentage weight*
(i)	Cash and bank balances including fixed deposits and certificates of deposits with banks	0
(ii)	Investments	
	(a) Approved securities [expected at **(c)** below]	0
	(b) Bonds of public sector banks	20
	(c) Fixed deposits/certificates of deposits/bonds of public financial institutions	100
	(d) Shares and debentures/bonds/commercial papers of all companies and units of all mutual funds	100
	(e) All assets covering PPP (public-private-partnership) and post-commercial operations date (COD) infrastructure projects in existence over a year of commercial operations	50
(iii)	Current assets	
	(a) Stock on hire (net book value)	100
	(b) Intercorporate loans/deposits	100
	(c) Loans and advances fully secured against deposits held	0
	(d) Loans to staff	100
	(e) Other secured loans and advances considered good [except at **(vi)** below]	100
	(f) Bills purchased/discounted	100
	(g) Others (to be specified)	100
(iv)	Fixed Assets (net of depreciation)	
	(a) Assets leased out (net book value)	100
	(b) Premises	100
	(c) Furniture and fixtures	100
(v)	Other assets	
	(a) Income tax deducted at source (net of provision)	0
	(b) Advance tax paid (net of provision)	0
	(c) Interest due on Government securities	0
	(d) Others (to be specified)	100
(vi)	Domestic sovereign	
	(a) Fund based claims on the Central Government	0

(b) Direct loan/credit/overdraft exposure and investment in State Government securities	0
(c) Central Government guaranteed claims	0
(d) State Government guaranteed claims, which have not remained in default/which are in default for a period not more than 90 days	20
(e) State Government guaranteed claims which have remained In default for more than 90 days.	100

Notes:

1. Netting should be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.
2. Assets which have been deducted from owned fund to arrive at net owned fund should have a weightage of 'zero'.
3. While calculating the aggregate of funded exposure of a borrower for the purpose of assignment of risk weight, cash margin/caution money/security deposits (against which right to setoff is available) held as collateral against the advances out of the total outstanding exposure of the borrower should be netted off.
4. Norms for investment in securities pertaining to infrastructure facility: (a) Risk weight for investment in AAA rated securitised paper should attract risk weight of 50 per cent subject to the fulfilment of the following conditions: (i) infrastructure facility generates income/cash flows, which ensures servicing/repayment of the securitised paper, (ii) the rating is current and valid, that is, is not more than one month old, and the rating rationale is not more than one year old on the date of opening of the issue, and the rating letter and the rating rationale form part of the offer document, (iii) In the case of secondary market acquisition, the 'AAA' rating of the issue is in force and confirmed from the monthly bulletin published by the respective rating agency, (iv) The securitised paper is a performing asset.

II. Off-balance Sheet Items

(1) General The applicable NBFC should calculate the total risk weighted off-balance sheet credit exposure as the sum of the risk-weighted amount of the market related and non-market related off-balance sheet items. It should be calculated by means of a two-step process: **(i)** the notional amount of the transaction should be converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method; and **(ii)** the resulting credit equivalent amount should be multiplied by the risk weight applicable, for example, zero percent for exposure to Central/State Governments, 20 per cent for exposure to banks and 100 per cent for others.

(2) Non-market-related Off- balance Sheet Items The credit equivalent amount in relation to a non-market related off-balance sheet item should be determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor (CCF) as detailed below.

Sr. No.	*Instruments*	*Cash conversion factor*
(i)	Financial and other guarantees	100
(ii)	Shares/debentures/underwriting obligations	50
(iii)	Partly-paid shares/debentures	100
(iv)	Bills discounted/rediscounted	100

(v)	Lease contracts entered into but yet to be executed	100
(vi)	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the applicable NBFC	100
(vii)	Forward asset purchases, forward deposits and partly paid share and securities, which represent commitments with certain draw down	100
(viii)	Lending of NBFC securities or posting of securities as collateral, including instances where these arise out of repo style transactions	100
(ix)	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of:	
	up to one year	20
	over one year	50
(x)	Similar commitments that are unconditionally cancellable at any time without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness	0
(xi)	Take-out finance in the books of taking-over institution:	
	(i) Unconditional take-out	100
	(ii) Conditional take-out	50
(xii)	Commitment to provide liquidity facility for securitisation of standard asset transactions	100
(xiii)	Second loss credit enhancement for securitisation of standard transactions provided by third party	100
(xiv)	Other contingent liabilities (to be specified)	50

Note:

1. Cash margins/deposits should be deducted before applying the conversion factor.
2. Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility, the amount of undrawn commitment to be included in calculating the off-balance sheet non-market related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms a part of on-balance sheet credit exposure.

   For example: A term loan of ₹700 crore is sanctioned for a large project which can be drawdown in stages over 3-year period. The terms of sanction allow drawdown in three stages: ₹150 crore in Stage I, ₹200 crore in Stage II and ₹350 crore in Stage III, where the borrower needs the applicable NBFC's explicit approval for drawdown under Stages II and III after completion of certain formalities. If the borrower has drawn already ₹50 crore under Stage I, the undrawn portion would be computed with reference to Stage I alone, that is, it will be ₹100 crore. If Stage I is scheduled to be completed within one year, the CCF will be 20 per cent and if it is more than one year then the applicable CCF will be 50 per cent.

(3) Market Related Off-Balance Sheet Items The applicable NBFCs should take into account all market related off-balance sheet items (OTC derivatives and securities financing transactions such as repo/ reverse repo/ CBLO etc.) while calculating the risk weighted off-balance sheet credit exposures. The credit risk on market related off-balance sheet items is the cost to an applicable NBFC of replacing the cash flow specified by the contract in the event of counterparty default. This should depend, among other things, upon the maturity of the contract and on the volatility of rates

underlying the type of instrument. The market related off-balance sheet items would include: **(a)** interest rate contracts including single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate futures; **(b)** foreign exchange contracts, including contracts involving gold, includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options; **(c)** credit default swaps; and **(d)** any other market related contracts specifically allowed by the RBI which give rise to credit risk. Exemption from capital requirements is permitted for - **(a)** foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and **(b)** instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments. The exposures to central counter parties (CCPs), on account of derivatives trading and securities financing transactions (e.g. collateralised borrowing and lending obligations: CBLOs, Repos) outstanding against them should be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures. A CCF of 100 per cent should be applied to the corporate securities posted as collaterals with CCPs and the resultant off-balance sheet exposure should be assigned risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight should be 20 per cent and for other CCPs, risk weight should be 50 per cent. The total credit exposure to a counterparty in respect of derivative transactions shall be calculated according to the current exposure method as explained below.

(4) Current Exposure Method The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of **(i)** Current credit exposure and **(ii)** potential future credit exposure of the contract. **Current credit exposure** is defined as the sum of the gross positive mark-to-market value of all contracts with respect to a single counterparty (positive and negative marked-to-market values of various contracts with the same counterparty should not be netted). The current exposure method requires periodical calculation of the current credit exposure by marking these contracts to market. **Potential future** credit exposure is determined by multiplying the notional principal amount of each of these contracts, irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

Credit Conversion Factors for interest rate related, exchange rate related and gold related derivatives

	Credit Conversion Factors (%)	
	Interest Rate Contracts	*Exchange Rate Contracts and Gold*
1 year or less	0.50	2
Over 1 year to 5 years	1.00	10
Over 5 years	3.00	15

(a) For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

(b) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity should be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the above criteria, the CCF or add-on factor is subject to a floor of 1 per cent.

(c) No potential future credit exposure should be calculated for single currency floating / floating interest rate swaps. The credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

(d) Potential future exposures should be based on 'effective' rather than 'apparent notional amounts'. In the event that the 'stated notional amount' is leveraged or enhanced by the structure of the transaction, the 'effective notional amount' must be used for determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the lending rate of the applicable NBFC would have an effective notional amount of USD 2 million.

(5) Credit Conversion Factors for Credit Default Swaps (CDS): The applicable NBFCs are only permitted to buy credit protection to hedge their credit risk on corporate bonds they hold. The bonds should be held in current category or permanent category. The capital charge for these exposures shall be as under:

(i) For corporate bonds held in current category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, the credit protection should be permitted to be recognised to a maximum of 80 per cent of the exposure hedged. Therefore, the applicable NBFC should continue to maintain capital charge for the corporate bond to the extent of 20 per cent of the applicable capital charge. This can be achieved by taking the exposure value at 20 per cent of the market value of the bond and then multiplying that with the risk weight of the issuing entity. In addition, the bought CDS position should attract a capital charge for counterparty risk which should be calculated by applying a credit conversion factor of 100 per cent and a risk weight as applicable to the protection seller, that is, 20 per cent for banks and 100 per cent for others.

(ii) For corporate bonds held in permanent category and hedged by CDS where there is no -mismatch between the CDS and the hedged bond. The applicable NBFCs can recognise full credit protection for the underlying asset and no capital should be required to be maintained thereon. The exposure should stand fully substituted by the exposure to the protection seller and attract risk weight as applicable to the protection seller, that, 20 per cent for banks and 100 per cent for others.

Prudential Regulations The prudential regulations relate to income recognition, income from investments, accounting standards, accounting of investments, policy on demand call loans, asset classification and provisioning requirements.

Income Recognition The income recognition should be based on recognised accounting principles. Income including interest/discount/hire-charges/lease rentals or any other charges on non-performing assets (**NPA)** should be recognised only when it is actually realised. Any income recognised before the asset became non-performing (NPA) and remaining unrealised should be reversed.

Income From Investments Income from dividend on shares of corporate bodies and units of mutual funds should be taken into account on cash basis. However, the income from dividend on shares should be taken into account on accrual basis when it has been declared by the corporate body in its annual general meeting and the applicable NBFCs right to receive payment is established. Income from bonds and debentures of corporate bodies and from Government securities/bonds should be taken into account on accrual basis if the interest rate on these instruments is pre-determined and interest is serviced regularly and is not in arrears. Income on securities of corporate bodies/public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government, should be taken into account on accrual basis.

Accounting Standards The Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India (**ICAI**) should be followed insofar as they are not inconsistent with any of RBI directions.

Accounting of Investments The Board of Directors of every applicable NBFC should frame investment policy for the company and implement the same. The criteria to classify the investments into **current** and **long term** investments should be spelt out in the investment policy. **Current investments** means an investment which is by its nature readily realisable and is intended to be held for not more than one year. Investments other than current are **long-term investments**. Investments in securities should be classified into current and long term, at the time of making each investment. Inter-class transfer, should not be on ad-hoc basis. It should be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board. The investments should be transferred scrip-wise, from current to long term or *vice-versa*, at the lower of the book value or market value. The depreciation in each scrip should be fully provided for and appreciation ignored. The depreciation in one scrip should not be set-off against appreciation in another scrip even in respect of the scrips of the same category.

Quoted current investments should, for the purposes of valuation, be grouped into the following categories: **(a)** equity shares, **(b)** preference shares, **(c)** debentures and bonds, **(d)** Government securities including treasury bills, **(e)** units of mutual fund, and **(f)** others. They should be valued at the lower of the cost or market value. The investments in each category should be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost, the net depreciation should be provided for/charged to the profit and loss account. If the aggregate market value exceeds the aggregate cost, the net appreciation should be ignored. Depreciation in one category of investments should not be set-off against appreciation in another category.

Unquoted equity shares in the nature of current investments should be valued at cost or breakup value, whichever is lower. However, applicable NBFCs should substitute fair value for the breakup value of the shares, if considered necessary. **Break-up value** means the equity capital and reserves less intangible assets and revaluation reserves divided by the number of equity shares. **Fair value** means the mean of the earning value and break-up value. **Earning value** means the value of an equity share computed by taking the average of profits after tax less the preference dividend and adjustment for extraordinary/non-recurring items for the immediately preceding 3 years and further divided by the number of equity shares and capitalised at the following rates: in case of **(i)** predominantly manufacturing company, 8 per cent, **(ii)** predominantly trading company, 10 per cent and **(iii)** any other company including NBFC, 12 per cent. In case of a loss making company, the earning value will be zero. Where the balance sheet of the investee company is not available for two years, such shares should be valued at one Rupee only. **Unquoted preference** shares in the nature of current investments should be valued at cost or face value, whichever is lower. Investments in unquoted Government securities/guaranteed bonds should be valued at carrying cost. **Unquoted investments** in the units of mutual funds in the nature of current investments should be valued at the net asset value declared by the mutual fund in respect of each particular scheme. **Commercial papers** should be valued at carrying cost. A **long-term investment** should be valued in accordance with the accounting standard issued by ICAI.

***Note*:** Unquoted debentures should be treated as term loans or other type of credit facilities depending upon their tenure for the purpose of income recognition and asset classification.

Need for Policy on Demand/Call Loans The Board of Directors of every applicable NBFC granting/intending to grant demand/call loans should frame a policy for the company stipulating, *inter alia*, the following **(i)** A cut-off date within which the repayment of demand/call loan should be demanded/called up; **(ii)** The sanctioning authority should record specific reasons in writing, at the time of sanctioning demand or call loan, if the cut-off date for demanding/calling-up is stipulated beyond a period of one year from the date of sanction; **(iii)** The rate of interest payable should be at monthly/quarterly rests; **(iv)** The sanctioning authority should record specific reasons in, if no interest is stipulated or a moratorium is granted for any period; **(v)** A cut-off date, for review of performance of the loan, not exceeding 6 months commencing from the date of sanction; **(vi)** The demand/call loans should not be renewed unless the periodical review has shown satisfactory compliance with the terms of sanction.

Asset Classification The following asset classification norms would apply to every applicable NBFC (**except NBFC-MFIs**). Every NBFC should, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire-purchase assets, loans and advances and any other forms of credit into the following classes: **(i)** Standard assets; **(ii)** Sub-standard assets; **(iii)** Doubtful assets; and **(iv)** Loss assets. The assets should not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the upgradation. **Standard asset** means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem or carry more than normal risk attached to the business. **Sub-standard asset** means: an asset **(a)** which has been classified as NPA upto 12 months; **(b)** where the terms of the agreement regarding interest and / or principal have been renegotiated/rescheduled/restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms. **Doubtful asset** means: **(a)** a term loan/lease asset, a hire-purchase asset/any other asset, which remains a sub-standard asset beyond 12 months. **Loss assets** mean: an asset which **(a)** has been identified as loss asset by the NBFCs its internal/external auditor/RBI during inspection, to the extent it is not written-off; and **(b)** is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower.

Non-performing asset means: **(a)** an asset in respect of which interest has remained overdue for of 3 months, **(b)** a term loan inclusive of unpaid interest, when the instalment/interest amount is overdue for of 3 months, **(c)** a demand or call loan which interest remained overdue for 3 months, **(d)** a bill which remains overdue for of 3 months, **(e)** other current assets, that is, the interest in respect of a debt/income on receivables in the nature of short term loans/

advances, which facility remained overdue for 3 months, **(f)** any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue of 3 months, **(g)** the lease rental and hire-purchase instalment, which has been overdue for of 12 months, **(h)** loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes NPA. In the case of lease and hire-purchase transactions, an applicable NBFC should classify each account on the basis of its record of recovery.

Provisioning Requirements The following provisioning requirements apply to every applicable NBFC (except **NBFC-MFIs**). Every applicable NBFC should, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard/doubtful/loss assets. The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted should be as below: **(i) Loss Assets**: the entire asset written-off. If the assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for; **(ii) Doubtful Assets (a)** 100 per cent provision to the extent to which the advance is not covered by the realisable value of the security to which the applicable NBFC has a valid recourse should be made. The realisable value is to be estimated on a realistic basis; **(b)** In addition to **(a)** above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20 to 50 per cent of the secured portion (i.e. estimated realisable value of the outstanding) should be made on the following basis:

Period for which the asset has been considered as doubtful	*Provision (%)*
Up to 1 year	20
1 – 3 years	30
More than 3 years	50

(iii) Sub-standard assets: A general provision of 10 per cent of total outstanding.

The provisioning requirements in respect of hire purchase and leased assets should be as follows: The total dues (overdue and future instalments taken together) as reduced by **(a)** the finance charges not credited to the profit and loss account and carried forward as unmatured finance charge; and **(b)** the depreciated value of the underlying asset. The depreciated value of the asset should be notionally computed as the original cost of the asset to be reduced by 20 per cent per annum depreciation on a straight line method and in the case of second hand asset, the original cost would be the actual cost incurred for acquisition. The additional provision for overdue hire-charges/lease rentals (per cent of net book value) should be made.

(a) Upto 12 months	Nil
(b) 12 – 24 months	10
(c) 24 – 36 months	40
(d) 36 – 48 months	70
(e) More than 48 months	100

On expiry of 12 months after the due date of the last instalment of hire-purchase/leased asset, the entire net book value should be fully provided for. **Net book value** means **(i)** the aggregate of overdue and future instalments receivable less unmatured finance charge and the provisions for NPAs and **(ii)** the aggregate of capital portion of overdue lease rentals accounted as receivables and depreciated book value of the lease assets as adjusted by the balance of lease adjustment account in case of hire-purchase and leased assets respectively.

Standard Asset Provisioning Every applicable NBFC should make provisions for standard assets at 0.40 per cent of the outstanding, which would not be reckoned for arriving at net NPAs. The provision towards standard assets need not be netted from gross advances but shown separately as **Contingent Provisions against Standard Assets** in the balance sheet.

Multiple NBFCs Applicable NBFCs that are part of a corporate group/are floated by a common set of promoters should not be viewed on a standalone basis. The total assets of the NBFCs in a group including deposit-taking NBFCs should be aggregated to determine if the consolidation falls within the asset sizes of the two categories, that is, those with asset size of below ₹500 crore and those with asset size of ₹500 crore and above. The regulations applicable to the two categories should be applicable to each of the non-deposit taking NBFCs within the group. The statutory auditors should certify the asset size of all the NBFCs in the group. However, NBFC-D, within the group should be governed under the RBI NBFCs Acceptance of Public Deposits Directions 2016 and prudential norms and other directions applicable to deposit-taking NBFCs.

Disclosure in the Balance Sheet Every applicable NBFC should separately disclose in its balance sheet the provisions without netting them from the income or against the value of assets. They should be distinctly indicated under separate heads of account, namely, **(i)** provisions for bad and doubtful debts; and **(ii)** provisions for depreciation in investments. They should not be appropriated from the general provisions and loss reserves held. They should be debited to the profit and loss account. The excess of provisions held under the heads general provisions and loss reserves should be written back without making adjustment against them. In addition, every applicable NBFC should disclose the following particulars in its balance sheet: **(i)** capital to risk assets ratio (CRAR); **(ii)** direct/indirect exposure to real estate sector and **(iii)** maturity pattern of assets and liabilities.

Accounting Year Every applicable NBFC should prepare its balance sheet and profit and loss account as on March 31 every year. Whenever it intends to extend the date of its balance sheet, it should take prior approval of the RBI before approaching the ROCs. Even in cases where the RBI/ROCs grant extension of time, it should furnish to the RBI a proforma balance sheet (unaudited) and the statutory returns as on March 31 of the year. It should finalise its balance sheet within 3 months from the date to which it pertains.

Schedule to the Balance Sheet Every applicable NBFC should append to its balance sheet prescribed under the Companies Act, the particulars in the specified schedule.

Transactions in Government Securities Every applicable NBFC should undertake transactions in Government securities through its CSGL account/its demat account. It should not undertake any transaction in government security in physical form through any broker.

Loans Against NBFCs Own Shares Prohibited No applicable NBFC should lend against its own shares.

Loans Against Security of Shares Applicable NBFC lending against the collateral of listed shares should, maintain a loan to value (LTV) ratio of 50 per cent for loans granted against the collateral of shares. The LTV ratio of 50 per cent should be maintained at all times. Any shortfall in the maintenance of the LTV occurring on account of movement in the share prices should be made good within 7 working days. In case where lending is done for investment in capital markets, accept only Group 1 securities as collateral for loans of value more than ₹5 lakh, subject to review by the RBI.

Concentration of Credit/Investment for Applicable NBFC (except NBFC-MFIs with asset size of ₹500 crore and above) No applicable NBFC should, **(i)** lend to **(a)** any single borrower/any single group of borrowers exceeding 15/25 per cent of its owned fund respectively, **(ii)** invest in **(a)** the shares of another company/single group of companies exceeding 15/25 per cent of its owned fund respectively; **(iii)** lend and invest (loans/investments taken together) exceeding 25 per cent to a single party and 40 per cent of its owned fund to a single group of parties. However, the ceiling on the investment in shares of another company would not be applicable to an applicable NBFC in respect of investment in the equity capital of an insurance company up to the extent specifically permitted by the RBI. The concentration of credit/investment norms may be exceeded by 5 per cent for any single party and by 10 per cent for a single group of parties, if the additional exposure is on account of infrastructure loan and/ or investment. However, these restrictions would not apply to **(a)** investments in shares of subsidiaries/companies in the same group, to the extent they have been reduced from owned funds for the calculation of NOF, and **(b)** the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with subsidiaries and companies in the same group to the extent they have been reduced from owned funds for the calculation of NOF. The infrastructure finance companies may, however, exceed the concentration of credit norms **(a)** in lending to any single borrower, by 10 per cent and any single group of borrowers, by 15 per cent of its owned fund; **(b)** in lending to and investing in, (loans/investments taken together) a single party, by 5 per cent and a single group of parties, by 10 per cent of its owned fund.

The concentration of credit/ investment norms would not apply to any applicable NBFC not accessing public funds in India, either directly or indirectly and not issuing guarantees. Every applicable NBFC (other than NBFC-D) should formulate a policy in respect of exposures to a single party/group of parties. An applicable NBFC which is held by an NOFHC should not **(i)** have any exposure (credit and investments including investments in the equity/debt capital instruments) to the promoters/promoter group entities or individuals associated with the promoter group or the NOFHC, **(ii)** make investment in the equity/ debt capital instruments in any of the financial entities under the NOFHC and **(iii)** invest in equity instruments of other NOFHCs.

***Notes*:**

1. For determining the limits, off-balance sheet exposures should be converted into credit risk by applying the conversion factors as explained earlier.
2. The investments in debentures for should be treated as credit and not investment.
3. These ceilings should be applicable to the credit/investment by an applicable NBFC to companies/firms in its own group as well as to the borrowers/ investee company's group.
4. **(a)** In case of factoring on **with-recourse** basis, the exposure should be reckoned on the assignor. **(b)** In case of factoring on **without-recourse** basis, the exposure should be reckoned on the debtor, irrespective of credit risk cover / protection provided, except

in cases of international factoring where the entire credit risk has been assumed by the import factor.

Information With Respect to Change of Address, Directors, Auditors, etc. to be Submitted Every applicable NBFC should communicate to the RBI within one month from the occurrence of any change in: **(i)** the complete postal address, telephone number(s) and fax number(s) of the registered/corporate office; **(ii)** the names and residential addresses of the directors of the company; **(iii)** the names and the official designations of its principal officers; **(iv)** the names and office address of the auditors of the company; and **(v)** the specimen signatures of the officers authorised to sign on behalf of the company.

Norms for Restructuring of Advances Norms for restructuring of advances by applicable NBFCs should be on the lines of the norms specified by the RBI for banks. **These are available in Khan, M. Y., Indian Financial System, MHE (India) 2017, Chapter 11**.

Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries Norms for flexible structuring of long term project loans to infrastructure and core industries by applicable NBFCs should be on the lines of the norms specified by the RBI for banks.

Loans Against Security of Single Product–Gold Jewellery All applicable NBFCs should **(i)** maintain a loan-to-value (LTV) ratio not exceeding 75 per cent for loans granted against the collateral of gold jewellery. The value of gold jewellery should be the intrinsic value of the gold content and no other cost elements should be added. The intrinsic value of the gold jewellery should be arrived at (as **detailed below**); **(ii)** disclose in their balance sheet the percentage of such loans to their total assets. They should not grant any advance against bullion/primary gold and gold coins. They should also not grant any advance for purchase of gold in any form including primary gold, gold bullion, gold jewellery, gold coins, units of exchange traded funds (ETF) and units of gold mutual fund.

Verification of the Ownership of Gold Where the gold jewellery pledged by a borrower at any one time or cumulatively on loan outstanding is more than 20 grams, the NBFCs should keep a record of the verification of its ownership. The ownership verification need not necessarily be through original receipts for the jewellery pledged but a suitable document should be prepared to explain how the ownership has been determined, particularly in each and every case where the gold jewellery pledged by a borrower at any one time or cumulatively on loan outstanding is more than 20 grams.

Standardisation of Value of Gold Accepted as Collateral in Arriving at LTV Ratio The gold jewellery accepted as collateral by the NBFC should be valued as follows. It should be valued by taking into account the preceding 30 days' average of the closing price of 22 carat gold as per the rate quoted by the Bombay Bullion Association Ltd. (BBA) or the historical spot gold price data publicly disseminated by a commodity exchange regulated by the Forward Markets Commission. If the purity of the gold is less than 22 carats, the NBFC should translate the collateral into 22 carat and state the exact grams of the collateral. In other words, jewellery of lower purity of gold should be valued proportionately. While accepting gold as collateral, it should give a certificate to the borrower on their letterhead, of having assayed the gold and state the purity (in terms of carats) and the weight of the gold pledged. They may have suitable caveats to protect themselves against disputes during redemption, but the certified purity should be applied both for determining the maximum permissible loan and the reserve price for auction.

Auction The auction should be conducted in the same town or taluka in which the branch that has extended the loan is located. While auctioning the gold, the NBFC should declare a reserve price for the pledged ornaments which should not be less than 85 per cent of the previous 30-day average closing price of 22 carat gold as declared by the Bombay Bullion Association Ltd. (BBA) or the historical spot gold price data publicly disseminated by a commodity exchange regulated by the Forward Markets Commission and value of the jewellery of lower purity in terms of carats should be proportionately reduced. It would be mandatory on its part to provide full details of the value fetched in the auction and the outstanding dues adjusted and any amount over and above the loan outstanding should be payable to the borrower. They should also disclose in their annual reports the details of the auctions conducted during the financial year including the number of loan accounts, outstanding amounts, value fetched and whether any of its sister concerns participated in the auction.

Safety and Security Measures to be Followed by NBFCs Lending Against Collateral of Gold Jewellery The NBFCs, which are in the business of lending against collateral of gold jewellery, should ensure that necessary infrastructure and facilities are put in place, including safe deposit vault and appropriate security measures for operating the vault, in each of its branches to safeguard the gold jewellery accepted as collateral and to ensure convenience of borrowers. No new branch(es) should be opened without suitable arrangements for security and for storage of gold jewellery, including safe deposit vault.

Fair Practices Code for Applicable NBFCs The applicable NBFCs having customer interface should adopt the following guidelines in respect of processing of applications, loan appraisals and terms/conditions, disbursement of loans, general responsibility of Board of Directors, grievances redressal officer, language and mode communication, regulation of excessive interest, complaint about excessive interest, repossession of vehicles financed and lending against jewellery.

Applications for Loans and Their Processing All communications to the borrower should be in the vernacular language or a language as understood by him. The loan application forms should include necessary information which affects his interest, so that a meaningful comparison with the terms and conditions offered by other NBFCs can be made and informed decision can be taken by him. It should indicate the documents required to be submitted with the application form. The NBFCs should devise a system of giving acknowledgement for receipt of all loan applications. Preferably, the time frame within which loan applications will be disposed of should also be indicated in the acknowledgement.

Loan Appraisal and Terms/Conditions The applicable NBFCs should convey in writing to the borrower in the vernacular language as understood by him by means of sanction letter or otherwise, the amount of loan sanctioned along with the terms and conditions including annualised rate of interest and method of application and keep their acceptance of these terms and conditions by the borrower on its record. As complaints received against NBFCs generally pertain to charging of high interest/penal interest, they should mention the penal interest charged for late repayment **in bold** in the loan agreement.

Borrowers may not fully be aware of the terms and conditions of the loans including rate of interest at the time of sanction of loans, either because the NBFC does not provide details of the same or the borrower has no time to look into detailed agreement. Not furnishing a copy of the loan agreement or enclosures quoted in the loan agreement is an unfair practice and this could lead to disputes between the NBFC and the borrower with regard to the terms and conditions. The applicable NBFCs should furnish a copy of the loan agreement as understood by the borrower along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction / disbursement of loans.

Disbursement of Loans Including Changes in Terms and Conditions The applicable NBFCs should give notice to the borrower in the vernacular language or a language as understood by him of any change in the terms and conditions including disbursement schedule, interest rates, service charges, prepayment charges and so on. They should also ensure that changes in interest rates and charges are effected only prospectively. A suitable condition in this regard must be incorporated in the loan agreement.

Any decision to recall/accelerate payment or performance under the agreement should be in consonance with the loan agreement. The applicable NBFCs should release all securities on repayment of all dues or on realisation of the outstanding amount of loan subject to any legitimate right or lien for any other claim they may have against borrower. If such right of set- off is to be exercised, the borrower should be given notice about the same with full particulars about the remaining claims and the conditions under which they are entitled to retain the securities till the relevant claim is settled/paid.

General The applicable NBFCs should refrain from interference in the affairs of the borrower except for the purposes provided in the terms and conditions of the loan agreement (unless information, not earlier disclosed by the borrower, has been noticed). In case of receipt of request from the borrower for transfer of borrowal account, the consent or otherwise, that is, objection of the applicable NBFC, should be conveyed within 21 days from the date of receipt of request. Such transfer should be as per transparent contractual terms in consonance with law. In the matter of recovery of loans, an applicable NBFC should not resort to undue harassment, namely, persistently bothering the borrowers at odd hours, use muscle power for recovery of loans and so on. As complaints from customers also include rude behavior from the staff of the companies, they should ensure that the staff are adequately trained to deal with the customers in an appropriate manner. As a measure of customer protection and also in order to bring in uniformity with regard to prepayment of various loans by borrowers of banks and NBFCs, they should not charge foreclosure charges/pre-payment penalties on all floating rate term loans sanctioned to individual borrowers.

Responsibility of Board of Directors The Board of Directors of applicable NBFCs should also lay down the appropriate grievance redressal mechanism within the organisations to ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. They should also provide for periodical review of the compliance of the **Fair Practices Code** and the functioning of the grievances redressal mechanism at various levels of management. A consolidated report of such reviews should be submitted to the Board at regular intervals prescribed by it.

Grievance Redressal Officer At the operational level, all applicable NBFCs should display the following information prominently, for the benefit of their customers, at their branches/places where business is transacted. The name and contact details (telephone/mobile nos. as also *email* address) of the grievance redressal officer who can be approached by the public for resolution of complaints against the company. If the complaint / dispute is not redressed within one month, the customer may appeal to the RBI (with complete contact details).

Language and Mode of Communicating Fair Practice Code The fair practices code (preferably in the vernacular language or a language as understood by the borrower) based on the directions outlined above be put in place by all applicable NBFCs having **customer interface** (i.e. interaction between NBFC and its customers while carrying on it business) with the approval of their Boards. The applicable NBFCs will have the freedom of drafting the fair practices code, enhancing the scope of the directions but in no way sacrificing the spirit underlying the above directions. The same should be put up on their *web-site*, for the information of various stakeholders.

Regulation of Excessive Interest Charged by Applicable NBFC The Board of each applicable NBFC should adopt an interest rate model taking into account relevant factors such as cost of funds, margin and risk premium and determine the rate of interest to be charged for loans and advances. The rate of interest and the approach for gradations of risk and rationale for charging different rate of interest to different categories of borrowers should be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter. They should also be made available on the *web-site* of the companies or published in the relevant newspapers. The information should be updated whenever there is a change in the rates of interest. The rate of interest must be annualised rate so that the borrower is aware of the exact rates that would be charged to the account.

Complaints About Excessive Interest Charged by Applicable NBFCs Though interest rates are not regulated by the RBI, rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor be conforming to normal financial practice. The Board of Directors of applicable NBFCs, therefore, should lay out appropriate internal principles and procedures in determining interest rates and processing and other charges. In this regard, the directions in the fair practices code about transparency in respect of terms and conditions of the loans are to be kept in view.

Repossession of Vehicles Financed The applicable NBFCs must have a built-in re-possession clause in the contract/loan agreement with the borrower which must be legally enforceable. To ensure transparency, the terms and conditions of the contract/loan agreement should also contain provisions regarding: **(i)** notice period before taking possession, **(ii)** circumstances under which the notice period can be waived, **(iii)** the procedure for taking possession of the security, **(iv)** a provision regarding final chance to be given to the borrower for repayment of loan before the sale/auction of the property, **(v)** the procedure for giving repossession to the borrower, and **(vi)** the procedure for sale/auction of the property. A copy of these terms and conditions must be made available to the borrower. The applicable NBFCs should invariably furnish a copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction/disbursement of loans, which forms a key component of such contracts/loan agreements.

Lending Against Collateral of Gold Jewellery While lending to individuals against gold jewellery, applicable NBFCs should adopt the following in addition to the general directions as above.

- They should put in place Board-approved policy for lending against gold that should, *inter alia*, cover the following: **(a)** adequate steps to ensure that the KYC guidelines stipulated by the RBI are complied with and to ensure that adequate due diligence is carried out on the customer before extending any loan, **(b)** proper assaying procedure for the jewellery received, **(c)** internal systems to satisfy ownership of the gold jewellery,

(d) adequate systems for storing the jewellery in safe custody, reviewing the systems on an on-going basis, training the concerned staff and periodic inspection by internal auditors to ensure that the procedures are strictly adhered to. Normally, such loans should not be extended by branches that do not have appropriate facility for storage of the jewellery, **(e)** the jewellery accepted as collateral should be appropriately insured, **(f)** transparent auction procedure in case of non-repayment with adequate prior notice to the borrower. There should be no conflict of interest and the auction process must ensure that there is arm's length relationship in all transactions during the auction including with group companies and related entities, **(g)** the auction should be announced to the public by issue of advertisements in at least two newspapers, one in vernacular and another in national daily, **(h)** as a policy, the NBFCs themselves should not participate in the auctions held, **(i)** gold pledged should be auctioned only through auctioneers approved by the Board of Directors, **(j)** the policy should also cover systems and procedures to be put in place for dealing with fraud including separation of duties of mobilisation, execution and approval.

- The loan agreement should also disclose details regarding auction procedure.
- **Other instructions (a)** The NBFCs must insist on a copy of the PAN Card of the borrower for all transaction above ₹5 lakh. High value loans of ₹1 lakh and above must only be disbursed by cheque. Documentation across all branches must be standardised. The NBFCs should not issue misleading advertisements like claiming the availability of loans in a matter of 2-3 minutes.

Specific Directions Applicable to NBFC-Factor The main elements of the specific directions applicable to NBFC-Factor are: registration, net owned funds, principal business, conduct of business, asset classification, risk management, and import-export factoring. **These are discussed in Chapter 4**.

Specific Directions Applicable to Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFC) The IDF should be set up as a trust/as a company. A trust-based IDF should normally be a mutual fund (MF) while a company-based IDF should normally be a NBFC. The IDF-NBFC should raise resources through issue of either rupee or dollar denominated bonds of minimum 5-year maturity. With a view to facilitate better asset liability management (ALM), IDF-NBFCs can raise funds through shorter tenor bonds and commercial papers (CPs) from the domestic market to the extent of upto 10 per cent of their total outstanding borrowings. The IDF-MF would be regulated by the SEBI while IDF-NBFC would be regulated by the RBI. The specific directions applicable to IDF-NBC relate to eligibility parameters, investments in IDFs, credit rating, capital adequacy, investment by IDF-NBFC and credit concentration.

Eligibility Parameters All NBFCs would be eligible to sponsor IDFs as mutual funds with prior approval of the RBI subject to the specified conditions, in addition to those prescribed by SEBI. The NBFC should have a minimum NOF of ₹300 crore and CRAR of 15 per cent. Its net NPAs should be less than 3 per cent of net advances. It should have been in existence for at least 5 years. It should be earning profits for the last 3 years and its performance should be satisfactory. The CRAR of the NBFC post-investment in the IDF-MF should not be less than the regulatory minimum prescribed for it. The NBFC should continue to maintain the required level of NOF after accounting for investment in the proposed IDF-MF. There should be no supervisory concerns with respect to the NBFC.

Only NBFC-IFCs can sponsor IDF-NBFC with the prior approval of the RBI subject to the specified conditions. The sponsor IFCs should be allowed to contribute a maximum of 49 per cent to the equity of the IDF-NBFCs with a minimum equity holding of 30 per cent of the equity of IDF-NBFCs. Post-investment in the IDF-NBFC, the sponsor NBFC-IFC must maintain minimum CRAR and NOF prescribed for the IFCs. There are no supervisory concerns with respect to the IFC.

The IDF-NBFCs should enter into tripartite agreements to which, the concessionaire, the project authority and IDF-NBFC should be parties. It binds all the parties to the terms and conditions of the other agreements referred to therein also and which collectively provide, *inter alia*, for the following: **(i)** takeover a portion of the debt of the concessionaire availed from senior lenders, **(ii)** a default by the concessionaire should trigger the process for termination of the agreement between project authority and concessionaire, **(iii)** the project authority should redeem the bonds issued by the concessionaire which have been purchased by IDF-NBFC, from out of the termination payment as per the tripartite agreement and other agreements referred to therein (compulsory buyout), **(iv)** the fee payable by IDF-NBFC to the project authority as mutually agreed upon between the two. The NBFC and IFCs that fulfill the above eligibility criteria should approach the RBI, for sponsoring IDFs as MFs and NBFCs. **Concessionaire** means a party which has entered into agreement called concession agreement with a project authority for developing infrastructure. **Project authority** means a authority constituted by a statute for infrastructure development in the country.

Investment by NBFCs and IFCs in IDFs The exposure of sponsor NBFCs/IFCs and non-sponsor NBFCs / IFCs to the equity and debt of the IDFs should be governed by **the credit concentration norms discussed earlier in this Section**. As regards foreign exchange-related aspects of the functioning of IDF-NBFCs, the guidelines issued by RBI should be adhered to.

Credit Rating The IDF-NBFC should have a minimum credit rating grade of '**A**' or equivalent issued by accredited rating agencies.

Capital Adequacy They should have at the minimum CRAR of 15 per cent and Tier-II capital should not exceed Tier-I.

Investment by IDF-NBFCs They can invest in post-COD infrastructure projects which have completed at least one year of satisfactory commercial operation that are: **(i)** PPP projects and are a party to a tripartite agreement with the concessionaire and the project authority for ensuring a compulsory buyout with termination payment, **(ii)** non-PPP projects and PPP projects without a project authority, in sectors where there is no project authority.

Credit Concentration Norms In addition to the provisions **discussed earlier in this Section**, the following credit concentration norms would be applicable to IDF-NBFCs:

- For PPP and post-COD infrastructure projects which have completed at least one year of satisfactory commercial operation and the IDF-NBFC is a party to a tripartite agreement with the concessionaire and the project authority for ensuring a compulsory buyout with termination payment, the following additional exposures should be applicable: **(a)** the maximum exposure on individual projects should be at 50 per cent of its total capital funds [Tier-I plus Tier-II], **(b)** an additional exposure up to 10 per cent can be taken at the discretion of the Board of the IDF-NBFC, **(c)** the RBI may, upon receipt of an application from an IDF-NBFC and on being satisfied that the financial position of the IDF-NBFC is satisfactory, permit additional exposure up to 15 per cent (over 60 per cent) subject to such conditions as it may deem fit to impose regarding additional prudential safeguards.

- The exposure in respect of other assets should be governed by the directions as applicable to infrastructure finance companies **discussed earlier in this Section.**

Specific Directions Applicable to Non-Banking Finance Company – Micro Finance Institutions (NBFC-MFIs) The main elements of these directions are: entry point norm, prudential norms, pricing of credit, transparency in interest rates, multiple lending, over-borrowing and ghost-borrowers, compliance with conditionalities, channelising agents for schemes and so on.

Entry Point Norms All new companies desiring registration as NBFC-MFI would need a minimum NOF of ₹5 crore and should comply, from the beginning, with all other criteria applicable to the NBFC-MFIs.

Prudential Norms relates to capital adequacy, asset classification ad provisioning norms.

Capital Adequacy The NBFC-MFIs should maintain a minimum capital adequacy ratio consisting of Tier-I and Tier-II capital of 15 per cent of its aggregate risk weighted assets. The total of Tier-II capital at any point of time should not exceed 100 per cent of Tier-I capital. The risk weights for on-balance sheet assets and the credit conversion factor for off-balance sheet items will be as applicable to systematic important non-deposit/deposit accepting NBFCs (**discussed in the preceding Section**).

***Notes*:**

1. For loans guaranteed by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH), NBFC-MFIs should assign zero risk weight for the guaranteed portion. The balance outstanding in excess of the guaranteed portion should attract a risk-weighted a detailed **in the earlier Section**.
2. For calculation of CRAR, the provisioning made towards loan portfolio in the Andhra Pradesh (AP) should be notionally reckoned as part of NoF to the extent of 20 per cent. Capital adequacy on non-AP portfolio and the notional AP portfolio (outstanding as on the balance sheet date less the provision on this portfolio not notionally added back) should be maintained at 15 per cent of the risk weighted assets.

Asset Classification Norms Standard asset means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business. Non-performing asset means an asset for which, interest/principal payment has remained overdue for 90 days or more.

Provisioning Norms For NPAs meeting **qualifying assets** criteria, provisioning norms for the Andhra Pradesh (AP) portfolio would be applicable as discussed earlier. The provisioning norms for the non-AP portfolio should be the aggregate loan provision maintained by NBFC-MFIs should not be less than the higher of 1 per cent of the outstanding loan portfolio or 50 per cent of the aggregate loan instalments which are overdue for more than 90 days and less than 180 days and 100 per cent of the aggregate loan instalments which are overdue for 180 days or more. If the advance covered by the CRGFTLIH guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per **provisioning norms as mentioned earlier**. All other provisions mentioned in the **preceding Section** would be applicable to the NBFC-MFIs. An

NBFC which does not qualify as an NBFC-MFI would not extend loans to micro-finance sector in aggregate exceeding 10 per cent of its total assets.

Pricing of Credit Margin cap, cap on the difference between the amount charged to the borrower and the cost of funds to the NBFC-MFI, should not exceed 10 per cent for large MFIs (loans portfolios exceeding ₹100 crore) and 12 per cent for the others. The interest charged by an NBFC-MFI should be the lower of the cost of funds plus margin as indicated above and the average base rate of the 5 largest commercial banks by assets multiplied by 2.75. The NBFC-MFIs should ensure that the average interest rate on loans sanctioned during a quarter does not exceed the average borrowing cost during the preceding quarter plus the margin, within the prescribed cap. The maximum variance permitted for individual loans between the minimum and maximum interest rate cannot exceed 4 per cent. The average interest paid on borrowings and charged by the MFI are to be calculated on average monthly balances of outstanding borrowings and loan portfolio respectively. The figures should be certified annually by the statutory auditors and also disclosed in the balance sheet. Processing charges should not be more than 1 per cent of gross loan amount. They need not be included in the margin cap or the interest cap. The NBFC-MFIs should recover only the actual cost of insurance for group, or livestock, life, health for borrower and spouse. The administrative charges should be recovered as per the IRDA guidelines.

Transparency in Interest Rates There should be only three components in the pricing of the loan, namely, the interest charge, the processing charge and the insurance premium (which includes the administrative charges). There should be no penalty on delayed payment. The NBFC-MFIs should not collect any security deposit/ margin from the borrower. There should be a standard form of loan agreement. Every NBFC-MFI should provide to the borrower a loan card reflecting **(a)** the effective rate of interest charged; **(b)** all other terms and conditions attached to the loan; **(c)** information which adequately identifies the borrower; **(d)** acknowledgements by the NBFC-MFI of all repayments including instalments received and the final discharge; **(e)** all entries in the loan card should be in the vernacular language. The effective rate of interest charged by the NBFC-MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.

Multiple-lending, Over-borrowing and Ghost-borrowers The NBFC-MFIs can lend to individual borrowers who are not member of joint liability group (JLG)/self help group (SHG) or to borrowers that are members of JLG/SHG. A borrower cannot be a member of more than one SHG/JLG. Not more than 2 NBFC-MFIs should lend to the same borrower. There must be a minimum period of moratorium between the grant of the loan and the due date of the repayment of the first instalment. It should not 5 be less than the frequency of repayment, for example, in the case of weekly repayment, the moratorium should not be less than one week. Recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid.

Ensuring Compliance with Conditionalities Every NBFC-MFI has to be a member of all credit information companies (CICs) (**discussed in detail in a subsequent Section)** provide timely and accurate data to them and use the data available with them to ensure compliance with the conditions regarding membership of SHG/ JLG, level of indebtedness and sources of borrowing. While the quality and coverage of data with CICs will take some time to become robust, the NBFC-MFIs may rely on self-certification from the borrowers and their own local enquiries on these aspects as well as the annual household income.

Channelising Agents for Schemes Operated by Central/State Government Agencies The NBFC-MFIs acting as channelising agents for schemes operated by central/state government agencies should abide by the following guidelines: **(a)** loans disbursed/managed by NBFC-MFIs should be considered as a separate business segment. These loans should not be included either in the numerator (qualifying assets) or the denominator (total assets) for the purpose of determining compliance with the minimum qualifying assets criteria; **(b)** consequent to above, the interest charged on such loans should be excluded for determining the variance between the maximum and minimum interest rate; and **(c)** the cost of such funds should not be reckoned for arriving at average cost of funds as well as interest rates charged to borrowers.

The NBFC-MFIs may act as channelising agents for distribution of loans under special schemes of central/state government agencies subject to following conditions: **(a)** accounts and records for loans as well as funds received/ receivable from concerned agencies should be maintained in their books distinct from other assets and liabilities, and depicted in the financials/ final accounts/balance sheet with requisite details and disclosures as a separate segment; **(b)** such loans should be subject to applicable asset classification, income recognition and provisioning norms as well as other prudential norms as applicable to NBFC-MFIs except in cases where it does not bear any credit risk; **(c)** they should be reported to the CICs to prevent multiple borrowings and present complete picture of indebtedness of a borrower.

Others All NBFC-MFIs should refer to directions issued to banks by the Financial Inclusion and Development Department (FIDD) on bank loans to Micro Finance Institutions (MFIs) – Priority Sector status with regard to guidelines on priority sector. They should approach their Board of Directors for fixing internal exposure limits to avoid any undesirable concentration in specific geographical locations. They should become member of at least one self-regulatory organisation (SRO) recognised by the RBI and also comply with the code of conduct prescribed by the SRO. Further, the SRO should adhere to a set of specified functions and responsibilities. The same may be modified by the RBI from time to time to improve the efficiency of the sector. The responsibility for compliance to all regulations prescribed for NBFC- MFIs lies primarily with themselves. The industry associations/SROs should also play a key role in ensuring compliance with the regulatory framework. In addition, banks lending to them should also ensure that systems, practices and lending policies in them are aligned to the regulatory framework.

Fair Practices Code (FPC) for NBFC-MFIs In addition to the general principles on **FPC discussed earlier**, NBFC-MFIs should adopt the following specific fair practices:

General The FPC in vernacular language should be displayed by an NBFC-MFI in its office and branch premises. A statement should be made in vernacular language and displayed by them in their premises and in loan cards articulating their commitment to transparency and fair lending practices. The field staff should be trained to make necessary enquiries with regard to existing debt of the borrowers. Training offered to the borrowers should be free of cost. The field staff should be trained to offer such training and also make the borrowers fully aware of the procedure and systems related to loan/other products. The effective rate of interest charged and the grievance redress system set up by the NBFC-MFI should be prominently displayed in all its offices and in the literature issued by it (in vernacular language) and on its *website*. A declaration that it will be accountable for preventing inappropriate staff behaviour and timely grievance redressal, should be made in the loan agreement and also in the FPC displayed in its office/branch premises. The KYC Directions of the RBI should be complied with. Due diligence should be carried out to ensure the repayment capacity of the borrowers. All sanctions and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition, there should be close supervision of the disbursement function. Adequate steps should be taken to ensure that the procedure for application of loan is not cumbersome and loan disbursements are done as per the pre-determined time structure.

Disclosures in Loan Agreement/Loan Card All NBFC-MFIs should have a Board-approved, standard form of loan agreement preferably be in vernacular language, disclosing the following: **(i)** all the terms and conditions of the loan, **(ii)** the pricing of the loan involves only three components, namely, interest charge, processing charge and insurance premium including the administrative charges, **(iii)** there will be no penalty on delayed payment, **(iv)** no security deposit/margin is being collected from the borrower, **(v)** the borrower cannot be a member of more than one SHG/JLG, **(vi)** the moratorium period between the grant of the loan and the due date of the repayment of the first installment, **(vii)** an assurance that the privacy of borrower data would be respected.

The loan card should reflect the following details: **(i)** the effective rate of interest charged, **(ii)** all other terms and conditions attached to the loan, **(iii)** information which adequately identifies the borrower and acknowledgements by the NBFC-MFI of all repayments including installments received and the final discharge, **(iv)** it should prominently mention the grievance redress system and the name and contact number of the nodal officer, **(v)** non-credit products issued should be with full consent of the borrowers and fee structure communicated in the loan card itself, **(vi)** all entries in the loan card should be in the vernacular language.

Non-coercive Methods of Recovery The recovery should normally be made only at a central designated place. The field staff should be allowed to make recovery at the place of residence/work of the borrower only if he fails to appear at central designated place on two or more successive occasions. The NBFC-MFIs should ensure that a Board-approved policy is in place with regard to code of conduct by field staff and systems for their recruitment, training and supervision. The code should lay down minimum qualifications necessary for the field staff and necessary training tools identified for them to deal with the customers. The training to the field staff should include programmes to inculcate appropriate behaviour towards borrowers without adopting any abusive or coercive debt collection/recovery practices. The compensation methods for them should have more emphasis on areas of service and borrower satisfaction than merely the number of loans mobilised and the rate of recovery. Penalties may also be imposed in cases of non-compliance by the field staff with the code of conduct. Generally, only employees and not out-sourced recovery agents should be used for recovery in sensitive areas.

Customer Protection Initiatives The NBFC-MFIs should ensure that greater resources are devoted to professional inputs in the formation of SHG/JLG and appropriate training and skill development activities for capacity building and empowerment after formation of the groups. They should be prudent and responsible in their lending activity besides educating their borrowers on the dangers of wasteful conspicuous consumption.

Governance Issues

The governance issues pertaining to **(i)** acquisition/transfer of control and **(ii)** corporate governance are discussed below.

Acquisition/Transfer of Control of Applicable NBFCs An applicable NBFC would require prior written permission of the RBI for the following: **(a)** its takeover/acquisition of control of which may or may not result in change of management; **(b)** change in its shareholding including progressive increases over time, which would result in acquisition/transfer of shareholding of 26 per cent or more of its paid-up equity capital. However, prior approval would not be required in case of any shareholding going beyond 26 per cent due to buyback of shares/reduction in capital where it has approval of a competent court. This should be reported to the RBI within one month from its occurrence; **(c)** change in its management which results in change in more than 30 per cent of the directors, excluding independent directors. No prior approval would be required in case of directors who get re-elected on retirement by rotation.

Application for Prior Approval The applicable NBFCs should submit an application, in the company letter head, for obtaining prior approval of the RBI, along with the following documents: **(a)** the specified information about the proposed directors/shareholders, **(b)** sources of funds of the proposed shareholders acquiring its shares, **(c)** declaration by the proposed directors/shareholders that they are not associated with any **(i)** unincorporated body that is accepting deposits, **(ii)** company the application for CoR of which has been rejected by the RBI; **(d)** declaration by the proposed directors/shareholders that there is no criminal case, including for offence under the Negotiable Instruments Act, against them; and **(e)** bankers' report on the proposed directors/shareholders.

Requirement of Prior Public Notice About Change in Control/Management A public notice of at least 30 days should be given before effecting the sale/transfer of the ownership by sale of shares, or transfer of control, with or without sale of shares. The public notice be given by the applicable NBFC and also by the other party or jointly by the parties concerned, after obtaining the prior permission of the RBI. It should indicate the intention to sell or transfer ownership/control, the particulars of transferee and the reasons for such sale/transfer of ownership/control. It should be published in at least one leading national and in one leading local (covering the place of registered office) vernacular newspaper.

Corporate Governance The main elements of the corporate governance are: **(i)** constitution of the committees of the Board of Directors, **(ii)** fit and proper person criteria, **(iii)** disclosure and transparency and **(iv)** rotation of partners of the auditors/audit firm and **(v)** framing of internal guidelines.

Constitution of Committees of the Board of Directors: Audit Committee All applicable NBFCs should constitute an audit committee, consisting of atleast three members of its Board of Directors. It must ensure that an information system audit of the internal systems and processes is conducted at least once in two years to assess operational risks faced by them.

Nomination Committee They should form a nomination committee to ensure **fit and proper** status of the proposed/ existing directors.

Risk Management Committee To manage the integrated risk, they should form a risk management committee, besides the asset liability management committee.

Fit and Proper Criteria All applicable NBFCs should **(i)** ensure that a policy is put in place with the approval of its Board of Directors for ascertaining the fit and proper criteria of the directors at the time of appointment, and on a continuing basis on the lines of the RBI guidelines, **(ii)** obtain a declaration and undertaking from the directors giving additional information on the lines of the prescribed format, **(iii)** obtain a deed of covenant signed by the directors, in the prescribed format, **(iv)** furnish to the RBI a quarterly statement on change of directors, and a certificate from the managing director that fit and proper criteria in selection of the directors has been followed within 15 days of the close of the respective quarter. The statement submitted by applicable NBFC for the quarter ending March 31, should be certified by the auditors. The RBI, if it deems fit and in public interest, reserves the right to examine the fit and proper criteria of directors of any NBFC irrespective of the asset size of the NBFC.

Disclosure and Transparency All applicable NBFCs should put up to the Board of Directors, at regular intervals, as may be prescribed by the Board in this regard, the following: **(i)** the progress made in putting in place a progressive risk management system and risk management policy and strategy followed; **(ii)** conformity with corporate governance standards, namely, in composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions, and so on.

- They should also disclose the following in their annual financial statements: **(i)** registration/licence/authorisation, obtained from other financial sector regulators; **(ii)** ratings assigned by credit rating agencies and migration of ratings during the year; **(iii)** penalties levied by any regulator; **(iv)** information namely, area, country of operation and joint venture partners with regard to joint ventures and overseas subsidiaries and **(v)** asset-liability profile, extent of financing of parent company products, NPAs and movement of NPAs, details of all off-balance sheet exposures, structured products issued by them as also securitisation/assignment transactions and other specified disclosures.

Rotation of Partners of the Statutory Auditors Audit Firm The NBFCs should rotate the partner(s) of the chartered accountant firm conducting their audit so that the same partner would not conduct its audit continuously for more than three years. However, he would be eligible for conducting the audit of after an interval of three years. It should incorporate appropriate terms in the letter of appointment of the firm of auditors and ensure its compliance.

Framing of Internal Guidelines All applicable NBFCs should frame their internal guidelines on corporate governance with the approval of the Board of Directors, enhancing the scope of the guidelines without sacrificing the spirit underlying the above guidelines and it should be published on the company's *web-site* for the information of various stakeholders.

RBI NBFC NON-SYSTEMICALLY IMPORTANT NON-DEPOSIT-TAKING (NBFC-ND) COMPANIES DIRECTIONS, 2016

The RBI **(i)** in public interest, **(ii)** and to regulate the financial system to the advantage of the country **(iii)** and to prevent the affair of any NBFC-ND from being conducted in any manner detrimental/prejudicial to their interest, has been issuing directions in exercise of its powers under the RBI Act and the Factoring Regulation Act. These were comprehensively revised in 2016.

The provisions of these directions are applicable to:

(a) NBFCs not accepting/holding public deposits which are not systemically important, that is, having minimum total asset of ₹500 crore;

(b) NBFC-Factor registered with the RBI under the Factoring Regulation Act (**discussed in Chapter 4)** having an asset size below ₹500 crore. Its financial assets in the factoring business constitutes at least 50 per cent of its total assets and its income from factoring business is not less than 50 per cent of it total gross income;

(c) NBFC-Micro-Finance Institution (NBFC-MFI) registered under the RBI Act, having an asset size below ₹500 crore. It is a non-deposit taking NBFC, having a minimum net owned fund of ₹5 crore and not less than 85 per cent of its net assets are in the nature of qualifying assets (**discussed in detail in the earlier Section dealing with NBFC-ND-SI and NBFC-D**);

(d) NBFC Infrastructure Finance Company (NBFC-IFC) registered with the RBI having an asset size below ₹500 crore. A minimum of 75 per cent of its total assets should be deployed in infrastructure loans (**discussed in earlier Section dealing with NBFC-ND-SI**), having a minimum net owned funds of ₹300 crore/credit rating **A** or equivalent grade and CRAR of 15 per cent with a minimum Tier-I capital of 10 per cent. However, the provisions of the directions relating to **(i)** prudential regulations and **(ii)** fair practices code are not applicable to the NBFCs who have not accessed public funds and do not have any **customer interface** (i.e. interaction between the NBFC and its customers while carrying on its business). **Public funds** means funds received directly/indirectly through public/inter-corporate deposits, bank finance and all funds received from outside sources such as commercial papers/debentures but excludes funds raised by issue of compulsorily convertible instruments into equity within 5 years from the date of issue. Similarly, the provisions relating to fair practices code are not applicable to NBFCs accessing public funds but having no customer interface. Finally, NBFCs having customer interface but not accessing public funds are exempt from the applicability of the provisions relating to the prudential regulations;

(e) **Infrastructure Debt Fund-NBFC (IDF-NBFC)** which means a non-deposit taking NBFC that has a minimum NoF of ₹300 crore which invests only in public-private partnership (PPP) and post-commencement operation date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a **tripartite agreement** (i.e., between concessionaire, project authority and IDF-NBFC) is excluded from the application of these directions.

These directions are substantially on the same pattern as is applicable to the NBFC-ND-SI and NBFC-D (discussed in the preceding Section). However, they certain some additional features and some features applicable to the former are not applicable to the NBFC-ND.

Additional Features

The new/additional features of the prudential norms applicable to the NBFC-ND are listed below:

Leverage Ratio The maximum leverage ratio (total outside liabilities divided by owned funds) of an applicable NBFC (except NBFC-MFIs NBFC-IFCs) should be 7 at any point of time. The NBFCs primarily engaged in landing against gold jewellery accounting for at least 50 per cent of their financial assets should maintain a minimum Tier-I capital of 12 per cent.

Concentration of Credit/Investment An applicable NBFC held by an **NOFHC** (non-operative financial holding company) should not **(i)** have any exposure (credit/investments including investments in equity/debt capital instruments) to the promoters/promoter group entities/individuals associated with the promoter group/NOFHC **(ii)** invest in the equity/debt instruments in any financial entity under the NOFHCs and **(iii)** invest in equity instruments of the NOFHCs.

As already mentioned, NOFHC means a non-deposit-taking NBFC which holds the shares of a bank/all other financial services companies in its group to the extent permissible under the applicable regulatory prescriptions of the RBI/other financial regulators.

Specific Directions Applicable to NBFC-Factor The exposure norms relating to asset classification should be reckoned in case of factoring on **(a)** with recourse basis on the assigner, **(b)** without recourse on the debtor irrespective of the credit risk cover/protection except in cases of international factoring where the entire credit risk has been assumed by the import factor.

Feature Excluded/Not Applicable

The features/elements of the prudential norms relating to the NBFC-SI-ND and which are inapplicable/excluded to/from the NBFC-D relate to **(i)** Infrastructure Debt Fund-NBFCs (IDF-NBFCs), **(ii)** prudential regulations and **(iii)** fair practices code. These are not applicable to the NBFCs who have not accessed public funds and do not have any customer interface. The provisions pertaining to fair practice code are inapplicable to the NBFCs accessing public funds but having no customer interface. The NBFCs having customer interface but not accessing public funds are exempt from the prudential regulations.

NBFCS AUDITORS REPORT (RBI) DIRECTIONS, 2016

In exercise of the powers conferred by Subsection (1A) of Section 45MA of the amended RBI Act, the RBI has given directions to statutory auditors of NBFCs with effect from January 31, 1998. They are applicable to all auditors of NBFCs, as defined in Section 45I(f) of RBI Act. The main contents/requirements of the 2016 directions are briefly discussed in this Section.

Additional Report to the Board of Directors

In addition to the report under Section 143 of the Companies Act 2013 on the accounts of the NBFC for every financial year, the auditors should also make a separate report to its Board of Directors on the matters specified below.

In Case of all NBFCs The auditors have to report whether the NBFC:

- Is engaged in the business of a NBFI in terms of the specified principal business criteria (financial assets/income pattern) and has obtained a certificate of registration (CoR) from the RBI;
- Is entitled to hold the CoR in terms of its financial asset/income pattern;
- Is meeting the required net owned fund requirement. Every NBFC should submit a certificate from its statutory auditor that it is engaged in the business of NBFI requiring it to hold a CoR and is eligible to hold it within one month from the date of finalisation of the balance sheet and in any case before December, 30 of that year.

In Case of NBFCs Accepting/Holding Public Deposits The auditors should include a statement on the following additional matters, whether:

- The public deposits accepted by the NBFC together with other borrowings, namely, **(i)** issue of unsecured non-convertible debentures/bonds to the public, **(ii)** from its shareholders, in case of a public limited company, and **(iii)** any other deposits not excluded from the definition of public deposits in the NBFCs Acceptance of Public Deposits (RBI) Directions

2016 are within the limits admissible under these directions and any excess deposits are regularised in the prescribed manner;

- The NBFC is accepting public deposits without the stipulated minimum investment grade rating. The credit rating for each of the fixed deposit schemes that has been assigned by the rating agency in respect of the above NBFCs **(i)** is in force and **(ii)** the aggregate amount of deposits outstanding at any point during the year exceeds the limit specified by the rating agency;
- The NBFC has violated any stipulated restrictions on acceptance of public deposits;
- The NBFC has defaulted in paying to its depositors the due interest/principal;
- The NBFC has complied with the prescribed prudential norms on income recognition, accounting standards, asset classification, provisioning and concentration of credit/investments;
- The NBFC has complied with the liquid asset requirement prescribed by the RBI and the details of the designated bank in which the approved securities are held is communicated to the RBI;
- It has furnished to the RBI, within the stipulated period, the **(i)** return on deposits, and **(ii)** quarterly return on prudential norms; and
- It has complied with the requirements relating to the opening of new branches/offices to collect deposits or closure of existing branches/offices or appointment of agent(s).

In Case of NBFCs Not Accepting Public Deposits The auditor should include a statement on the following additional matters whether:

- The Board of Directors has passed a resolution for non-acceptance of public deposits;
- The NBFC has accepted any public deposit;
- It has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning;
- In respect of a systematically important non-deposit taking NBFC **(i)** the capital adequacy ratio as disclosed in the return submitted to the RBI has been correctly arrived at and it is in compliance with the minimum CRAR prescribed by the RBI, **(ii)** it has furnished to the RBI annual statement of capital funds, risk assets/exposures and risk asset ratio within the stipulated period;
- It has been correctly classified as NBFC – MFI in terms of the RBI directions.

In case of a NBFI not required to hold a CoR subject to certain conditions, the auditor should include a statement on the following additional matter, namely, where the NBFI has obtained a specific advice from the RBI that it is not required to hold a CoR, whether it is complying with the conditions stipulated as advised by the RBI.

Unfavourable/Qualified Statements

In case the statements in the auditors report relating to the above matters are unfavourable/qualified, the reasons for the same should also be stated. If the auditor is unable to express any opinion on any of the above items/statements, such fact together with reason(s) should also be included in the auditor's report to the RBI.

Obligations of the Auditors to Submit Exception Report to the RBI

If the statement regarding any of the above items is unfavourable/qualified or in the opinion of the auditor, the NBFC has bot complied with the provisions of **(i)** Chapter III-B of the RBI Act, **(ii)** NBFC Acceptance of Public Deposits Directions 2016, **(iii)** NBFC Prudential Norms Directions 2016, it would be his obligation to make a report containing the details of such unfavourable/ qualified statement and/or about the non-compliance to the RBI. The duty of the auditor would be to report only the contraventions of the RBI Act/Directions/Guidelines/Instructions but the report should not contain any statement with respect to compliance of any of those provisions.

ASSET-LIABILITY MANAGEMENT (ALM) SYSTEM

In the normal course, NBFCs are exposed to credit and market risks in view of the asset-liability transformation. With liberalisation in Indian financial markets, over the last few years and growing integration of domestic markets with external markets and the entry of MNCs for meeting the credit needs of not only the corporates but also the retail segments, the risks associated with NBFC operations have become complex and large, requiring strategic management. NBFCs are now operating in a fairly deregulated environment and are required to determine interest rates on deposits on their own; subject to the ceiling of maximum rate of interest on deposits, they can offer deposits prescribed by the RBI; they can also offer advances on a dynamic basis. The interest rates on investments of NBFCs in Government and other securities are also now market related. Intense competition for business involving both assets and liabilities has brought pressure on the management of NBFCs to maintain a good balance among spreads, profitability and long-term viability. Imprudent liquidity management can put NBFCs' earnings and reputation at great risk. These pressures call for structured and comprehensive measures and not just ad hoc action. The managements of NBFCs have to base their business decisions on a dynamic and integrated risk management system and process, driven by corporate strategy. NBFCs are exposed to several major risks in the course of their business: credit risk, interest rate risk, equity/commodity price risk, liquidity risk and operational risk. It is, therefore, important that NBFCs introduce effective risk management systems that address the issues relating to interest rate and liquidity risks.

NBFCs need to address these risks in a structured manner by upgrading their risk management and adopting more comprehensive Asset-Liability Management (ALM) practices than has been done hitherto. ALM, among other functions, is also concerned with risk management and provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rates and equity and commodity price risks of major operators in the financial system, which needs to be closely integrated with the NBCFs' business strategy. It involves assessment of various types of risks and altering the asset-liability portfolio in a dynamic order to manage risks.

The RBI guidelines relate to interest rate and liquidity risks management systems in NBFCs, which form part of the Asset-Liability Management (ALM) function**. The initial focus of the ALM function would be to enforce the risk management discipline, that is, managing businesses after assessing the risks involved. The objective of good risk management systems should be that these systems will evolve into a strategic tool for NBFC management.**

The ALM process rests on three pillars:

- ALM Information Systems
  - Management information systems
  - Information availability, accuracy, adequacy and expediency
- ALM Organisation
  - Structure and responsibilities
  - Level of top management involvement
- ALM Process
  - Risk parameters
  - Risk identification
  - Risk measurement
  - Risk management
  - Risk policies and tolerance levels.

ALM Information System

ALM has to be supported by a management philosophy that clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with the necessary information system as back up. Thus, information is the key to the ALM process. It is, however, recognised that varied business profiles of NBCFs in the public and private sectors do not make the adoption of a uniform ALM System for all NBFCs feasible. There are various methods prevalent worldwide for measuring risks. These range from the simple Gap Statement to extremely sophisticated and data intensive Risk Adjusted Profitability Measurement methods. However, though the central element for the entire ALM exercise is the availability of adequate and accurate information with expedience; and the systems existing some of the major NBFCs do not generate information in the manner required for ALM. Collecting accurate data in a timely manner would be the biggest challenge before the NBFCs, particularly those lacking full scale computerisation. However, the introduction of a base information system for risk measurement and monitoring has to be addressed urgently.

NBFCs have heterogeneous organisational structures, capital base, asset sizes, management profile, business activities and geographical spread. Some of them have a large number of branches and agents/brokers, whereas some have unitary offices. Considering the large network of branches and the lack of (an adequate) support system to collect information required for the ALM, which analyses information on the basis of residual maturity and repricing pattern of liabilities and assets, it would take time for NBFCs, in the present state, to get the requisite information. With respect to investment portfolio and funds management, in view of the centralised nature of the functions, it would be much easier to collect reliable information. The data and assumptions can then be refined over time as the NBFC management gain experience of conducting business within an ALM framework. The spread of computerisation will also help NBFCs in accessing data.

ALM Organisation

(a) Successful implement of the risk management process would require strong commitment on the part of the senior management in the NBFCs to integrate basic operations and strategic decision making with risk management. The Board of Directors of NBFCs should have overall responsibility for management of risks and should decide its risk management policy and set limits for liquidity, interest rate and equity/price risks.

(b) The Asset-Liability Committee (ALCO) consisting of the NBFC's senior management, including the Chief Executive Officer (CEO), should be responsible for ensuring adherence to the limits set by the Board of Directors as well as for deciding the business strategy of the NBFC (on the assets and liabilities sides) in line with the NBFC's budget and decided risk management objectives.

(c) The ALM Support Groups consisting of operating staff should be responsible for analysing, monitoring and reporting risk profiles to the ALCO. The staff should also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to NBFC's internal limits.

The ALCO is a decision making unit responsible for balance sheet planning from the risk-return perspective, including the strategic management of interest rate and liquidity risks. Each NBFC should decide on the role of its ALCO, its responsibility as also the decisions to be taken by it. The business and risk management strategy of the NBFC should ensure that the NBFC operates within the limits/parameters set by its Board of Directors. The business issues that an ALCO would consider, inter-alia, should include product pricing for both deposits and advances, desired maturity profile and mix of the incremental assets and liabilities, prevailing interest rates offered by other peer NBFCs for similar services/ products and so on. In addition to monitoring the risk levels of the NBFC, the ALCO should review the results of, and progress in, implementation of the decisions made in the previous meetings. The ALCO should also articulate the current interest rate view of the NBFC and base its decisions for future business strategy on this view. With respect to the funding policy, for instance, its responsibility would be to decide on the source and mix of liabilities or sale of assets. Towards this end, it should develop a view regarding the future direction of interest rate movements and decide on funding mixes between fixed vs floating rate funds, wholesale vs retail deposits, money market vs capital market funding, domestic vs foreign currency funding, and so on. Individual NBFCs should decide the frequency of holding their ALCO meetings.

Composition of ALCO The size (number of members) of ALCO would depend on the size of each institution, business mix and organisational complexity. To ensure commitment of the Top Management and timely response to market dynamics, the CEO/CMD/President/Director should head the Committee. The Chiefs of Investment, Credit, Resources Management/ Planning, Funds Management/Treasury, International Business and Economic Research can be members of the Committee. In addition, the Head of the Technology Division should also be an invitee for building up of MIS and related computerisation. Large NBFCs may even have sub-committees and support groups.

Committee of Directors The Management Committee or any other specific committee constituted by the Board of Directors should oversee the implementation of the system and review its functioning periodically.

ALM Process

The scope of the ALM function can be described as follows: **(1)** Liquidity risk management, **(2)** Management of market risks, **(3)** Funding and capital planning, **(4)** Profit planning and growth projection and **(5)** Forecasting and analysing 'What if scenario' and preparation of contingency plans. The guidelines, however, mainly address liquidity and interest rate risks.

Liquidity Risk Management Measuring and managing liquidity needs are vital for the effective operation of NBFCs. By ensuring an NBFC's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. The importance of liquidity transcends individual institutions, as liquidity shortfall in one institution can have repercussions on the entire system. The NBFC management should measure not only the liquidity positions of the NBFC on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions. Experience shows that assets commonly considered as liquid, like Government securities and other money market instruments, could also become illiquid when the market and players are unidirectional. Therefore, liquidity has to be tracked through maturity or cash flow mismatches. For measuring and managing net funding requirements, the use of a maturity ladder and calculation of cumulative surplus or deficit of funds at selected maturity dates is adopted as a standard tool. The Maturity Profile given in **Appendix 14-A on the website** could be used for measuring the future cash flows of NBFCs in different time-buckets. The time-buckets, may be distributed as under:

- **(i)** 1 day to 30/31 days (one month)
- **(ii)** Over one month and up to 2 months
- **(iii)** Over two months and up to 3 months
- **(iv)** Over 3 months and up to 6 months
- **(v)** Over 6 months and up to 1 year
- **(vi)** Over 1 year and up to 3 years
- **(vii)** Over 3 years and up to 5 years
- **(viii)** Over 5 years

NBFCs holding public deposits are required to invest up to a prescribed percentage (15 per cent as on date) of their public deposits in approved securities, in terms of the liquid asset requirement of Section 45-IB of the RBI Act, 1934. Residuary Non-Banking Companies (RNBCs) are required to invest up to 80 per cent of their deposits in the manner prescribed in the RBI Directions issued under the Act, as detailed in an earlier section. There is no such requirement for NBFCs that are not holding public deposits. Thus, various NBFCs, including RNBCs, would be holding, in their investment portfolio, securities that could be broadly classifiable as 'mandatory securities' (under obligation of law) and 'non-mandatory' securities. In case of NBFCs not holding public deposits, all the investment securities and in case of NBFCs holding public deposits, the surplus securities (held over and above the requirement) would fall in the category of 'non-mandatory securities'. NBFCs holding public deposits may place mandatory securities in any time-bucket suitable to them. The listed non-mandatory securities may be placed in any of the "1 day to 30/31 days (one month)", "over one month and upto 2 months" and "over two months and upto 3 months" buckets, depending upon the defeasance period proposed by NBFCs. Unlisted non-mandatory securities (e.g., equity shares, securities without a fixed term of maturity and so on) may be placed in the "over 5 years" buckets, whereas unlisted non-mandatory securities having a fixed term of maturity may be placed in the relevant time bucket, as per residual maturity. The mandatory securities and listed securities may be marked to market for the purpose of the ALM system. Unlisted securities may be valued as per RBI's Prudential Norms Directions.

Alternatively, NBFCs may also follow the concept of the trading book, which is as follows:

(i) The composition and volume are clearly defined;
(ii) Maximum maturity/duration of the portfolio is restricted;
(iii) The holding period not to exceed 90 days;
(iv) Cut-loss limit prescribed;
(v) Defeasance periods (product-wise), that is, time taken to liquidate the position on the basis of liquidity in the secondary market, are prescribed.

NBFCs that maintain such 'trading books' and comply with the above standards may show the trading securities under "1 day to 30/31 days (one month)", "over one month and upto 2 months" and "over two months and upto 3 months" buckets on the basis of the defeasance periods. The Board of Directors/ALCO of the NBFCs should approve the volume, composition, holding/defeasance period, cut-loss, and so on of the 'trading book'. The remaining investments, should also be classified as short-term and long-term investments, as required under RBI's Prudential Norms.

The policy note recorded by NBFCs on the treatment of the investment portfolio, for the purpose of ALM, and approved by their Board of Directors/ALCO should be forwarded to the Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located.

With in each time-bucket, there could be mismatches depending on cash inflows and outflows. While mismatches up to one year would be relevant since these provide early warning signals of impending liquidity problems, the main focus should be on the short-term mismatches, that is, 1–30/31 days. NBFCs, however, should monitor their cumulative mismatches (running total) across all time-buckets by establishing internal prudential limits with the approval of the Board of Directors/Management Committee. The mismatches (negative gap) during 1–30/31 days in normal course may not exceed 15 per cent of the cash outflows in this time-bucket.

The Statement of Structural Liquidity may be prepared by placing all cash inflows and outflows in the maturity ladder according to the expected timing of cash flows. A maturing liability is cash outflow while a maturing asset is a cash inflow. While determining the likely cash inflows/outflows, NBFCs should make a number of assumptions according to their asset-liability profiles. While determining the tolerance levels, NBFCs may take into account all relevant factors based on their asset-liability base, nature of business, future strategy and so on. The tolerance levels should be determined keeping all necessary factors in view and further refined with experience gained in liquidity management.

In order to enable NBFCs to monitor their short-term liquidity on a dynamic basis over a time horizon spanning from 1 day to 6 months, NBFCs should estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.

Currency Risk Floating exchange rate arrangement has brought in its wake pronounced volatility, adding a new dimension to the risk profile of NBFC balance sheets having foreign assets and liabilities. The increased capital flows across free economies, following deregulation, have contributed to an increase in the volume of transactions. Large cross border flows together with volatility has rendered NBFCs' balance sheets vulnerable to exchange rate movements.

Interest Rate Risk (IRR) The operational flexibility given to NBFCs in pricing most of the assets and liabilities imply the need for the financial system to hedge the interest rate risk—defined as the risk where changes in market interest rates might adversely affect an NBFC's financial condition.

The changes in interest rates affect NBFCs in a larger way. The immediate impact of changes in interest rates is on NBFC's earnings (ie, reported profits), by changing its net interest income (NII). A long-term impact of changing interest rates is on NBFCs' market value of equity (MVE) or net worth, as the economic value of NBFC's assets, liabilities and off-balance sheet positions get affected due to variation in market interest rates. The interest rate risk when viewed from these two perspectives is known as the 'earnings perspective' and 'economic value perspective', respectively. The risk from the earnings perspective can be measured as changes in the net interest income (NII) or net interest margin (NIM). There are many analytical techniques for measurement and management of interest rate risk. To begin with, the traditional Gap analysis is considered as a suitable method to measure the interest rate risk. It is the intention of the RBI to move over to modern techniques of interest rate risk measurement like Duration Gap Analysis, Simulation and Value at Risk (VaR) over a period of time, during which NBFCs would acquire sufficient expertise and sophistication in acquiring and handling MIS.

The Gap or mismatch risk can be measured by calculating Gaps over different time intervals, as on a given date. Gap analysis measures mismatches between rate sensitive liabilities and rate sensitive assets (including off-balance sheet position). An asset or liability is normally classified as rate sensitive if:

(i) Within the time interval under consideration, there is a cash flow;
(ii) The interest rate resets/reprices contractually during the interval;
(iii) Dependent on the RBI changes in interest rates/bank rate;
(iv) It is contractually pre-payable or withdrawn before the stated maturities.

The Gap Report should be generated by grouping rate sensitive liabilities, assets and off-balance sheet positions into time-buckets according to residual maturity or next pricing period, whichever is earlier. The difficult task in Gap analysis is determining the sensitivity rate. All investments, advances, deposits, borrowings, purchased funds and so on that mature/reprice within a specified timeframe are interest rate sensitive. Similarly, any principal repayment of loan is also rate sensitive if the NBFC expects to receive it within the time horizon. This includes final principal payment and interim instalments and certain assets and liabilities, to receive/pay rates that vary from a reference rate. These assets and liabilities are repriced at pre-determined intervals and are rate sensitive at the time of repricing. While the interest rates on term deposits are fixed during their currency, the trenches of advances portfolio is basically flowering. The interest rates on advances received could be repriced on any number of occasions, corresponding to the changes in PLR (prime lending rate).

Gaps may be identified in the following time-buckets:

(i) 1–30/31 days (one month)
(ii) Over one month to 2 months
(iii) Over two months to 3 months
(iv) Over 3 months to 6 months
(v) Over 6 months to 1 year
(vi) Over 1 year to 3 years
(vii) Over 3 years to 5 years
(viii) Over 5 years
(ix) Non-sensitive

The various items of rate sensitive assets and liabilities and off-balance sheet items may be classified as explained in **Appendix 14-B on the website. The website address is http://www.mhhe.com/khanifs10e.**

The Gap is the difference between the Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL) for each time bucket. The positive Gap indicates that it has more RSAs than RSLs whereas the negative Gap indicates that it has more RSLs than RSAs. The Gap reports indicate whether the institution is in a position to benefit from rising interest rates by having a positive Gap (RSA > RSL) or whether it is in a position to benefit from declining interests rates by a negative Gap (RSL > RSA). The Gap can, therefore, be used as a measure of interest rate sensitivity.

Each NBFC should set prudential limits on individual Gaps with the approval of the Board of Directors/Management Committee. The prudential limits should have a relationship with the total assets, earnings assets or equity. The NBFCs may work out earnings at risk (EaR) or a net interest margin (NIM), based on their views on interest rate movements, and fix a prudent level with the approval of the Board of Directors/Management Committee. For working out EaR or NIM, any of the current models may be used.

The RBI intends to introduce capital adequacy for market risks in due course.

General

The classification of various components of assets and liabilities into different time-buckets for preparation of Gap reports (Liquidity and Interest Rate Sensitivity), as indicated in **Appendix 14-A and Appendix 14-B on the website**, is the benchmark NBFCs that are better equipped to reasonably estimate the behavioural pattern of various components of assets and liabilities, on the basis of past data/empirical studies, could classify them in the appropriate time buckets, subject to approval from the ALCO/Board of Directors. A copy of the note approved by the ALCO/Board of Directors may be sent to the Regional Office of the Department of Non-banking Supervision of the RBI under whose jurisdiction the registered office of the company is located. These notes may contain 'what if scenario' analysis under various assumed conditions and the contingency plans to face various adverse developments.

The present framework does not capture the impact of premature closures of deposits and prepayment of loans and advances on the liquidity and interest rate risk profile of NBFCs. The magnitude of premature withdrawal of deposits at times of volatility in market interest rates is quite substantial. NBFCs should, therefore, evolve a suitable mechanism, supported by empirical studies and behavioural analysis, to estimate the future behaviour of assets, liabilities and off-balance sheet items to changes in market variables and estimate the probabilities of the options.

A scientifically evolved internal transfer pricing model of assigning values on the basis of current market rates to funds provided and funds used is an important component for effective implementation of the ALM System. The transfer price mechanism can enhance the management of margin, that is, lending or credit spread, the funding or liability spread and mismatch spread. It also helps centralising interest rate risk at one place, which facilitates effective control and management of interest rate risk. A well defined transfer pricing system also provides a rational framework for pricing of assets and liabilities. The asset liability management practices of a NBFC is illustrated with reference to an actual case in **Appendices 14-C to 14-E on the website. The website address is http://www.mhhe.com/khanifs10e.**

CREDIT INFORMATION COMPANIES (ACT) 2005

To facilitate the efficient distribution of credit and to provide for regulation of credit information companies (CICs), the CICs (Regulation) Act was enacted in 2005. **Credit information** means any information relating to **(a)** the amounts and nature of loans or advances, amounts outstanding under credit cards and other credit facilities granted/to be granted to a borrower by a credit institution (CI); **(b)** nature of security taken/proposed to be taken by a CI from any borrower for credit facilities granted/to be granted; **(c)** guarantee furnished/any other non-fund based facility granted/to be granted by a CI to any of its borrowers; **(d)** the creditworthiness of a borrower of a CI; and **(e)** any other matter which the RBI may consider necessary and specify for inclusion in the credit information to be collected and maintained by the CICs. A **credit institution** includes **(1)** banks, **(2)** NBFCs, **(3)** PFIs, **(4)** SFCs, **(5)** HFCs, **(6)** companies in the credit card business/dealing with the distribution of credit in any other manner and **(7)** any other institution specified by the RBI from time to time. **Borrower** means a person who has been granted a loan/any other credit facility by a CI, including a client. A **Client** includes **(1)** a guarantor/a person who proposes to give guarantee/security for a borrower of a CI and **(2)** a person who **(a)** has obtained/seeks to obtain financial assistance from a CI by way of loans, advances, hire-purchase, leasing facility, letter of credit, guarantee, venture capital assistance, credit cards, or in any other form/manner; **(b)** has raised/seeks to raise money by issue of securities under the provisions of SCRA/CPs/ depository receipt/any other instrument; and **(c)** whose financial standing has been assessed/ proposed to be assessed by a CI/other person/institution directed by the RBI. The main elements of the operation of CICs are their: Registration, Management, Auditors, Functions, Information Privacy, Offences and Penalties and Miscellaneous.

Registration of CICs

To commence (new) and to carry on business (existing), a CIC should obtain a certificate of registration from the RBI. While considering an application, the RBI would satisfy itself by an inspection of the records/books or otherwise that the application fulfils the following conditions: **(a)** it has the minimum capital structure (namely, authorised capital of ₹30 crore, which may be increased upto ₹50 crore by the RBI; issued capital of at least ₹20 crore, which may be increased upto the minimum authorised capital of and paid-up capital, not less than 75 per cent of the issued capital; **(b)** the general character of management would not be prejudicial to the interest of the specified users (i.e. etc. any CI/CIC including such other person/institution specified by the RBI), clients, borrowers or any other CIS; and **(c)** any other condition the fulfilment of which would be necessary to ensure that the commencement/carrying on of business of the CIC would not be detrimental/prejudicial to public interest, banking policy, credit system, specified users, clients, borrowers, other CICs or others who would provide credit information to CICs. On being satisfied about these conditions, the RBI would grant registration subject to conditions it may consider fit. It can cancel the registration of an CIC if it **(i)** ceases to carry on its business, **(ii)** fails to comply with any condition subject to which registration was granted, **(iii)** fails to fulfil any condition such as requirement of minimum capital, general character of management and so on and or **(iv)** fails to comply with any provision of any law for the time being in force or any RBI directions to submit, or offer for inspection, its books of accounts and other relevant documents, demanded by the officers, persons, or agency responsible for conducting investigation into its affairs under directions from Government.

Management of CICs

Subject to the superintendence, control and direction of the Board of Directors, the Chairperson/ Managing Director would be entrusted with the management of the whole of its affairs. At least 50 per cent directors should have special knowledge in, or practical experience of, matters relating to public administration, law, banking, finance, accountancy, management and information technology. The Board should act on business principles, with due regard to the interests of its specified users, CIs and the clients/borrowers of the CIs. The specified users mean any CI/ CIC, including any other person/institution specified by the RBI regulations for obtaining credit information from a CIC. In public interest/in the interest of banking policy or credit system the for preventing the affairs of a CIC being managed in a manner detrimental to the interest of the banking policy, CIs, borrowers or clients or for securing its proper management, the RBI can supersede the Board for upto 12 months and appoint an Administrator who would be duly bound to follow RBI directions. He would exercise all the powers, functions and duties of the Board.

Power to Determine Policy and Give Directions If necessary or expedient in public interest/or in the interest of specified users, CICs, CIs, clients or borrowers, the RBI has the power to determine policy in relation to the functioning of the CICs, CIs, specified users generally or in particular, and all concerned parties would be bound to follow it. Similarly, the RBI may issue directions in public interest or in the interest of Cis, specified users, banking policy, or to prevent the affairs of a CIC being conducted in a manner detrimental/prejudicial to the interests of specified users, Cis, borrowers or clients and to secure the proper management of CICs.

The RBI may, in public interest/in the interest of a CIC, **(i)** require the CIC to consider in a meeting of its Board, any matter relating to/arising out of its affairs; **(ii)** depute its officers to watch the proceedings of the meeting, who should be heard and submit a report to it; **(iii)** appoint its officers to observe and report on the manner in which the affairs of the CIC are conducted; and **(iv)** require the CIC to make necessary changes in its management. It may also direct a CIC to furnish within the specified time, statements/information relating to its business/ affairs considered necessary/expedient for the purpose.

Inspection The RBI on its own or on direction from the Government, may carry out by its officers/through other person, or agency, an inspection of a CIC, CI or a specified user and their books of accounts. Every director/other officer/employee would be duty bound to produce all specified books, accounts and other documents in his custody and to furnish any statement/ information relating to them. A director/other officer/employee may be examined on oath in relation to their business. The expenses of or incidental to the inspection would be borne by the CIC/CI/specified user.

Auditors

An auditor would be duty bound to inquire if the CIC has furnished to the RBI, the required statements/information/particulars relating to its business and, if not satisfied, make a report to the RBI. In public interest/in the interest of the CIC or its members/credit system or the CI or its borrower or clients, the RBI may order a special audit by the company auditor or any other auditor, of the accounts of the CIC in relation to any transaction(s)for specified period(s). The auditor should submit a report to the RBI. The remuneration of the auditors and the expenses of audit would be borne by the concerned CIC.

Functions

A CIC may engage in the following forms of business:

- To collect, process and collate information on trade, credit and financial standing of borrowers of the CI which is a member of the CIC;
- To provide credit information/credit scoring to its specified users as well as any other CIC or to any other CIC, being its members. Credit scoring means a system which enables a CI to assess the creditworthiness and capacity of a borrower to repay his loans/advances and discharge his other obligations in respect of credit policy availed/to be availed by him;
- To undertake research projects;
- To undertake any other form of business specified by the RBI as lawful for a CIC to engage in.

A CIC may **(a)** register CIs/other CICs as members, **(b)** charge a reasonable amount of fee, within the ceiling specified by the RBI, for furnishing credit information to a specified user and **(c)** generally do all other acts/perform other functions as are necessary to facilitate a proper conduct of its affairs/business/functions.

Membership Every CI should become a member of at least one CIC. A CIC has the option to become a member of another CIC. Every specified user would be entitled to obtain credit information for its use from the CIC of which he is a member.

Collection/Furnishing of Credit Information A CIC/an authorised person may require its members (i.e., CICs/CIs) to furnish, in the RBI specified form, necessary information within the specified time. The CIC would provide for a specified purpose, the credit information received, to its specified users, on a written request from him as per the specified RBI directions. Any credit information received by the CIC/specified user should not be disclosed to any person other than the specified user/any other person, for purpose other than as permitted or required by any other law for the time being in force.

Information Privacy Principles

The prescribed steps (including security safeguards) should be taken by all CICs/CIs/ specified uses who are in possession/control of credit information to ensure that the data maintained by them is accurate, complete, duly protected against loss or unauthorised access or use or unauthorised disclosure. They should follow the following privacy principles in relation to the collection, processing, collating, recording, preservation, secrecy, sharing and usage of credit information:

- The principle which may be **(i)** followed by every CI for collection of information from borrowers and clients/CIC, for collection of credit information from member CIs or CICs, for processing, recording and protecting the data relating to credit information furnished by, or obtained from, member CIs or CIC and sharing them with specified users, **(ii)** adopted by every specified user for processing, recording, preserving and protecting data and **(iii)** adopted by every CIC for allowing access to records containing credit information of borrowers/clients and alteration of such records in case of need;
- The purpose for which the credit information may be used and the restrictions on such use and disclosures;
- The extent of obligations to check the accuracy before furnishing credit information to CICs/CIs/specified users;

- Preservation of credit information maintained by every CIC/CI/specified user, including the period, manner of deletion of such information and maintenance of records;
- Networking of CICs/CIs/specified users through electronic mode; and
- Any other principles/procedures specified by the RBI.

Any person who applies for grant/sanction of a credit facility from any CI should request and be furnished on the payment of specified charges, a copy of the credit information obtained from the CIC. On request from a borrower/client, the CIC/CI/ specified user would update the credit information in its possession/control by making appropriate correction(s)/addition/deletion/otherwise, within 30 days from the date of request.

No person would have unauthorised access to credit information in the possession/control of a CI/CIC/specified users. Unauthorised access would be punishable with a fine of upto ₹1 lakh for each offence, with a further fine of upto ₹10,000 for every day the default continues and the unauthorised information cannot be taken into account for any purpose.

Offences and Penalties

Penalties for offences are specified below:

- For a wilful false statement in any material particular/wilful omission of a material statement: Imprisonment upto 1 year, together with the fine.
- Breach of any privacy principle by a CIC/CI/Specified user: Fine upto ₹1 crore.
- Wilful provision by CIC/CI/specified user false information in any material particular/wilful omission to make a material statement: Fine upto ₹1 crore.
- Contravention of the provisions of the CICs Act/rules/orders or obstruction of the lawful exercise of any power under the CICs Act/rules/orders/directions: Fine upto ₹1 lakh, with a further fine upto ₹5,000 for each day of contravention/default.
- Every person who was incharge of/responsible to the CIC/CI/specified user for the conduct of business of a company (i.e., body corporate, including a firm/other association of individuals), would be deemed guilty of the contravention/default and punished unless he proves that it was committed without his knowledge or that he exercised all due diligence to prevent the contravention/default. The chairperson/MD/director (i.e., partner in relation to a firm)/manager/secretary/other officers of the CIC/CI would also be liable for punishment if proved that the contravention/default was committed with their consent/connivance or is attributable to any gross negligence on their part. The term 'company' means any body corporate, including a firm/other association of individuals.

Penalty by RBI The RBI can impose penalty as specified below:

- For unauthorised access to credit information: Upto ₹1 lakh.
- For breach of the privacy principle/wilful provision or omission of material particulars: Upto ₹1 crore.
- Contravention of the provisions of the CICs Act/rules/orders/directions: Upto ₹1 lakh, with ₹5,000 each day, after the first day, of the contravention/default.

Miscellaneous

The miscellaneous provisions of the CICs Act are summarised below:

- The RBI would specify the fee leviable for providing information to the specified users and for admission as member of a CIC.

- A chairperson/director/member/auditor/adviser, officer/other employee/agent of a CIC/ specified user can disclose any information to any person only if required by a court/ tribunal/authority.
- Every CIC should observe the **customary practices/usages** and not divulge any information relating to, or to the affairs of, its members/specified users. A declaration of fidelity and secrecy in the prescribed form should be made before entering upon his duties, by the chairperson/director/member/auditor/adviser/officer/other employee of a CIC. Included in 'practices/usages customary' are such practices and usages which are generally followed by the CICs or may develop in due course in relation to their functions in pursuance of the provisions of the CICs Act/rules/regulations/directions.
- The Government, in consultation with the RBI, can make rules to carry out the provisions of the CICs Act, in particular to provide for the following matters: **(i)** the authority/tribunal to hear appeal against an order of the RBI rejecting/cancelling registration of a CIC; **(ii)** the steps to be taken by every CIC/CI/specified users for ensuring accuracy, completeness and protection of data from any loss/unauthorised access/use/disclosure; **(iii)** the form in which a declaration of secrecy/fidelity would be made; and **(iv)** any other matter.
- The RBI can make regulations consistent with the provisions of the CICs Act/rules, to carry out the provisions of the CICs Act, in particular to provide for the following: **(i)** the persons/institutions to be specified as specified users, **(ii)** the form and the manner of filling of application for registration; **(iii)** any other form of business in which a CIC may engage; **(iv)** the form and notice for the collection and furnishing of information and the procedure and purpose for which credit information may be prescribed; **(v)** the principles/procedures relating to credit information to be specified under privacy principles; **(vi)** the amount to be paid for obtaining a copy of credit information and **(vii)** the maximum charges for providing information to the specified users and for admission of CIs/CICs as members of a CIC.

RBI CORE INVESTMENT COMPANIES DIRECTIONS, 2016

A **core investment company** (CIC) means a non-banking financial company carrying on the business of acquisition of shares and securities satisfying the following conditions as on the date of the last audited balance sheet: **(i)** it holds at least 90 per cent of its **net assets** (total assets excluding cash and bank balances, investments in money market instruments/mutual funds, advance payment of taxes and deferred tax payment) in the form of investment in equity/preference shares, bonds, debentures, debt/loans in group companies; **(ii)** its investments in the equity shares (including compulsorily convertible instruments within 10 years from the date of issue) in group companies constitute not less than 60 per cent of its net assets; **(iii)** it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment; **(iv)** it does not carry on any other financial activity except **(a)** investment in **(i)** bank deposits, **(ii)** money market instruments, including money market mutual funds and liquid mutual funds, **(iii)** government securities, and **(iv)** bonds or debentures issued by group companies, **(b)** granting of loans to group companies and **(c)** issuing guarantees on behalf of group companies.

The provisions of Section 45-I-A of the RBI Act would not apply to a systematically important core investment company (**CIC-ND-SI**) defined as a core company having minimum total assets of ₹100 crore either individually or in aggregate along with other group **CICs** which raise/hold public deposits. The provisions of Section 45I-A(1) **(b)** would also not apply if it meets the stipulated capital requirements and leverage ratios.

The main elements of these directions **(i)** registration, **(ii)** prudential issues, **(iii)** governance issues and **(iv)** overseas investments are discussed in this Section.

Registration

Every CIC-ND-SI should apply to the RBI for grant of certificate of registration (CoR) within three months from the date of becoming a CIC-ND-SI. Every CIC exempted from registration requirement should pass a Board resolution that it will not, in the future, access public funds. However, CICs may be required to issue guarantees or take on other contingent liabilities on behalf of their group entities. Before doing so, they must ensure that they can meet the obligations, as and when they arise. In particular, CICs which are exempt from registration requirement must be in a position to do so without recourse to public funds in the event the liability devolves, else they should approach the RBI for registration before accessing public funds. If unregistered CICs with asset size above ₹100 crore access public funds without obtaining a CoR, they would be seen as violating the RBI directions.

Prudential Issues

Included in prudential issues are: **(i)** capital requirements and leverage ratio and **(ii)** prudential regulations.

Capital Requirements The **adjusted net worth** (i.e. the aggregate of owned funds **plus (i)** 50 per cent of the unrealised appreciation in terms of excess of market value over book value in the book value of quoted investments, **(ii)** any increase in the equity share capital **minus (a)** the amount of diminution in the total value of quoted investments in terms of excess of book value over market value and **(b)** any reduction in the equity share capital) of a CIC-ND-SI should not be less than 30 per cent of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items as on the date of the last audited balance sheet as at the end of the financial year. The risk weighted assets and credit conversion factors are the same as applicable to NBFC-SI-ND/NBFC-D discussed in Section 2.

Leverage Ratio The outside liabilities of a CIC-ND-SI should never exceed 2.5 times its adjusted net worth as on the date of the last audited balance sheet as at the end of the financial year.

Prudential Regulations

The prudential regulations applicable to the CIC-ND-SI are the same as applicable to the NBFC-ND-SI/NBFC-D. These are detailed in Section 2 of this Chapter.

Governance Issues

Included in governance issues are **(i)** acquisition/transfer of control of systematically important CICs, **(ii)** application for prior approval, **(iii)** prior public notice about charge in management control.

Acquisition/Transfer of Control of Systematically Important CICs A systematically important CIC would require prior written permission of the RBI for any **(a)** takeover/acquisition of its control, which may or may not result in change of management; **(b)** change in the shareholding of CIC, including progressive increases over time, which results in the acquisition/transfer of its shareholding of 26 per cent or more of the paid-up equity capital. However, prior approval would not be required in case of any shareholding going beyond 26 per cent due to buyback of shares/reduction in capital where it has approval of a competent Court. It should be reported to the RBI within one month from its occurrence; **(c)** any change in the management of the CIC which results in change in more than 30 per cent of the directors, excluding independent directors. However, prior approval would not be required in case of directors who get reelected on retirement by rotation. In any case, the CICs should continue to inform the RBI regarding any change in their directors/management within one month from the occurrence of any change.

Application for Prior Approval The CICs should submit an application, in the company letter head, for obtaining prior approval of the RBI, along with the following: **(a)** specified information about the proposed directors/shareholders, **(b)** sources of funds of the proposed shareholders acquiring the shares in the CIC, **(c)** declaration by the proposed directors/shareholders that **(1)** they are not associated with any **(i)** unincorporated body that is accepting deposits, **(ii)** CoR of which has been rejected by the RBI, **(2)** there is no criminal case, including for offence under the Negotiable Instruments Act, against them and **(d)** Bankers' report on the proposed directors/shareholders.

Requirement of Prior Public Notice About Change in Control/Management A public notice of at least 30 days should be given before effecting the sale of, or transfer of the ownership by sale of shares, or transfer of control, with or without sale of shares by the CIC and also by the other party or jointly by the parties concerned, after obtaining the RBI's prior permission. The public notice should indicate the intention to sell/transfer ownership/control, the particulars of transferee and the reasons for the sale or transfer of ownership/control. It should be published in at least one leading national and in one leading local (covering the place of registered office) vernacular newspaper.

Overseas Investment

These directions are in addition to those prescribed by Foreign Exchange Department of the RBI for overseas investment. The main elements of the directions, namely, **(i)** investment in financial sector overseas, **(ii)** investment in non-financial sector, **(iii)** eligibility criteria, **(iv)** general/specific conditions are discussed below.

Investment in Financial Sector Overseas All CICs investing in joint venture/subsidiary/representative offices overseas in the financial sector would require the RBI's prior approval. They should hold a CoR from the RBI and should comply with all the regulations applicable to CIC-ND-SI.

Investment in Non-Financial Sector A CIC-ND-SI does not need RBI's prior approval for overseas investment in non-financial sector. However, it should report within 30 days of such investment in the stipulated format and at the prescribed periodicity.

Eligibility Criteria The adjusted net worth (ANW) of the CIC should not be less than 30 per cent of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items as on the date of the last audited balance sheet as at the end of the financial year. The CIC should continue to meet the requirement of minimum ANW, post overseas investment. The level of NPAs of the CIC should not be more than 1 per cent of the net advances as on the date of the last audited balance sheet. It should generally be earning profit continuously for the last three years and its performance should be satisfactory during the period of its existence.

General Conditions Direct investment in activities prohibited under FEMA would not be permitted. The total overseas investment should not exceed 400 per cent of the owned funds of the CIC. The total overseas investment in financial sector should not exceed 200 per cent of its owned funds. Investment in financial sector should be only in regulated entities abroad. The entities set-up/acquired abroad would be treated as wholly owned subsidiaries (WOS)/joint ventures (JVs) abroad.

The overseas investments by a CIC in financial /non-financial sector should be restricted to its financial commitment. However, with regard to issuing guarantees/letter of comfort in this regard, the following should be noted. The CIC can issue guarantees/letter of comfort to the overseas subsidiary engaged in non-financial activity. It must ensure that investments made overseas would not result in creation of complex structures. In case the structure overseas requires a non-operating holding company, there should not be more than two tiers in the structure. The CICs having more than one non-operating holding company in existence should report the same to the RBI for a review. They should comply with the regulations issued under FEMA from time to time. An annual certificate from statutory auditors should be submitted by the CIC to the RBI, certifying that it has fully complied with all the conditions stipulated under these guidelines for overseas investment. The certificate as on end-March every year should be submitted by April 30 each year. If any serious adverse features come to the notice of the RBI, the permission granted would be withdrawn. All approvals for investment abroad would be subject to this condition.

Specific Conditions ***Opening of Branches*** As CICs are non-operating entities, they would not, in the normal course, be allowed to open branches overseas.

Opening of WOS/JV Abroad by CICs In the case of opening of a WOS/JV abroad by a CIC, all the conditions as stipulated above would be applicable. The NoC to be issued by the RBI is independent of the overseas regulators' approval process. The following additional conditions would apply to all CICs: The WOS/JV should not be **(a)** a **shell company**, that is, a company that is incorporated, but has no significant assets or operations. However, companies undertaking activities such as financial consultancy and advisory services would not be considered as shell companies; **(b)** used as a vehicle for raising resources for creating assets in India for the Indian operations. In order to ensure compliance of these provisions, the parent CIC should obtain periodical/audit reports at least quarterly about the business undertaken by the WOS/JV abroad and make them available to the inspecting officials of the RBI. If the WOS/JV has not undertaken any activity or such reports are not forthcoming, the approvals given for its setting-up the WOS/JV abroad would be reviewed. It should make disclosure in its balance sheet the amount of liability of the parent entity towards it and also whether it is limited to equity/loan or if guarantees are given, the nature of such guarantees and the amount involved. All the operations of the WOS/JV abroad would be subject to regulatory prescriptions of the host country.

Opening of Representative Offices Abroad The CICs would need prior approval from the RBI for opening representative offices abroad for liaison work, undertaking market study and research but not for undertaking any activity which involves outlay of funds. They should also comply with the regulations in this regard stipulated by a regulator in the host country. As it is not envisaged that such offices would be carrying on any activity other than liaison work, no line of credit should be extended. The parent CICs should obtain periodical reports about the business undertaken by the representative offices abroad. If the representative offices have not undertaken any activity or such reports are not forthcoming, the RBI may advise the CIC to wind up the establishment.

CONCLUDING OBSERVATIONS

- The system/scheme of regulation of the working and operations of the NBFCs comprises: **(i)** RBI Act (Chapter III-B) **(ii)** RBI Directions, **(iii)** ALM Framework, **(iv)** Guidelines for Fair Practices Code and **(v)** Credit Informations Companies Act.
- The RBI regulates and supervises the NBFCs under Chapter III-B of the RBI Act. The regulatory and supervisory objective is to **(a)** ensure the healthy growth of the NBFCs, **(b)** ensure that they function as part of the financial system within the policy framework in such a manner that their existence and functioning do not lead to any systematic aberration and **(c)** ensure that the quality of surveillance and supervision is sustained by keeping pace with the developments that take place in this sector of the financial system. An NBFC is a company engaged in the business of loans and advances, acquisition of shares/bonds/debentures/securities issued by the Government or local authority or other similar marketable securities, leasing, hire-purchase, insurance business, venture capital, merchant banking, broking and housing finance.
- It is mandatory that every NBFC should be registered with the RBI to commence/carry on any business. It should have a minimum net owned fund of ₹25 lakh. The NBFCs registered with the RBI are **(i)** equipment leasing, **(ii)** hire-purchase, **(iii)** loan and **(iv)** investment companies. The other types of NBFCs are regulated by other regulators. They could be further classified into those accepting deposits and those not accepting deposits. The registered NBFCs are required to invest in unencumbered approved securities worth at least 5 per cent of their outstanding deposits. Every NBFC must create a reserve fund by transferring at least 20 per cent of its net profits before declaring any dividend. The RBI can regulate/prohibit solicitation of deposits from public. It can give directions to NBFCs relating to (a) prudential norms for income recognition, accounting standards, provisioning on capital adequacy and (b) deployment of funds. It can also issue directions for providing information relating to deposits/for conduct of business. For contraventions/defaults by an NBFC, the RBI can impose penalty. It can also cancel the registration of an NBFC.
- The RBI has issued five directions to the NBFCs: **(1)** Acceptance of Public Deposits Directions, **(2)** Prudential Norms Directions for NBFCs-D and NBFCs-ND-SI, **(3)** NBFC-ND directions, **(4)** Auditors Reports Directions, and **(5)** Core Investment Companies Directions.
- As per the public deposits directions, there is a ceiling on the acceptance of public deposits. An NBFC maintaining the required net owned funds (NOF) and capital adequacy ratio (CRAR) and complying with the prudential norms, can accept public deposits as follows: Equipment leasing (EL)/hire-purchase companies (HP) maintaining CRAR of 15 per cent without credit rating—the lower of 1.5 times of NOF or ₹10 crore; EL/HP with 12 per cent CRAR and minimum investment grade rating—4 times of NOF; and loan companies/investment companies with 12 per cent CRAR and minimum investment grade rating—1.5 times of NOF. The NBFCs

can accept/renew deposits for 12-60 months. They cannot offer interest higher than the ceiling rate prescribed by RBI which may be paid/compounded at rests not shorter than monthly rests. Deposits may be accepted by NBFCs in joint names. Premature withdrawal of deposits within 3 months from the date of acceptance is not permitted. The NBFCs cannot offer gifts/incentives or any other additional benefit to the depositors. They can open branch(es)/appoint agents to collect deposits. They should furnish deposit receipts containing details to the depositors and maintain register(s) of deposits. The unencumbered approved securities required to be maintained by an NBFC should be kept with a bank/depository and cannot be withdrawn/encashed except for payment of deposits.

- The provisions of NBFC-ND-SI/NBFC-D Directions apply to the following: **(i)** (**NBFC-ND-SI**), **(ii)** (**NBFC-D**), **(iii) NBFC-factor**, **(iv)** (**IDF-NBFC**), **(v)** (**NBFC-MFIs**) and **(vi)** (**NBFC-IFC**) having an asset size of ₹500 crore and above. There are specific directions applicable to the specific categories of NBFCs registered as NBFC-Factors, IDF-NBFCs and NBFC-MFIs.
- The main elements of the NBFC-ND-ST/NBFC-D directions are: **(i)** prudential issues and **(ii)** governance issues.
- The prudential issues pertain to **(i)** capital requirements, **(ii)** prudential regulations, **(iii)** fair practices, **(iv)** specific directions applicable to NBFC-Factor, IDF-NBFC and NBFC-MFIs.
- Every applicable NBFC should maintain a minimum capital ratio consisting of Tier-I and Tier-II capital of 15 per cent of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items.
- The prudential regulations relate to income recognition, income from investments, accounting standards, accounting of investments, policy on demand call loans, asset classification and provisioning requirements.
- The applicable NBFCs having customer interface should adopt the specified guidelines pertaining to fair practices code in terms of processing of applications, loan appraisals and terms/conditions, disbursement of loans, general responsibility of Board of Directors, grievances redressal officer, language and mode communication, regulation of excessive interest, complaint about excessive interest, repossession of vehicles financed and lending against jewellery.
- The main elements of the specific directions applicable to NBFC-Factor are: registration, net owned funds, principal business, conduct of business, asset classification, risk management, and import-export factoring.
- The specific directions applicable to IDF-NBC relate to eligibility parameters, investments in IDFs, credit rating, capital adequacy, investment by IDF-NBFC and credit concentration.
- The main elements of the NBFC-MFIs directions are: entry point norm, prudential norms, pricing of credit, transparency in interest rates, multiple lending, over-borrowing and ghost-borrowers, compliance with conditionalities, channelising agents for schemes and so on.
- The governance issues pertain to **(i)** acquisition/transfer of control and **(ii)** corporate governance.
- The main elements of the corporate governance are: **(i)** constitution of the committees of the Board of Directors, **(ii)** fit and proper person criteria, **(iii)** disclosure and transparency and **(iv)** rotation of partners of the auditors/audit firm and **(v)** framing of internal guidelines.
- The provisions of NBFC-ND directions are applicable to **(a)** NBFCs not accepting/holding public deposits which are not systemically important, that is, having minimum total asset of ₹500 crore, **(b)** NBFC-Factor registered with the RBI under the Factoring Regulation Act **(c)** NBFC-Micro-Finance Institution (NBFC-MFI), **(d)** NBFC Infrastructure Finance Company (NBFC-IFC),

(e) Infrastructure Debt Fund-NBFC (IDF-NBFC). These directions are substantially on the same pattern as is applicable to the NBFC-ND-SI and NBFC-D. However, there are some additional features and some features applicable to the former are not applicable to the NBFC-ND.

- The new/additional features of the prudential norms applicable to the NBFC-ND are: **(1)** Leverage Ratio, **(2)** Concentration of Credit/Investment, **(3)** Specific Directions Applicable to NBFC-Factor The exposure norms relating to asset classification should be reckoned in case of factoring on **(a)** with recourse basis on the assigner, **(b)** without recourse on the debtor irrespective of the credit risk cover/protection except in cases of international factoring where the entire credit risk has been assumed by the import factor.
- The features/elements of the prudential norms relating to the NBFC-SI-ND and which are inapplicable/excluded to/from the NBFC-D relate to **(i)**Infrastructure Debt Fund-NBFCs (IDF-NBFCs), **(ii)** prudential regulations and **(iii)** fair practices code. These are not applicable to the NBFCs who have not accessed public funds and do not have any customer interface. The provisions pertaining to fair practice code are inapplicable to the NBFCs accessing public funds but having no customer interface. The NBFCs having customer interface but not accessing public funds are exempt from the prudential regulations.
- The main elements of the core investment companies directions are: **(i)** registration, **(ii)** prudential issues, **(iii)** governance issues and **(iv)** overseas investments.
- Included in prudential issues are: **(i)** capital requirements and leverage ratio and **(ii)** prudential regulations. The **adjusted net worth** of a CIC-ND-SI should not be less than 30 per cent of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items as on the date of the last audited balance sheet as at the end of the financial year.
- The outside liabilities of a CIC-ND-SI should never exceed 2.5 times its adjusted net worth as on the date of the last audited balance sheet as at the end of the financial year.
- The prudential regulations applicable to the CIC-ND-SI are the same as applicable to the NBFC-ND-SI/NBFC-D.
- The main elements of the governance issues are: **(i)** transfer of control, **(ii)** prior approval and **(iii)** change in management and control.
- The main elements of the overseas investment directions are **(i)** investment in financial sector overseas, **(ii)** investment in non-financial sector, **(iii)** eligibility criteria, **(iv)** general/specific conditions.
- In addition to the normal auditors report under the Companies Act, the auditors of the NBFCs should also make a separate report on their financial statements to the shareholders containing statements on matters of supervisory concern to the RBI in respect of all NBFCs/NBFCs accepting deposits/NBFCs not accepting deposits. In case of an unfavourable, qualified report relating to the above matters, the reasons for the same should also be stated. The auditors should also submit a report to the RBI in case of unfavourable/qualified report.
- The main elements of the regulatory framework for core investment companies are their registration, capital requirements, leverage ratio, submission of annual statutory auditors certificate, and overseas investments directions.

Every systematically important core investment company (CIC-ND-SI) should be registered with the RBI. A CIC-ND-SI means a core investment company, having total assets of at least ₹100 crore and holding public funds in the form of deposits/CPs/bank finance excluding compulsorily convertible instruments within 10 years from the date of issue. A core investment company (CIC) means a NBFC carrying on the business of acquisition of shares/securities where at least **(i)** 90 per cent net assets are in the form of shares/debentures/debt/loan to group companies, **(ii)** 60 per cent net assets are in equity shares including compulsorily convertible instruments in group companies and **(iii)** which trades in its investment only through block sale for dilution/disinvestment/carries on only the business of investment in deposits, money market instruments, units of mutual funds, Government securities, bonds, debentures of and grant of loan/guarantee to, on behalf of, group companies. Group companies refer to an arrangement involving entities related to each other through any of the following relationships: subsidiary—parent; joint venture; associate; promoter-promotee; common brand name; and at least 20 per cent investment in equity.

The adjusted net worth (ANW) of CIC-ND-SI should be at least 30 per cent of its aggregate risk weighted assets on balance sheet items and risk adjusted value of off-balance sheet items. The ANW means total owned funds **plus** 50 per cent of the unrealised appreciation in the book value of quoted investments and increase in share capital **minus** the diminution in the book value of quoted investments and reduction in share capital.

Their outside liabilities should never exceed 2.5 times their ANW.

An annual compliance certificate from the auditors should be submitted to the RBI within one month of the finalisation of the balance sheet.

- The RBI guidelines relating to ALM focus on interest rate and liquidity risk management systems in banks, which form a part of the ALM function. The main elements of the ALM system are: ALM information system, ALM organisation and ALM process.
- The ALM system should be built up on a sound methodology, with the necessary information system as a back up. Information is key to the ALM process. A uniform system is not feasible for all banks. The ALM system analyses information on the basis of residual maturity and behavioural pattern. Banks should initially follow the ABC approach, that is, analyse the behaviour of the asset and liability products in the sample branches that account for significant business and make rational assumptions about the behaviour of the assets and liabilities in other branches. The data and assumptions can be refined over time in the light of experience of conducting business within the ALM framework. The spread of computerisation would facilitate accessing of data.
- The Board of Directors should have the overall responsibility for the management of risk and of deciding the risk management policy of the bank, besides setting limits for liquidity, interest rate, forex and equity price risk. The ALCO should ensure adherence to the limits set by the Board and decide the business strategy of the bank on the assets and liability side, in line with the budget and risk management objectives. A sub-committee of the Board should oversee the implementation of the system and review its functioning periodically.
- The ALM process mainly addresses liquidity and interest rate risks.
- NBFCs management should not only measure the liquidity position of NBFCs on an ongoing basis, but also examine how liquidity requirements are likely to evolve under different assumptions. Liquidity should be tracked through maturity/cashflow estimates. The use of the maturity ladder and calculation of cumulative surplus/deficit of funds at selected maturity dates may be used to measure/manage the net funding requirements. The maturity profile of the various heads of accounts should be used for measuring the future cashflows in different time brackets: 1-14 days; 15-28 days; 29 days upto 3 months; 3-6 months; 6 months – 1 year; 1 – 3 years; 3 – 5 years; and over 5 years. Within each time bracket, there could be mismatches between cash-inflows and outflows. The main focus should be on short-term mismatches, namely, 1-14 days and 15-28 days. The mismatches (negative gap) in the normal course should not exceed 20 per cent of the cashoutflows in each time bracket.
- A statement of structural liquidity may be prepared by placing all cash inflows (i.e., maturing assets) and cash outflows (i.e., maturing liabilities) in the maturity ladder, according to the

timing of the cashflows. While determining the tolerance level in mismatches, NBFCs should take into account all the relevant factors, based on their asset liability base, nature of business, future strategy and so on and further refined with experience gained in liquidity management. To monitor their short-term liquidity on a dynamic basis, over a time horizon spanning from 1–90 days, NBFCs may estimate their short-term liquidity profiles on the basis of business projections and other commitments for planning purposes.

- Interest rate risk has two dimensions. The immediate effect of a change in the interest rate is on its net interest income (NII) or net interest margin (NIM). The long-term impact is on the market value of equity (MVE)/networth.
- Initially, NBFCs should use the traditional gap analysis to measure the interest rate risk and move over to modern techniques of interest risk measurement, such as duration gap analysis, simulation and VaR overtime, when they acquire sufficient expertise and sophistication in acquiring and handling MIS.
- Gap analysis measures mismatches between rate sensitive liabilities and assets. Such assets and liabilities should be grouped into time brackets according to the residual maturity or next repricing period, whichever is earlier. The gaps may be classified into the following time-brackets: 1–28 days; 29 days to 3 months; 3–6 months; 6 months – 1 year; 1–3 years; 3–5 years; over 5 years; and non-sensitive.
- The gap is the difference between rate sensitive assets (RSAs) and rate sensitive liabilities (RSLs) for each time bracket. RSAs > RSLs = positive gap; RSAs < RSLs = negative gap. The gap report indicates whether the bank can benefit from rising interest rates (positive gap) or from a declining interest rate (negative gap).
- To facilitate the efficient distribution of credit and to provide for regulation of CICs, the CICs Act was enacted in 2005. Credit information includes **(1)** nature of loans, advances, amount under credit cards, other credit facilities; **(2)** nature of security; **(3)** guarantee/non-fund based facility; **(4)** credit worthiness of a borrower and so on. Credit institutions include banks, NBFCs, PFIs, SFCs, HFCs, companies in credit card business and so on. The main elements of the framework of regulation of CICs are: registration, management, auditors, functions, information privacy principles, and offences/penalties.
- To commence/carry on its business, a CIC requires registration with the RBI, for which it has to satisfy conditions like minimum capital, general character of its management and any other condition to ensure that it would not be detrimental/prejudicial to public interest/banking policy/credit system/specified users/borrowers/clients and so on. While granting registration, RBI may impose conditions it may consider fit. It can cancel the registration of a CIC on failure **(1)** to comply with the conditions of registration, **(2)** to fulfil conditions relating to capital, general character of its management and so on, **(3)** to comply with provisions of any law/RBI directions and so on.
- The superintendence, control and direction of the CIC would be vested in its Board of Directors, who should act on business principles. At least 50 per cent directors should have special knowledge in public administration, law, banking, finance, accounting, management and IT. The RBI can supersede the Board for upto 12 months. It has also the powers to determine the policy and to issue directions and conduct inspection of a CIC.
- The auditors of the CIC are duty bound to inquire if it has complied with RBI's requirements of submission of statements/information/particulars of its business and report to the RBI if not satisfied. The RBI may order a special audit of the accounts of the CIC.
- The functions of a CIC are: **(i)** to collect, process and collate information on trade, credit and financial standing of borrowers, **(ii)** to provide credit information/credit scoring to specified users/CICs,

(iii) to undertake research projects and **(iv)** to undertake any other form of business specified by the RBI. A CIC may register CIs/CICs as members and charge a fee for furnishing credit information to specified users.

- All CICs/CIs/specified users in possession/control of credit information should ensure that the data maintained by them is accurate and complete, duly protected against loss and unauthorised access/use/disclosure. They should follow the following privacy principles in relation to collection, processing, collating, recording, preservation, secrecy, sharing and usage of credit information: **(i)** principles followed/adopted; **(ii)** purpose, **(iii)** extent of obligation, **(iv)** preservation, **(v)** networking and **(vi)** any other.
- Penalties for offences relate to **(a)** a wilful false statement in any material particular/omission of a material statement, **(b)** breach of any privacy principle, **(c)** wilful provision/omission of false information in any material particular/to make a material statement, and **(d)** contravention of any legal provision. The RBI can impose penalty **(a)** for unauthorised access, **(b)** for a breach of the privacy principle/wilful provision or omission of material particulars and **(c)** for a contravention of the provisions of the CICs Act/rules/orders/directions.
- The CICs desirous of making overseas investment in the **financial sector** (i.e. a sector regulated by a financial sector regulator) should hold a certificate of registration (CoR) from the RBI and comply with all the regulations applicable to registered CICs. A registered CIC need not obtain prior approval from the RBI, for overseas investment in non-financial sector. The eligibility criteria for investments abroad and other conditions prescribed for CICs are discussed below.
- The adjusted net worth (ANW) of the CIC should not be less than 30 per cent of its aggregate risk weighted assets on-balance sheet and risk adjusted value of off-balance sheet item. The level of net non-performance assets of the CIC should not be more than 1 per cent of its net advances. The CIC should generally be earning profit continuously for the last three years and its performance should be satisfactory during the period of its existence.
- Direct investment in activities prohibited under the FEMA is not permitted. The total overseas investment should not exceed 400 per cent of the owned funds of the CIC. The total overseas investment in financial sector should not exceed 200 per cent of its owned funds. The investment in financial sector should be only in regulated entities abroad. Entities set up/acquired abroad should be treated as wholly owned subsidiaries (WOS)/joint ventures (JV) abroad. Overseas investments by a CIC in financial/non-financial sector would be restricted to its **financial commitment** (i.e. the amount of direct investment by way of contribution to equity and loan and 50 per cent of the amount of guarantees issued by an Indian party to or on behalf of its overseas JV/WOS).
- As non-operating entities, the CICs will not, in the normal course, be allowed to open branches overseas. In the case of opening of a WOS/JV abroad, all the conditions as stipulated above would be applicable. The WOS/JV being established abroad should not be a **shell company**, that is, **a company that is incorporated, but has no significance assets or operations**. They should not be used as a vehicle for raising resources for creating assets in India for the Indian operations.
- The CICs will need prior approval from the RBI for opening representative offices abroad for the purpose of liaison work, undertaking market study and research but not for undertaking any activity which involves outlay of funds.

CHAPTER 15

Mutual Funds and Investment Trusts: Regulations and Operations

INTRODUCTION

With the emergence of the capital market at the centre stage of the Indian financial system, from its marginal role a decade earlier, the Indian capital market also witnessed, during the same period, a significant institutional development in the form of a diversified structure of mutual funds. A mutual fund is a special type of investment institution that acts as an investment conduit. It pools the savings, particularly of the relatively small investors, and invests them in a well diversified portfolio of sound investment. Mutual funds issue securities (known as units) to the investors (known as unit-holders) in accordance with the quantum of money invested by them. The profits (or losses) are shared by the investors in proportion to their investments. A mutual fund is set up in the form of a trust, which has **(i)** sponsor, **(ii)** trustees, **(iii)** asset management company (AMC) and, **(iv)** custodian. The trust is established by a sponsor(s) who is/are like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit-holders. The AMC manages the funds by making investments in various types of securities. The custodian holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC, they monitor the performance and compliance of the SEBI Regulations by the mutual fund. As an investment intermediary, they offer a variety of services/advantages to the relatively small investors who, on their own, cannot successfully construct and manage an investment portfolio mainly due to the small size of their funds, lack of expertise and experience and so on. These, inter-alia, include convenience, lower risk through diversification, expert management and reduced cost due to economies of scale.

It is obviously in recognition of these benefits that the official policy in India is geared to promote mutual funds as the preferred route for investment of funds for small investors, through measures such as raising the threshold/minimum limit of investment in the primary market to ₹7,500; schemes of firm and proportional allotments; the treatment of capital gains arising out of long-term holdings of units of mutual funds for one year instead of three years as it was (earlier); the reduction from 20 to 10 per cent; in capital gains tax exemption of dividend income from mutual funds in the hands of the investors, together with the total exemption of the income of the mutual funds from tax and so on. However, mutual funds whose investment in equity shares is less than 50 per cent of the funds of the scheme have to pay 12.5 per cent tax on dividend payment. Mutual funds have emerged as significant avenue of finance for industry and a notable intermediary in the Indian capital market.

Until 1987, the UTI (Unit Trust of India) was the sole mutual fund/unit trust in the country. Subsidiaries of public sector banks launched mutual funds subsequently. Later, the Life Insurance Corporation of India and the General Insurance Corporation of India also floated mutual funds. In the post–1992 period, mutual funds sponsored by other public and private sector financial institutions, corporates in collaboration with foreign investment and fund managers and foreign institutional investors emerged on the scene. At present, there are about 38 players in the market including the UTI with net assets as on April 30, 2006 aggregating ₹2,57,500 crore. With the repeal of the UTI Act and the consequent reorganisation, the UTI operates, like other mutual funds, within the framework of SEBI regulations/guidelines. The present Chapter is devoted to a discussion on mutual funds. Section 1 of the chapter outlines the broad regulatory mechanism of this segment of the capital market in terms of the SEBI Mutual Fund Regulations. The SEBI mutual funds guidelines issued under the Mutual Fund Regulations are covered **in Appendix 15-B in the website. The website address is http://www.mhhe.com/khanifs10e**. **The SEBI (a) Real Estate Investment Trusts Regulations 2014, and (b) Infrastructure Investment Trusts Regulations 2014 are discussed in Sections 2-3 respectively**. Some concluding observations are given in the last Section.

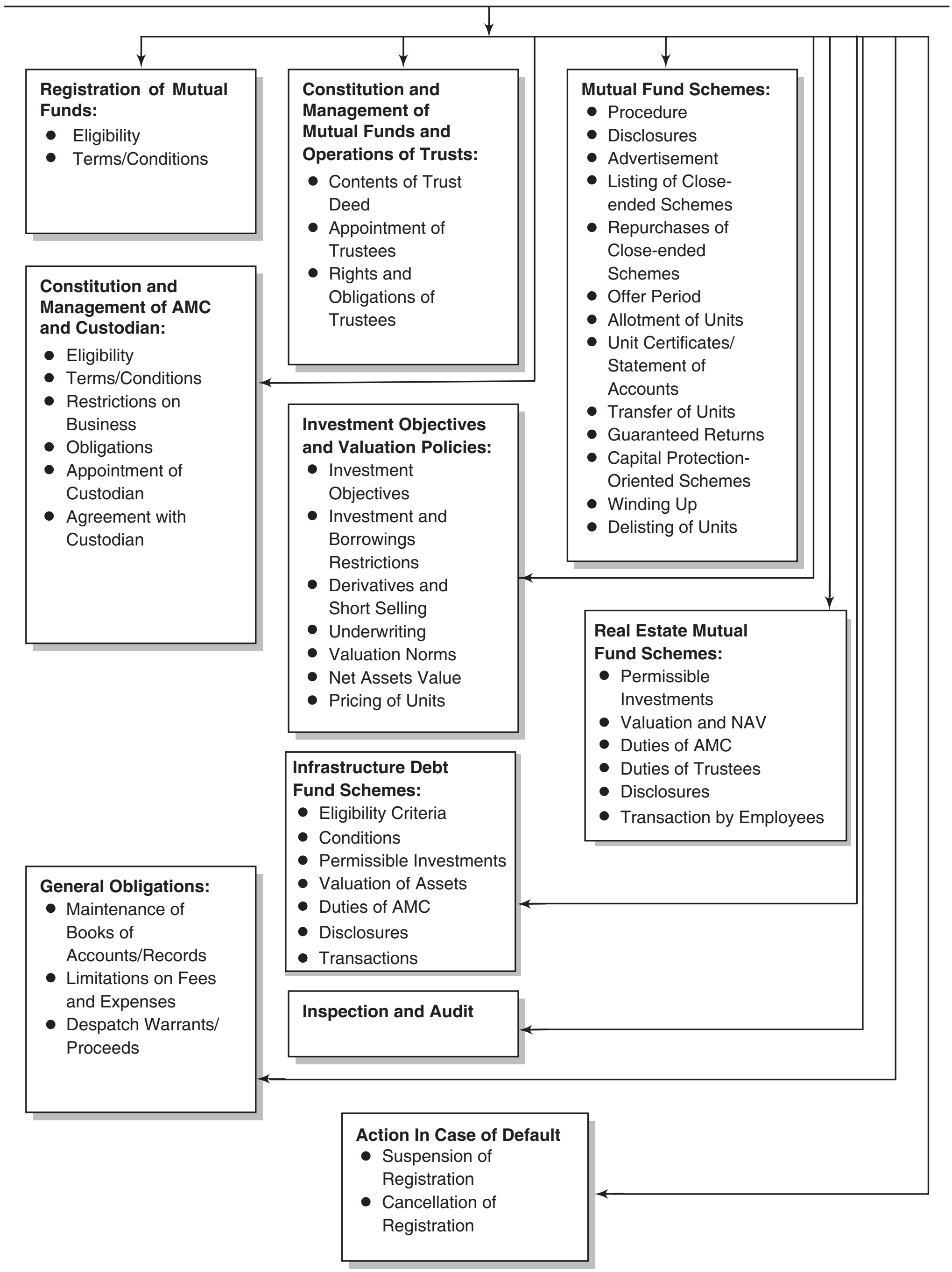
REGULATORY MECHANISM: THE SEBI MUTUAL FUND REGULATIONS

The Reserve Bank of India (RBI) had issued a set of guidelines in 1987 for bank sponsored mutual funds. This was followed, in 1990, by stipulations for mutual funds from the Ministry of Finance, Government of India. In 1991, the Government of India initiated the process of creating a common regulation for all mutual funds and to permit the entry of private mutual funds. The Dave Panel submitted its recommendations regarding the regulation of mutual funds in 1991. In October 1991, the Securities and Exchange Board of India (SEBI) issued guidelines for the formation of Asset Management Companies (AMCs) for mutual funds. A comprehensive set of guidelines was issued by the Ministry of Finance in February 1992. In 1993, the SEBI issued comprehensive mutual funds regulations. These were replaced by a more rigorous SEBI framework in 1996, which have been amended from time to time. **The SEBI regulatory framework is portrayed in Exhibit 15.1**. The main elements of the SEBI regulatory mechanism of mutual funds, are: **(i)** registration of mutual funds with the SEBI, **(ii)** constitution and management of mutual funds, and operation of trusts, **(iii)** constitution and management of asset management company and custodian, **(iv)** schemes of mutual funds, **(v)** investment objectives and valuation policies, **(vi)** general obligations, **(vii)** inspection and audit and **(viii)** procedure for action in case of default.

Registration of Mutual Funds

Mutual funds are defined by the SEBI regulations as funds established in the form of a trust to raise money through the sale of units—that is, the interest of the unit-holders in a scheme—to public under one/more scheme(s) for investing in securities, including money market instruments consisting of commercial papers, commercial bills, treasury

Exhibit 15.1 Regulatory Mechanism for Mutual Fund Operations



bills, government securities having an unexpired maturity up to one year, call/notice money, certificate of deposits, usance bills and so on or gold or gold related instruments or real estate assets. To carry on business, mutual funds must be registered with the SEBI. The application for registration, together with a non-refundable fee of ₹25,000, should be made in the prescribed form. The procedure prescribed by the SEBI is outlined below.

Eligibility Criteria The eligibility criteria for registration of sponsors who can establish mutual funds are given below:

1. The applicant-sponsor should have a sound track-record and general reputation of fairness and integrity in all his business transactions and he should be a fit and proper person. The test of a sound track-record is:
   (i) carrying on business in financial services for at least five years;
   (ii) positive net worth in all the immediately preceding five years;
   (iii) net worth in the immediately preceding year should be more than the capital contribution of the sponsor in the asset management company and
   (iv) profit after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year.
2. The sponsor should contribute at least 40 per cent of the net worth of the asset management company.
3. The sponsor/any director/principal officer to be employed by the mutual fund should not have been guilty of any fraud/convicted of an offence involving moral turpitude/guilty of any economic offence.
4. Appointment of trustees/trustee company to act as trustees for the mutual fund who hold the property of the mutual fund in trust for the benefit of the unit holders.
5. Appointment of asset management company set up under the provisions of the Companies Act to manage the mutual fund and operate its schemes.
6. Appointment of custodian in order to keep custody of the securities or gold/gold related instruments (i.e. instrument having gold as the underlying as specified by the SEBI) or other assets of the mutual fund and provide such other custodial activities as may be authorised by the trustees. He should be registered with the SEBI under the SEBI Custodian of Securities Regulations, 1996.
7. For determining whether an applicant mutual funds is a fit and proper person, the SEBI may take into account the criteria specified in the SEBI Intermediaries Regulations, 2008.

Terms and Conditions of Registration The registration of mutual funds with the SEBI is subject to certain terms and conditions, namely **(i)** trustee/sponsor/asset management company/custodian would have to comply with the SEBI regulations, **(ii)** the mutual fund would immediately/forthwith inform the SEBI if any information/particulars previously submitted were misleading/false in any material respect as also of any material change in the information/particulars previously furnished, which have a bearing on the registration granted by it, and **(iii)** payment of **(a)** application fee of ₹ one lakh, **(b)** registration fee of ₹25 lakh and **(c)** annual fee based on net assets as follows:

- Net assets as on March 31, ₹500 crore: ₹2.5 lakh
- ₹500 – ₹1,000 crore: ₹3.5 lakh
- ₹1,000 – ₹3,000 crore: ₹4.50 lakh
- ₹3,000 – ₹5,000 crore: ₹5.5 lakh
- ₹5,000 – ₹10,000 crore: ₹6.5 lakh
- Above ₹10,000 crore: ₹7.5 lakh

The SEBI may not permit a mutual fund who has not paid the annual fee to launch any scheme.

Constitution and Management of Mutual Fund and Operation of Trusts

A mutual fund can be constituted in the form of a trust and the instrument of trust should be in the form of a deed, duly registered under the Indian Registration Act, 1908, executed by the sponsor in favour of the trustees named in the instrument.

The trust deed should contain, in addition to the clauses prescribed by the SEBI, such other clauses that are necessary for safeguarding the interests of the unit-holders. However, no trust deed should contains clause(s) that has the effect of **(i)** limiting/extinguishing the obligations/liabilities of the trust in relation to any mutual fund/unit-holder or **(ii)** indemnifying the trustees/asset management company for loss/damage caused to the unit-holders by their acts of negligence/commission/omission.

Contents of Trust Deed The contents of trust deed, prescribed by the SEBI, are as follows:

1. **(i)** A trustee, in carrying out his responsibilities as a member of the Board of Trustees/Trustee Company, should maintain an arms' length relationship with companies/institutions/financial intermediaries/any body corporate with which he may be associated.

(ii) No trustee should participate in the meetings of the Board of Trustees/Trustee Company when any decisions for investment, in which he may be interested are taken.

(iii) All the trustees must furnish to the Board of Trustees/Trustee Company particulars of interest that they may have in any other company/ institution/financial intermediary/any corporate body by virtue of their position as director, partner or with which they may be associated in any other capacity.

2. The minimum number of trustees would be four.

3. The trustees must take into their custody/under their control all the property of the schemes of the mutual fund and hold it in trust for the unit-holders.

4. Unit-holders would have beneficial interest in the trust property to the extent of individual holding in respective schemes only.

5. It would be the duty of the trustees to act in the interests of the unit-holders.

6. It is also the duty of trustees to provide or cause to provide information to unit-holders and the SEBI, as may be specified by the SEBI.

7. The trustees should appoint an asset management company (AMC), approved by the SEBI, to float schemes for the mutual fund after approval by the trustees and the SEBI, and manage the funds mobilised under various schemes, in accordance with the provisions of the trust deed and the SEBI regulations. They should enter into an investment management agreement with the AMC for this purpose, and should enclose the same with the trust deed.

8. It is the duty of the trustee to take reasonable care to ensure that the funds under the schemes floated and managed by the AMC are in accordance with the trust deed and the SEBI regulations.

9. The trustees have the power to dismiss the AMC under specific events only with the approval of the SEBI, in accordance with these regulations.

10. Appointment of a custodian and responsibility for the supervision of its activities in relation to the mutual fund, and enter into a custodian agreement for this purpose.

11. The auditor for the mutual fund must be different from the auditor of the AMC.

12. The responsibility of the trustees to supervise the collection of any income due to be paid to the scheme and for claiming any repayment of tax and holding any income received in trust for the holders in accordance with the trust deed and the SEBI regulations.

13. Broad policies regarding allocation of payments to capital or income.
14. Explicitly forbid the acquisition of any asset out of the trust property that involves the assumption of any unlimited liability or should not result in encumbrance of the trust property in any way.
15. Forbid the mutual fund from making or guaranteeing loans to take up any activity in contravention of the SEBI regulations.
16. Trusteeship fee, if any, payable to trustees.
17. No amendment to the trust deed can be carried out without the prior approval of the SEBI and unit-holders. However, in case of subsequently conversion of Board of Trustees into a Trustee Company, such conversion would not require the approval of the unit-holders.
18. The removal of the trustee in all cases would require the prior approval of the SEBI.
19. The procedure for seeking approval of the unit-holders under such circumstances as are specified in the SEBI regulations.
20. A meeting of the trustees would be held at least once in every two calendar months and at least six meetings should be held every year.
21. The quorum for a meeting should be specified with at least one independent trustee/director present.
22. The Minimum number of trustees would be four.

Appointment of Trustees According to the SEBI regulations, **trustees** mean the Board of Trustees or the Trustee Company who hold the property of the mutual fund in trust for the benefit of the unit-holders. Any person can be appointed as a trustee if he **(i)** is a person of ability, integrity and standing; **(ii)** has not been guilty of moral turpitude, **(iii)** has not been convicted of any economic offence/violation of any securities laws such as the SEBI Act, 1992, the Securities Contracts (Regulation) Act, 1956, the Depositories Act, 1996 and such other laws as may be enacted from time to time and **(iv)** has furnished the particulars specified in Form C, such as:

- Details of trustees, that is, trust company; debenture trustees/bank/financial institutions, individual trustees
- Draft trust deed to, inter-alia, provide:
  - **(a)** Responsibilities, obligations and rights of the trustees for the protection of the mutual fund's assets.
  - **(b)** A statement that investments should be of the permitted kind and within set limits.
  - **(c)** Responsibilities, obligations and rights of the fund manager, that is, the AMC.
  - **(d)** Policies for investments; the creation, issue and cancellation of units; pricing and redemption of units; listing of units in case of close-ended schemes; expenses of the mutual fund, including payment of fees and distribution of income and gains and accounting.
  - **(e)** Policies for disclosure of scheme objectives and investment objectives in offer documents and advertisements, and annual and half-yearly reporting requirements to the investors of various schemes of the mutual fund.
  - **(f)** Right of the trustees to obtain necessary information, besides obtaining a quarterly report from the AMC.
  - **(g)** Right to make spot checks on the AMC regarding pricing of units and payment into and out of the fund, proper accounting of the income of the fund, charging of expenses and distribution of income as permitted.
  - **(h)** Public availability of the trust deed.

An AMC/any of its officers/or employers are not eligible to act as trustee. A trustee of one mutual fund is not eligible to be appointed as trustee of another mutual fund. Two-thirds of the trustees should be independent persons and should not be associated with the sponsors or be associated with them in any manner whatsoever. In case a company is appointed as a trustee of a mutual fund, its directors can act as a trustee of any other trust, provided the object of the trust is not in conflict with the object of the mutual fund. The appointment of trustees requires prior approval of the SEBI.

Rights and Obligations of Trustees The trustees and the AMC should, with the prior approval of the SEBI, enter into an investment management agreement containing, in addition to the clauses specified below, such other clauses as are necessary for the purpose of making investments.

Contents of Investment Management Agreement The AMC appointed by the trustees, with the prior approval of the SEBI, would be responsible for floating schemes for the mutual fund after approval of the same by the trustees, and for managing the funds mobilised under various schemes, in accordance with the provisions of the trust deed and the SEBI regulations.

It would not undertake any other business activity other than the management of mutual funds and such other activities as financial service consultancy, exchange of research and analysis on a commercial basis as long, as these are not in conflict with the fund management activity itself, without the prior approval of the trustees and the SEBI.

The funds raised under various schemes would be invested by it in accordance with the provisions of the trust deed and the SEBI regulations.

The AMC would not **(i)** acquire any of the assets out of the scheme property that involves the assumption of any unlimited liability or which may result in encumbrance of the scheme property in any way, or **(ii)** take up any activity in contravention of the SEBI regulations.

No loss or damage or expenses incurred by the AMC, its officers or any person delegated by it should be met out of the trust property.

The AMC should ensure that no offer document of a scheme, key information memorandum, abridged half-yearly and annual result is issued or published without the trustees' prior approval in writing; that it does not and contain any statement or matter extraneous to the trust deed or offer document scheme particulars approved by the trustees and the SEBI and that it should provide an option of nomination to the unit-holders in the prescribed form. It should also disclose the basis of calculating the repurchase price and NAV of the various schemes of the mutual fund in the scheme particulars and the investors of the same, at such intervals as may be specified by the trustees and the SEBI.

The trustees would have the right to obtain from the AMC all information concerning the operations of the various schemes of the mutual fund managed by it at such intervals and in such manner as required by them to ensure that the AMC is complying with the provisions of the trust deed and the SEBI regulations.

1. The AMC should submit quarterly reports on the functioning of the schemes of the mutual fund to the trustees, or at such intervals as may be required by the trustees or the SEBI.
2. The trustees would have the power to dismiss the AMC under specific events, with the approval of the SEBI, in accordance with the SEBI regulations.
3. The trustees would have a right to obtain from the AMC such information as is considered necessary by them.

4. They should ensure before the launch of any scheme that the AMC has:
   - **(a)** systems in place for its back office, dealing room and accounting;
   - **(b)** appointed all key personnel, including fund manager(s) for the scheme(s), and submitted their bio-data, containing their educational qualifications and past experience in the securities market, to the trustees, within 15 days of their appointment;
   - **(c)** appointed auditors to audit its accounts;
   - **(d)** appointed a compliance officer who would be responsible for monitoring the compliance of the SEBI Act/rules/regulations/notifications, guidelines, instructions and so on issued by the SEBI/government and for redressal of investors grievances. He would immediately and independently report to the SEBI any non-compliance observed by him;
   - **(e)** appointed registrars and laid down parameters for their supervision;
   - **(f)** prepared a compliance manual and designed internal control mechanisms, including internal audit systems;
   - **(g)** specified norms for empanelment of brokers and marketing agents;
   - **(h)** obtained, wherever required under these regulations, prior in-principle approval from the recognised stock exchange(s) where units are proposed to be listed.
5. They should also ensure that the AMC has been diligent in empanellng the brokers, in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.
6. They are also required to ensure that the AMC has not given any undue or unfair advantage to any associate or deals with any of its associates in any manner detrimental to the interests of the unit-holders.
7. The transactions entered into by the AMC must be in accordance with these regulations and the scheme(s) of the mutual fund.
8. The AMC has been managing mutual fund schemes independently of other activities and has taken adequate steps to ensure that the interests of investors of its one scheme are not being compromised by those of any other scheme or by its other activities.
9. The trustees should ensure that all the activities of the AMC are in accordance with the provisions of these regulations.
10. Where the trustees have reason to believe that the conduct of business of the mutual fund is not in accordance with the SEBI mutual fund regulations and the mutual fund scheme, they should forthwith take such remedial steps as are necessary by them and immediately inform the SEBI of the violation and the action taken by them.
11. Each trustee should file a quarterly report giving the details of his transactions in the securities with the mutual fund.
12. The trustees would be accountable for, and be the custodian of, the funds and property of the respective schemes and should hold the same in trust for the benefit of the unit-holders, in accordance with these regulations and the provisions of the trust deed.
13. They should take steps to ensure that the transactions of the mutual fund are in accordance with the provisions of the trust deed.
14. They would be responsible for the calculation of any income due to be paid to the mutual fund and also of any income received in the mutual fund for the unit-holders of any scheme, in accordance with these regulations and the trust deed.
15. The trustees should obtain the consent of the unit-holders:
   - **(a)** whenever required to do so by the SEBI in the interest of the unit-holders; or

(b) whenever required to do so on the requisition made by three-fourths of the unit-holders of any scheme; or

(c) when the majority of the trustees decide to wind up or prematurely redeem the units.

15-A The trustees should ensure that no change in the fundamental attributes of any scheme/the trust or fees/expenses payable or any other changes that would modify the scheme and affect the interests of the unit-holders should be carried out, unless **(i)** a written communication about the proposed change is sent to each shareholder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of region where the head office of the mutual fund is situated and **(ii)** the unit-holders are given an option to exit at the prevailing NAV, without any exit load.

16. They should call for the details of transactions in securities by the key personnel of the AMC, in his own name or on behalf of the AMC, and should report to the SEBI, as and when required.

17. They should review, quarterly, all transactions carried out between the mutual fund, AMC and its associates.

18. They should review, quarterly, the networth of the AMC and in case of any shortfall, ensure that it makes up for the shortfall as stipulated by the SEBI within a period of 12 months to a level of ₹10 crore.

19. They should also periodically review all service contracts such as custody arrangements, transfer agency of the securities and satisfy themselves that such contracts are executed in the interest of the unit-holders.

20. They should ensure that there is no conflict of interest between the manner of deployment of its net worth by the AMC and the interest of the unit-holders.

21. They should periodically review the investor complaints received and the redressal of the same by the AMC.

22. ***Code of Conduct*** The trustees should abide by the code of conduct as specified below:

(a) Mutual funds schemes should not be organised, operated, managed or the portfolio of securities selected—in the interest of sponsors, directors of AMC, members of Board of Trustees or directors of Trustee Company, and associated persons—as in the interest of special class of unit-holders other than in interest of all classes of unit-holders of the scheme.

(b) Trustees and AMCs **(i)** must ensure the dissemination, to all unit-holders, of adequate, accurate, explicit and timely information, fairly presented in a simple language about the investment policies, investment objectives, financial position and general affairs of the scheme; **(ii)** should avoid excessive concentration of business with broking firms, affiliates and also excessive holding of units in a scheme among a few investors; **(iii)** must avoid conflicts of interest in managing the affairs of the schemes and keep the interest of all unit-holders paramount in all matters; **(iv)** must ensure schemewise segregation of bank accounts and securities accounts; **(v)** should carry out the business and invest in accordance with the investment objectives stated in the offer documents and take investment decisions solely in the interest of unit-holders; **(vi)** must not use any unethical means to sell, market or induce any investor to buy their schemes; **(vii)** should maintain a high standard of integrity and fairness in all their dealings and in the conduct of their business; **(viii)** render at all times a high standard of service, exercise due diligence, ensure proper care and exercise independent professional judgement and **(ix)** the AMCs should not make any exaggerated oral/written statement either about their qualifications or capability to render investment management services or their achievements.

The sponsor of the mutual fund/trustees/AMC or any of their employees should not, directly/indirectly, render any investment advice about any security in the publicly accessible media, whether real-time or non-real-time without disclosing his interest (long/short position) in the security while rendering such advice. An employee who renders such advice should also disclose the interest of his dependent family members and the employer, including their long/short-term position in the security.

23. The trustees should furnish to the SEBI on a half-yearly basis the following documents:
- A report on the activities of the mutual fund
- A certificate stating that the trustees have satisfied themselves that there have been no instances of self-dealing or front-running by any of the trustees, directors and key personnel of the AMC
- A certificate to the effect that the AMC has been managing the schemes independently of any other activities and in case any prohibited activities, as specified in these regulations have been undertaken by it adequate steps have to be taken to ensure that the interests of the unit-holders are protected.

24. The independent trustees should give their comments on the report received from the AMC regarding investments by the mutual fund in the securities of group companies of the sponsor, as defined in the Monopolies and Restrictive Trade Practices Act.

25. ***Due Diligence*** Trustees should exercise general and specific due diligence as under:

General Due Diligence They should **(i)** be discerning in the appointment of the directors on the Board of the AMC; **(ii)** review the desirability/continuance of the AMC if substantial irregularities are observed in any scheme, and not allow it to float new schemes; **(iii)** ensure that the trust property is properly protected, held and administered by proper persons and by a proper number of such persons; **(iv)** arrange for test checks of service contracts and **(v)** immediately report to the SEBI any special developments in the mutual fund.

Specific Due Diligence: The trustees should:
- Obtain internal audit reports at regular intervals from independent auditors appointed by them
- Obtain compliance certificates at regular intervals from the AMC
- Hold meetings of trustees more frequently
- Consider the reports of independent auditor(s) and compliance reports of the AMC at their meetings, for appropriate action
- Maintain records of decisions/minutes of their meetings
- Prescribe and adhere to a code of ethics by the trustees/AMC and its personnel
- Communicate in writing to the AMC about its deficiencies and check on the rectification of the deficiencies

26. The trustees would not be held liable for acts done in good faith if they have exercised adequate due diligence honestly.

27. The independent trustees/directors of the AMC should pay specific attention to the following: **(i)** the investment management agreement and the compensation paid under it; **(ii)** service contracts with affiliates to check whether the AMC has charged higher fee than an outside contractor for the same services; **(iii)** selection of the independent directors of the AMC; **(iv)** securities transactions with affiliates, to the extent permitted; **(v)** selection and nomination of individuals to fill vacancies of independent directors; **(vi)** designing a code of ethics to prevent fraudulent/deceptive/manipulative practices by insiders in connection with personal securities transactions; **(vii)** the reasonableness of fees paid to sponsors/AMC/others for service provided; **(viii)** principal underwriting contracts and the renewal and **(ix)** any service contract with the associates of the AMC.

Constitution and Management of an Asset Management Company (AMC) and Custodian

The sponsors of mutual funds or trustees would appoint the **AMC** with the prior approval of the SEBI. Its appointment can be terminated by a majority of trustees or by 75 per cent of the unit-holders of the scheme. Any change in its appointment also requires prior approval of the SEBI as well as the unit-holders.

Eligibility Criteria For grant of approval of the AMC by the SEBI, the applicant has to fulfill the following:

(a) An existing AMC should have a sound track record/general reputation and fairness in transactions and should be a fit and proper person.

(b) The directors of the AMC should have adequate professional experience in finance and financial service related fields and have not be found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws.

(c) The key personnel of the AMC have not been found guilty of moral turpitude or been convicted of economic offence or violation of securities laws, or worked for any AMC or mutual fund or any intermediary during the period when its registration has been suspended or cancelled at any time by the SEBI.

(d) The Board of Directors of such AMC has at least fifty per cent directors who are not an associate of, or associated in any manner with, the sponsor or any of its subsidiaries or the trustees.

(e) The chairman of the AMC is not a trustee of any mutual fund.

(f) The AMC has a net worth (paid-up capital and free reserves minus miscellaneous expenditure not written off/adjusted or deferred revenue expenditure, intangible assets and accumulated losses) of not less than ₹50 crore. However, the minimum net worth of an AMC eligible to launch an infrastructure debt fund scheme should be at least ₹10 crore.

Terms and Conditions The approval granted by the SEBI, to the AMC, is subject to the following conditions:

(a) Any director of the AMC would not hold the office of the director in another AMC unless he is an independent director and the approval of the Board of AMC, of which he is a director, has been obtained.

(b) The AMC should forthwith inform the SEBI of any material change in the information or particulars previously furnished, that have a bearing on the approval granted by it.

(c) The appointment of a director of an AMC can be made only with prior approval of the trustees.

(d) The AMC undertakes to comply with these regulations.

(e) No change can be made in the controlling interest of the AMC, unless **(i)** prior approval of trustees and the SEBI is obtained, **(ii)** a written communication about the proposed change is sent to each unit-holder and an advertisement is given in one English daily newspaper having nationwide circulation and in a newspaper published in the language of the region where the head office of the mutual fund is situated and **(iii)** the unit-holders are given an option to exit at the prevailing NAV, without any exit load.

(f) The AMC would furnish such information and documents to the trustees as and when required by them.

Restrictions on Business Activities An AMC cannot **(i)** act as a trustee of any mutual fund; **(ii)** undertake any other business activities other than in the nature of management/advisory services to pooled assets including offshore/insurance/pension/provident if they do not conflict with those of mutual fund. The AMC itself/through subsidiaries can undertake them if it **(a)** satisfies the SEBI about activity-wise segregation of bank and securities account, **(b)** meets with the capital adequacy requirements separately for each of them, **(c)** ensures there is no material conflict of interest across different activities, **(d)** discloses the absence of the conflict of interest to the trustees/unitholders, **(e)** satisfies itself, in case of unavoidable conflict situations, that disclosures are made of the detailed parameters of source of conflict/potential material risk/ damage to investor interests, **(f)** appoints separate fund manager for each separate fund if the investment objectives/asset allocation are not the same and the portfolio not replicated across all funds, **(g)** ensures fair treatment of investors across different products including simultaneous buy/sell in the same equity security only through market mechanism and written trade order management system and **(h)** ensures independence to key personnel handling the relevant conflict of interest through removal of direct link between remuneration to personnel and revenue generated by the activity. An AMC may itself or through a subsidiary undertake portfolio management services. It may also become a proprietary member for carrying out trade in the debt segment of a stock exchange.

Obligations The AMC must take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme is not contrary to the provisions of these regulations and the trust deed. It should: **(i)** exercise due diligence and care in all its investment decisions as would be exercised by the other persons engaged in the same business; obtain, wherever required under these regulations, prior in-principle approval from the recognised stock exchange(s) where units are proposed to be listed; **(ii)** be responsible for the acts of commission or omission by its employees or the persons whose services have been procured by it and **(iii)** submit to the trustees quarterly reports of each year of its activities and the compliance with these regulations.

The trustees, at the request of the AMC, may terminate its assignments at any time, which would become effective only after the trustees have accepted the termination of assignment and communicated their decision in writing. However, the directors and other officers would not be absolved of liability to the mutual fund for their acts of commission or omission, while holding such position or office.

The Chief Executive Officer (whatever his designation may be) of the AMC should ensure that the **(i)** mutual fund complies with all the provisions of the SEBI mutual fund regulations/ guidelines/circulars issued from time to time and **(ii)** investments made by the fund managers are in the interest of the unitholders. He would also be responsible for the overall risk management function of the mutual fund.

The fund managers (whatever the designation may be) should ensure that the funds of the scheme are invested to achieve the objectives of the scheme and in the interest of the unitholders.

A mutual fund cannot, through any broker associated with the sponsor, purchase/sell securities that is an average of 5 per cent or more of the aggregate purchases/sales of securities (exclusive of sale and distribution of units issued) made by the mutual funds in all its schemes for a block of any three months. The justification for exceeding the 5 per cent limit, together with reports of all such investments, must be sent to the trustees on a quarterly basis. Similarly, it cannot utilise the services of the sponsor or any of its associates, employees or their relatives, for the purpose of any transaction, distribution and sale of securities unless a disclosure to that effect is made to the unit-holders, and the brokerage or commission paid is also disclosed in the half yearly/annual accounts of the mutual fund. Moreover, the mutual fund should disclose at the time of declaring half-yearly results: **(i)** any underwriting obligations of the schemes with respect to the issue of securities of associate companies, **(ii)** devolvement, if any, **(iii)** subscription in issues lead managed by associate companies and **(iv)** subscription to any issue of equity/debt or private placement basis where the sponsor/its associates companies have acted as arranger/manager. It has to file with the trustees the details of transactions in securities by its key personnel in their own name or on behalf of the AMC and also report to the SEBI as and when required. If the AMC enters into any securities transactions with any of its associates, a report to that effect must be sent to the trustees in their next meeting.

In case any company has invested more than 5 per cent of the net asset value of a scheme, the investment made by that scheme or by any other scheme of the same mutual fund in that company or its subsidiaries must be brought to the notice of the trustees by the AMC and disclosed in the half-yearly and annual accounts of the respective schemes, with justification for such investment, provided that the latter investment has been made within one year of the date of the former investment calculated on either side.

The AMC is required to file with the trustees and the SEBI: **(a)** detailed bio-data of all its directors along with their interest in other companies, within fifteen days of their appointment; **(b)** any change in the interests of directors, every six months and **(c)** a quarterly report to the trustees giving details and adequate justification about the purchase/sale of securities of the group companies of the sponsor/AMC by the mutual fund, during the relevant quarter.

Each director of the AMC should file the details of his transactions of dealing in securities with the trustees on a quarterly basis, in accordance with guidelines issued by SEBI.

The AMC is prohibited from appointing, as key personnel, any person who has been found guilty of any economic offence or is involved in violation of securities laws. It is allowed to appoint registrars and share transfer agents who are registered with the SEBI.

If the work relating to the transfer of units is processed in-house, the charges at competitive market rates may be debited to the scheme and for rates higher than the competitive market rates, the prior approval of the trustees should be obtained and reasons for charging higher rates disclosed in the annual accounts.

The AMC has to abide by the same code of conduct as specified above in the case of trustees.

The AMC should make full disclosure in the offer document of its intention to invest in any of its schemes. It would not be entitled to charge any fee for such investment. It also cannot carry out its operation's outside India.

The AMC should compute/carry out/publish valuation of investments in accordance with SEBI-specified valuation norms (**discussed later in this chapter**). The sponsor/AMC should be liable to compensate the affected investors/scheme for any unfair treatment to any investor resulting from inappropriate valuation. All the transactions in debt/money market securities including inter-scheme transfers should also be reported/disclosed as specified by the SEBI.

Appointment of Custodian The mutual fund should appoint a **custodian** to carry out the custodial services for the scheme and send intimation of the same to the SEBI within fifteen days of the appointment. However, in case of a gold exchange traded fund scheme (i.e. a mutual fund scheme that invests primarily in gold/gold related instruments), the assets may be kept in custody of a bank registered as a custodian with the SEBI. In case of a real estate asset mutual fund scheme (i.e. a mutual fund scheme that invests directly/indirectly in real estate assets/ other permissible assets), the title deed of the assets held by it may be kept in the custody of a SEBI-registered custodian.

A custodian in which the sponsor or its associates hold 50 per cent or more of the voting rights or the share capital or where 50 per cent or more of the directors of the custodian represent the interest of the sponsor or its associates, cannot act as custodian for a mutual fund constituted by the same sponsor or any of its associates or subsidiary company. However, a custodian whose 50 per cent or more rights in held by the sponsors/its associates, can act as a custodian for mutual fund constituted by the same sponsor/associates/subsidiaries if **(i)** networth of the sponsor is ₹20,000 crore, **(ii)** its 50 per cent/more directors do not represent the interest of the promoter/associates, **(iii)** the custodian and the AMC are not subsidiaries of each other and do not have common directors and they undertake to act independently in their dealings with the scheme.

Agreement with Custodian The mutual fund should enter into a custodian agreement, which should contain the clauses that are necessary for the efficient and orderly conduct of the affairs of the custodian. The agreement, the service contract, terms and appointment of the custodian can be entered into only with the prior approval of the trustees.

Schemes of Mutual Funds

The stipulations of the SEBI regulations pertaining to mutual fund schemes are outlined below.

Procedure An AMC can launch a scheme after its approval by the trustees and filing of the offer document with the SEBI, together with filing fee 0.005 per cent of the amount raised in the new fund offer or by way of private placement subject to a minimum and a maximum of ₹ two lakh and ₹ fifty lakh respectively. The sponsor/AMC should invest, in case of an open-ended scheme, the lower of ₹50 lakh or 1 per cent of the amount raised in the new fund offer in the growth option of the scheme to be redeemed only on its winding-up.

Disclosures in the Offer Document The offer document should contain adequate disclosures to enable the investors to make an informed investment decision, including disclosure regarding the maximum investment proposed to be made by the scheme in the listed securities of the group companies of the sponsor. The SEBI can suggest modifications in the offer document, in the interest of the investors, which would be binding on the AMC. If, however, no modifications are suggested within 21 working days from the date of filing, it may issue the offer document to the public. No one should issue any form of application for units of a mutual fund unless the form is accompanied by the memorandum containing such information as specified by the SEBI. **The contents of a standard offer document prescribed by the SEBI are listed in Appendix 15-B on the website: The website address is http://www.mhhe.com/khanifs10e.** The offer document should contain the disclosures regarding the prior in-principle approval obtained from the recognised stock exchange(s) where units are proposed to be listed in accordance with these regulations. The AMC should provide an option to unit-holders to nominate a person in whom the units held by him would vest in the event of his death. In case of joint holding, the joint unit-holders may together make such nomination in the event of death of all joint unitholders.

Advertisement Material An **advertisement** should include all forms of communication issued by/on behalf of the AMC/mutual fund that may influence investment decision of any investor/prospective investors. All advertisements should conform to the advertisement code specified below and should be submitted to the SEBI within seven days from the date of issue.

Advertisement Code The main elements of the code are listed below.

The advertisements should: **(i)** be accurate, true, fair, clear, complete, unambiguous and concise;, **(ii)** not contain statements which are false/misleading/biased/deceptive, based on assumptions/projections or any testimonials/ranking based on any criteria, **(iii)** not **(a)** be no designed as likely to be misunderstood/disguise the significance of any statement, **(b)** contain statements which directly/by implication/omission may mislead the investors, **(iv)** not carry any exaggerated/unwarranted, inconsistence with/unrelated to nature, risk/return profile of the product slogan, **(v)** be framed as to exploit the lack of experience/knowledge of the investors. Excessive use of technical/legal terminology/complex language/inclusion of excessive details which may detract investors should be avoided, **(vi)** contain information which is timely/consistent with the disclosures in the scheme information document/statement of additional information/key information memorandum, **(vii)** not directly/indirectly discredit other advertisements/make unfair comparisons, and **(viii)** be accompanied by a standard warning in legible fonts stating **Mutual Fund Investments are Subject to Market Risks, Read All Scheme-Related Documents Carefully**. In audio-visual media-based advertisement, the standard warning should be audible in a clear/understandable manner. For example, in standard warning both the visual and the voice over reiteration containing 14 words running for at least 15 seconds may be considered as clear/understandable. Finally, no celebrities should form part of the advertisement.

Misleading Statements The offer document and advertisement materials should not be misleading or contain any statement or opinion that is incorrect or false.

Listing of Close-ended Schemes A **close-ended scheme** is a scheme of a mutual fund in which the maturity period is specified. Every close-ended scheme, other than an equity linked savings scheme, has to be listed on a recognised stock exchange within such time period and subject to such conditions as specified by the SEBI. However, listing of a closed-ended scheme launched prior to April 2009 is not mandatory if:

(a) It provides for periodic repurchase facility to all the unitholders, with restriction, if any, on the extent of such repurchase;
(b) It provides for monthly income or caters to special classes of persons like senior citizens, women, children, widows or physically handicapped or any special class of persons, providing for repurchase of units at regular intervals;
(c) The details of such repurchase facility are clearly disclosed in the offer document and
(d) It opens for repurchase within a period of six months from the closure of subscription;
(e) It is a capital protection oriented scheme, that is, a scheme designated as such and endeavours to protect the capital invested through suitable orientation of its portfolio structure.

In order to further strengthen the framework of close-ended schemes, all such schemes (excepting equity-linked savings schemes) launched after December 12, 2008 must be mandatorily listed. The trustees should ensure that before launch of the scheme, the in-principle approval for listing has been obtained from the stock exchange(s) and appropriate disclosures are made in the scheme information document. Moreover, NAV should be computed and published on daily basis. A close-ended debt scheme can invest only in such securities which mature on or before the date of maturity of the scheme.

Repurchase of Close-ended Schemes Units of a closed-ended scheme, other than those of equity linked savings scheme, launched after April 2009 cannot be repurchased before the end of its maturity period. The units of such schemes may be open for sale or redemption at fixed predetermined intervals if the maximum and minimum amount of sale or redemption of the units and the periodicity of such sale or redemption have been disclosed in the offer document. The units of such scheme may be converted into an open-ended scheme if: **(a)** the offer document of such scheme discloses the option and the period of such conversion; or **(b)** the unit-holders are provided with an option to redeem their units in full, and **(c)** the initial issue expenses of the scheme prior to 2008 have been amortised fully.

All close-ended schemes should be fully redeemed at the end of the maturity period. However, they can be rolled over if the purpose, period and other terms of roll-over and all other material details of the scheme, including the likely composition of assets immediately before the roll-over and the net assets/NAV are disclosed to the unitholders, and copy of the same is filed with the SEBI. The unit-holders who do not opt for the rollover or have not given their consent in writing should be allowed to redeem their holdings in full at an NAV based price.

Offering Period No scheme of a mutual fund, other than the initial offering period of any equity linked savings scheme, can be open for subscription for more than 15 days. The period would be 30 days in case of Rajiv Gandhi equity savings scheme.

Allotment of Units and Refunds of Money The AMC should specify in the offer document **(a)** the minimum subscription amount it seeks to raise under the scheme; and **(b)** in case of over subscription, the extent of subscription it may retain. Where the AMC retains the oversubscription, all the applicants applying up to 5,000 units should be given full allotment, subject to oversubscription. The mutual fund and AMC are liable to refund the application money to the applicants if: **(i)** the mutual fund fails to receive the minimum subscription amount and **(ii)** the monies received from the applicants for units are in excess of subscription. Any refundable amount should be refunded to the applicants within a period of six weeks from the date of closure of subscription list, by registered post with acknowledgement due, through a cheque or demand draft marked "A/c Payee". In the event of failure to refund the amount within the specified period, the AMC is liable to pay interest to the applicants at a rate of 15 per cent per annum from the expiry of 5 days from the date of closure of the subscription list. The period would be 15 days in case of Rajiv Gandhi equity savings scheme.

Unit Certificates/Statement of Accounts The AMC should issue, to the applicant whose application has been accepted, a statement of accounts specifying the number of units allotted, as soon as possible, but not later than 5 days from the date of closure of the initial subscription list and or from the date of the receipt of the request from the unit-holders in any open-ended scheme. If, however, an applicant so desires, the AMC should issue the unit certificates to the applicant within 5 days of the receipt of request for the certificates.

An applicant in a close-ended scheme would have the option to receive the statement of accounts or hold units in demat form. The AMC should issue the statement of accounts specifying the number of units allotted or issue units in demat form within 5 days from the date of closure of the initial subscription list. The period would be 15 days in case of Rajiv Gandhi equity savings scheme. Units in demat form to a unitholder in a closed-ended scheme listed on a recognised stock exchange should be issued by the AMC within two working days of receipt of request from the unitholder.

The AMC should ensure that the consolidated account statement for each calendar month is issued before the tenth day of the succeeding month, giving details of all the transactions (i.e. purchase/redemption/switch/dividend payout/dividend reinvestment, systematic investment/ withdrawal/transfer plan and bonus transactions) and holding at the month-end including transaction charges paid to the distributors, across all the schemes of the mutual fund to all the investors in whose folios transaction has taken place during the month. Similarly, it should be ensured that a consolidated account is issued every half-yearly (September/March) before the tenth day of the succeeding month detailing holding at the end of the sixth month. For the purpose of sending the consolidated statement, the AMC should identify common investors across fund houses by their permanent account number.

Transfer of Units A unit unless otherwise restricted or prohibited under the scheme is freely transferable by act of parties or by operation of law. A unitholder in a listed closed-ended scheme desirous of trading in units share hold units in demat form. The AMC should, on production of the instrument of transfer, together with relevant unit certificates, register the transfer and return the unit certificates to the transferee within thirty days from the date of such production. If the units are with the depository, such units are transferable in accordance with the provisions of the SEBI (Depositories and Participants) Regulations, 1996.

Guaranteed Returns Guaranteed returns can be provided in a scheme, if: **(a)** such returns are fully guaranteed by the sponsor or the AMC; **(b)** a statement indicating the name of the person who would guarantee the return is made in the offer document; and **(c)** the manner in which the guarantee is to be met has been stated in the offer document.

Capital Protection Oriented Schemes Such schemes may be launched subject to the following: **(i)** the units are rated by a registered credit rating agency from the viewpoint of the ability of the portfolio structure to attain protection of the invested capital, **(ii)** the scheme is close-ended, and **(iii)** compliance with other SEBI-specified requirements.

Winding Up A close-ended scheme is wound up on the expiry of the duration fixed in the scheme, on the redemption of the units, unless it is rolled over for a further period. A scheme of a mutual fund may be wound up, after repaying the amount due to the unitholders: **(a)** on the happening of any event that, in the opinion of the trustees, requires the scheme to be wound up; or **(b)** if 75 per cent of the unit-holders of a scheme pass a resolution that the scheme be wound up; or **(c)** if the SEBI so directs in the interest of the unitholders. Where a scheme is to be wound up, the trustees are required to give a notice disclosing the circumstances leading to the winding up of the scheme: **(i)** to the SEBI and **(ii)** in two daily newspapers having circulation all over India and a vernacular newspaper circulating at the place where the mutual fund is formed.

Effect of Winding Up On and from the date of the publication of notice, the trustee/AMC ceases **(a)** to carry on any business activities in respect of the scheme so wound up; **(b)** create or cancel units in the scheme and **(c)** issue or redeem units in the scheme.

Procedure and Manner of Winding Up The trustee should call a meeting of the unit-holders to approve by simple majority of the unit-holders present and voting at meeting for a resolution for authorising the trustees or any other person to take steps for winding up of the scheme. A meeting of the unit-holders is not necessary if the scheme is wound up at the end of the maturity of the scheme. The trustee or the person authorised should dispose off the assets of the scheme concerned in the best interest of the unit-holders of that scheme. The sale proceeds realised would be first utilised towards the discharge of such liabilities as are due and payable under the scheme and after making appropriate provisions for meeting the expenses connected with the winding up, the balance should be paid to the unit-holders in proportion to their respective interest in the asset of the scheme as on the date when the decision for winding up was taken.

On completion of the winding up, the trustee should forward to the SEBI and the unit-holders a report on the winding up containing particulars such as the circumstances leading to the winding up, the steps taken for disposal of assets of the fund before winding up, expenses of the fund for winding up, net assets available for distribution to the unit-holders and a certificate from the auditors of the mutual fund. However, the provisions of these regulations, with respect to disclosures in half-yearly/annual reports, would continue to be applicable until the winding up is completed, or the scheme ceases to exist.

Winding Up of the Scheme After the receipt of the report, if the SEBI is satisfied that all measures for winding up of the scheme have been complied with, the scheme ceases to exist.

Delisting of Units The units of a MF scheme can be delisted in accordance with the SEBI-specified guidelines in this regard.

Investment Objectives and Valuation Policies

The investment objectives and valuation policies of mutual funds as per the SEBI regulations are anlaysed below.

Investment Objective A mutual fund may invest money collected under any of its schemes only in: **(a)** securities, **(b)** money market instruments, **(c)** privately placed debentures, **(d)** securitised debt instruments, both asset-backed and mortgage-backed, **(e)** gold/gold related instruments; **(f)** real estate assets or **(g)** infrastructure debt instruments/assets. The investments should be in accordance with the investment objectives of the relevant scheme. Money collected under any money market scheme of a mutual fund should be invested only in money market instruments. Similarly, money collected under any gold exchange traded fund scheme should be invested only in gold/gold related instruments. Moreover, moneys collected under a real estate mutual fund scheme should be invested in accordance with the SEBI regulations (discussed later in this Chapter) applicable to it.

Investment and Borrowing Restrictions All investments and borrowings by mutual funds **except a gold exchange traded fund** scheme are subject to the restriction specified below.

Restrictions on Investments

1. A mutual fund scheme should not invest more than 15 per cent of its NAV in debt instruments of a single issuer other than Government securities and money market instruments, rated not below investment grade by a SEBI registered credit rating agency. With the prior approval of the Board of Trustees/AMC such limit may be extended to 20 per cent. Not more than 30 per cent of the net assets of a scheme can be invested in money market instruments of an issuer excluding Government securities/T-bills/collateralised borrowing and lending operation (CBLO). Within this limit, investments can be made in mortgage backed securitised debt rated not below investment grade by a SEBI registered rating agency. With the prior approval of their Boards of Directors, mutual fund schemes can invest in unrated debt instruments upto a maximum of 10 per cent in a single instrument

and 25 per cent in total.

2. No mutual fund, under all its schemes, should own more than 10 per cent of any company's paid-up capital carrying voting rights.
3. Transfer of investments from one scheme to another scheme in the same mutual fund are allowed only if **(a)** such transfers are done at the prevailing market price for quoted instruments on spot basis, as specified by stock exchanges for spot transactions and **(b)** the securities so transferred should be in conformity with the investment objective of the scheme to which such transfer has been made.
4. A scheme may invest in another scheme under the same AMC or any other mutual fund without charging any fees. However, aggregate inter-scheme investment made by the schemes under the same management or in the schemes under the management of any other AMC should not exceed 5 per cent of the NAV of the mutual fund. However, this restriction would not apply to any fund of funds schemes.
5. Every mutual fund should buy and sell securities on the basis of deliveries and, in all cases of purchases, take delivery of securities and in all cases of sales, deliver the securities. However, it may enter into derivative transactions in a recognised stock exchange subject to the SEBI-specified framework. The sale of government securities already contracted for purchase should be permitted in accordance with the RBI guidelines in this regard.
6. It should get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long-term nature.
7. Pending deployment of funds in securities in terms of its investment objectives, a mutual fund can invest the funds of the scheme in short-term deposits of scheduled commercial banks subject to the SEBI guidelines.
8. A mutual fund scheme should not invest in **(i)** any unlisted security **(ii)** or any security issued by way of private placement of any associate/group company of the sponsor, or **(iii)** listed security of group companies of the sponsor in excess of 25 per cent of the net assets. No scheme of a mutual fund would make any investment in any fund of funds scheme.

All mutual funds having an aggregate of securities worth ₹10 crore or more are required to settle their transactions only through dematerialised securities.

The maximum investment of a mutual fund scheme other than index fund/sector or industry specific scheme is equity shares/related instruments of any company can be 10 per cent of the NAV. A mutual fund scheme can invest upto 5 per cent of its NAV in unlisted equity shares/related instruments in case of an open-ended scheme and 10 per cent in case of close-ended schemes. Within these limits, mutual fund schemes can invest in the listed or unlisted securities or units of venture capital funds.

A fund of funds schemes should not invest in any other fund of funds scheme. A fund of funds scheme is a mutual fund scheme that invests primarily in other schemes of the same mutual fund or other mutual funds. It should also not invest its assets other than in schemes of mutual funds except to the extent of funds required for meeting the liquidity requirements for the purpose of repurchases/redemptions as disclosed in its offer document.

Restrictions on Borrowings Mutual funds are not permitted to borrow except to meet temporary liquidity needs for the purpose of repurchase, redemption of units or payment of interest or dividend to the unitholders. In any case, they cannot borrow more than 20 per cent of the net assets of the scheme for a period exceeding six months. They are prohibited from advancing any loans for any purpose. But they can borrow and lend securities in accordance with the SEBI framework relating to short selling and securities lending and borrowing.

A gold exchange traded scheme would be subject to the following restrictions : **(i)** the funds should be invested only in gold/gold related instruments in accordance with its investment objectives except to the extent necessary to meet liquidty requirements for honouring repurchases/ redemption as disclosed in the offer document and **(ii)** pending deplayment of funds, such funds may be inverted in short-term bank deposits.

Carry Forward, Derivatives and Short Selling Transactions The funds of a scheme should not in any manner be used in carry forward transactions. However, a mutual fund may enter into derivative transactions on a recognised stock exchange within the SEBI framework. It may enter into short selling transactions on a recognised stock exchange subject to the framework specified by the SEBI relating to short selling and securities lending/borrowing.

Underwriting of Securities Mutual funds may enter into an underwriting agreement after obtaining a certificate of registration in terms of the SEBI (Underwriters) Rules and Regulations, 1993, authorising it to carry on activities as underwriters. The underwriting obligation would be deemed as if investments are made in such securities. The capital adequacy norms for the purpose of underwriting would be the net assets of the scheme. The underwriting obligations of a mutual fund, however, cannot at any time exceed the total NAV of the scheme.

Computation of Net Asset Value Every mutual fund must compute on a daily basis the NAV of a scheme as determined by dividing the net assets of the scheme by the number of outstanding units or the valuation date and published in at least two daily newspapers having all-India circulation.

Valuation of Investments Every mutual fund should ensure that the AMC computes and carries out valuation of investments of its scheme(s) according to the investment valuation norms in terms of **(i)** principles of fair valuation and **(ii)** valuation guidelines.

Principles of Fair Valuation Mutual funds should value their investments according to the following overarching principles to ensure fair treatment to **all** investors:

- The valuation should be based on the principle of fair valuation, that is, reflective of the realisable value of the assets/securities. It should be done in good faith/true and fair manner through appropriate policies/procedures;
- The policies/procedure approved by the AMC should identify the methodologies to be used for valuing each type of assets/securities. The investments in new type of securities/assets should be made only after establishment of the AMC-approved methodologies for them;
- The assets should be consistently valued according to the policies/procedures which should also describe the process to deal with exceptional events where market quotations are no longer reliable for a particular security;
- The AMC should periodically review them to ensure their appropriateness/accuracy and effective implementation. The Board of Trustees/AMC should be updated of these developments at appropriate intervals. They should be regularly (at least once in a year) reviewed by an independent auditor to ensure their continued appropriateness.
- The AMC-approved policies/procedures should address conflict of interest. Their disclosure should be made in **Statement of Additional Information** on the website of the AMC/ mutual fund or other SEBI-speecified place to ensure transparency of the valuation norms;

- The AMC should be responsible for true/fair valuation and correct NAV. It may deviate, with appropriate reporting to the Board of the AMC/Trustees and appropriate disclosures to the investors, from the established policies/procedures to value the assets/securities at fair value;
- It should have policies/procedures to detect/prevent incorrect valuation and maintain/preserve documentation of rationale for valuation including inter-scheme transfers to enable audit trail;
- For fair valuation of debt/money market securities, the AMC should take into consideration prices of trades of same/similar security reported at all available public platform(s).

Valuation Guidelines In addition to the above, a mutual fund may value investments according to the following guidelines. In case of any conflict, the principles of fair valuation should prevail over the valuation guidelines.

The NAV of a scheme is determined by dividing the net assets by the number of outstanding units on the valuation day.

1. Traded Securities

(i) The securities should be valued at the last quoted closing price on the stock exchange.

(ii) When the securities are traded on more than one recognised stock exchange, they should be valued at the last quoted closing price on the stock exchange where the security is principally traded. It is left to the AMC to select the appropriate stock exchange, but the reasons for the selection should be recorded in writing. However, all scrips can be valued at the prices quoted on the stock exchange where a majority in value of the investments are principally traded.

(iii) Once a stock exchange has been selected for valuation of a particular security, reasons for its change must be recorded in writing by the AMC.

(iv) When on a particular valuation day, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.

(v) When a security (other than debt securities) is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected exchange, or any other stock exchange, on the earliest previous day may be used, provided such date is not more than thirty days prior to the valuation date. When a debt security (other than Government securities) is not traded on any stock exchange, on any particular valuation day, the value at which it was traded on the principal stock exchange, or any other stock exchange on the earliest previous day may be used, provided such date is not more than 15 days prior to valuation date. When such a security is purchased by way of placement, the value at which it was bought may be used for a period of 15 days beginning from the date of purchaser.

2. Non-traded Securities

(i) When a security is not traded on any stock exchange for a period of thirty days prior to the valuation date, the scrip must be treated as a **'non-traded'** scrip.

(ii) Non-traded securities should be valued "in good faith" on the basis of appropriate valuation methods, based on the principles approved by the Board of Directors of the AMC. For example, debt/money market securities may be valued on amortisation basis if it is reflective of their fair value and investors are fairly treated. Such decision of the Board of Directors must be documented in the minutes and the supporting data in respect of each security so valued must be preserved. The methods used to arrive at value "in good faith" should be periodically reviewed by the trustees and reported upon by the auditors as "fair and reasonable" in their report on the annual accounts of the mutual fund. For the purpose of valuation of non-traded securities, the following principles should be adopted:

(a) Equity instruments should generally be valued on the basis of capitalisation of earnings solely, or in combination with the net asset value, using for the purpose of capitalisation, the price or earning ratios of comparable traded securities and with an appropriate discount for lower liquidity;

(b) Debt instruments should generally be valued on a yield to maturity basis, the capitalisation factor being determined for comparable traded securities and with an appropriate discount for lower liquidity;

(c) While investments in call money, bills purchased under rediscounting schemes and short-term deposits with banks should be valued at cost plus accrual, other money market instruments should be valued at the yield at which they are currently traded. For this purpose, non-traded instruments (those not traded for seven days) would be valued at cost plus interest accrued at the beginning of the day plus the difference between the redemption value and the cost spread uniformly over the remaining maturity period of the instruments. Government securities should be valued at yield to maturity, based on the prevailing market rate;

(d) In respect of convertible debentures and bonds, the non-convertible and convertible components should be valued separately. The non-convertible component should be valued on the same basis as would be applicable to a debt instrument while the convertible component should be valued as would be an equity instrument. If, after the conversion, the resultant equity instrument would be traded pari passu with an existing traded instrument, the value of the later instrument can be adopted after an appropriate discount for the non-tradability of the instruments during the period preceding the conversion. While valuing such instruments, the fact whether the conversion is optional should also be factored in;

(e) Warrants to subscribe to shares attached to instruments can be valued at the value of the share, which would be obtained on exercise of the warrant as reduced by the amount that would be payable on exercise of the warrant. A discount similar to the discount to be determined in respect of convertible debentures as referred to above must be deducted to account for the period that must elapse before the warrant can be exercised;

(f) Where the instruments have been bought on 'repo' basis, the instrument must be valued at the resale price after the deduction of applicable interest, up to the date of resale. Where an instrument has been sold on a 'repo' basis, adjustment must be made for the difference between the repurchase price (after the deduction of applicable interest upto the date of repurchase) and the value of the instrument. If the repurchase price exceeds the value, the depreciation must be provided for and if the repurchase price is lower than the value, credit must be taken for the appreciation.

3. Rights Shares Until they are traded, the value of the 'right' shares should be calculated as:

$$V_r = \frac{n}{m} x \, (P_{ex} - P_{of})$$

where Vr = Value of rights

n = Number of rights offered

m = Number of original shares held

P_{ex} = Ex-rights price

P_{of} = Rights offer price

where the rights are not treated pari passu with the existing shares, suitable adjustment should be made to the value of rights. Where it is decided not to subscribe for the rights but to renounce them and renunciations are being traded, the rights can be valued at the renunciation value.

3-A Value of Gold The gold held by a gold exchange traded fund should be valued at the **AM** fixing price of the London Bullion Market Association (LBMA) in US dollars per troy ounce for gold having a fineness of 995.0 parts per thousand subject to the **(a)** adjustment for conversion **(i)** to metric measure as per standard conversion rates, **(ii)** of US dollars into Indian rupees as the RBI reference rate declared by the Foreign Exchange Dealers Association of India (FEDAI), and **(b)** addition of **(i)** transportation/other charges, **(ii)** notional custom duty/other applicable taxes and levies normally incurred in bringing gold from London to the place where it is actually stored on behalf of the mutual fund. These adjustments may be made on the basis of a national premium that is usually charged for delivery of gold to the place where it is stored. Where the gold held has a grater fineness, the relevant LBMA prices of **AM** fixing should be taken on the reference price.

If the acquired gold is not in the form of standard bars, it should be assayed and converted into standard bars which comply with the good delivery norms of the LBMA.

4. Expenses and Incomes All expenses and incomes accrued up to the valuation date should be considered for the computation of the net asset value. For this purpose, while major expenses like management fees and other expenses should be accrued on a day-to-day basis, other minor expenses and income need not be so accrued, provided their non-accrual does not affect the NAV calculations by more than 1 per cent.

5. Any change in securities and in the number of units are to be recorded in the books not later than the first valuation date following the date of transaction. If this is not possible given the frequency of the NAV disclosure, the recording may be delayed up to a period of seven days following the date of the transaction, provided that as a result of non-recording, the NAV calculation should not be affected by more than 1 per cent.

6. In case the NAV of a scheme differs by more than 1 per cent due to non-recording of the transactions, the investors/scheme(s) should be paid the difference in amount in the following manner. If the investors are allotted units at a price higher than the NAV or given a price lower than the NAV at the time of sale of their units, they should be paid the difference in amount by the scheme. If they are charged a lower NAV at the time of purchase of their units or are given a higher NAV at the time of sale of their units, the AMC should pay the difference in amount to the scheme and may recover the difference from the investors.

7. Thinly traded securities should be valued in the manner as specified by the SEBI guidelines in this respect.

8. The aggregate value of illiquid securities should not exceed 15 per cent of the total assets of the scheme. Any excess holdings should be valued in the manner specified by the SEBI guidelines in this regard.

Computation of Net Asset Value Every mutual fund should compute the Net Asset Value (**NAV**) of each scheme by dividing the net asset of the scheme by the number of units outstanding on the valuation date. It should be calculated and published in at least two daily newspapers, at intervals not exceeding one week. However, the NAV of a close-ended scheme other than that of equity linked savings scheme should be calculated on a daily basis and published in at least two daily newspapers having circulation all over India.

Pricing of Units The price at which the units may be subscribed or sold and repurchased by the mutual fund should be made available to the investors.

In case of an open-ended scheme that offers units for sale without specifying any duration of redemption, it should publish the sale and purchase price of units, at least once a week, in a daily newspaper with all India circulation. While determining the prices of the units, it must be ensured that the repurchase price is not lower than 93 per cent and the sale is not higher than 107 per cent of the NAV. The difference between the repurchase price and the sale price of the units should not exceed 7 per cent of the sale price.

A mutual fund should deduct from the repurchase proceeds of closed-ended schemes launched prior to April 2009 such proportion of the initial issue expenses of the scheme as are attributable to the units being purchased if **(i)** the scheme is launched after May 2006 but prior to Ma 2008 and **(ii)** initial issue expenses in respect of the scheme are accounted in the books of account of the scheme in accordance with the applicable regulations.

Amortisation of Initial Issue Expenses for Closed-Ended Schemes

(a) The AMCs/sponsor/trustees may launch schemes either on a 'load' or 'no load basis', or on a mixed basis with two classes of units in the same scheme—one with load and other without load—provided that the implications of such load on the NAV for the investors are clearly explained through a worked out example in the offer document. They may also launch 'partial load' schemes in which a part of the load would be borne by the AMCs/trustees/sponsor and the balance by the scheme. However, such schemes would not qualify to be 'no load' schemes and would be treated in the same manner as 'load' schemes. In the case of a no load scheme, the initial issue expenses would be borne by the AMC/trustees/sponsor.

(b) For a close-ended scheme floated on a 'load' basis, prior to May 2008, the initial issue expenses should be amortised on a weekly basis over the period of the scheme. But in case the scheme provides for partial redemption during its life, the amortisation has to take into account the number of outstanding units and the aggregate amount during the relevant periods.

(c) In case of close-ended schemes floated on a 'load' basis, prior to May 2008, the unamortised portion of the expenses are to be included in the calculation of the NAV. However, such portion cannot be included in the NAV for the purposes of determining the AMC's investment management and advisory fees or for determining the limitation of expenses under these regulations.

(d) All subsequent distribution charges must, in the case of load schemes, be borne by the scheme and, in the case of no load schemes, by the AMC.

Any excess over the 6 per cent initial issue expense would have to be borne by the AMC.

The price of units must be determined with reference to the last determined NAV, unless **(a)** the scheme announces the NAV on a daily basis and **(b)** the sale price is determined with or without a fixed premium added to the future NAV, which is declared in advance.

Real Estate Mutual Fund Schemes

The SEBI stipulations relating to real estate mutual funds schemes (REMFS) and trustees and asset management companies in relation to such schemes are discussed below.

The SEBI would grant a certificate of registration to an applicant proposing to launch only real estate mutual fund scheme if he **(i)** has been carrying on business in real estate for at least 5 years and **(ii)** satisfies the eligibility criteria applicable to sponsors of other types of mutual fund schemes (**discussed earlier in the Chapter**). The REMFS should have key personnel having adequate professional experience in finance and financial services related fields. An existing mutual fund may launch a REMFS if it has an adequate number of key personnel and directors having adequate experience of working in real estate. All REMFSs would be close-ended and listed on a recognised stock exchange. However, redemption of a REMFS may be done in a staggered manner. The unitholders of the REMFS would have no right to use the real assets held by the scheme. **Real estate assets** means an identifiable immovable property which is **(i)** located within India in a city specified by the SEBI from time to time or in a special economic zone, **(ii)** is usable and construction is complete, **(iii)** evidenced by valid title documents, **(iv)** legally transferable, **(v)** free from all encumbrances, and **(vi)** not subject-matter of litigation. It does not include **(i)** a project under construction, **(ii)** vacant land, **(iii)** deserted property, **(iv)** agricultural land, and **(v)** a property reserved/attached by government/other authority or pursuant to a court order or the acquisition of which is otherwise prohibited under any law.

The title deeds pertaining to the real estate should be kept in safe custody with the custodian of the mutual fund. The REMFS cannot undertake lending or house finance activities. All financial transactions of such schemes should be routed through normal banking channels and should not be cash/unaccounted transaction.

Permissible Investments At least 25 per cent of the net assets of the scheme should be invested directly in real estate assets. Subject to this, at least 75 per cent of the net assets should be invested in real estate assets, mortgage backed securities (but not directly in mortgages) and equity shares/debentures of listed/unlisted companies engaged in dealing in real estate assets/undertaking real estate development projects and the balance in other securities. No mutual fund should invest:

- Under all its REMFSs more than **(i)** 30 per cent of its net assets in a single city, **(ii)** 15 per cent in a single project, that is, a project by a builder in a single location within a city and **(iii)** 25 per cent of the total issued capital of an unlisted company;
- More than 15 per cent of the assets of any REMFS in the equity shares/debentures of an unlisted company;
- Any **(i)** unlisted security of the sponsor/associate/group company, **(ii)** listed security issued by way of preferential allotment by the sponsor/associate/group company, and **(iii)** any listed security of the sponsor/associate/group company exceeding 25 per cent of the net assets of the scheme;
- Transfer real estate assets amongst its schemes; and
- In any real estate asset which was owned by the sponsor/AMC/any associate during the last 5 years or in which they hold tenancy/lease rights.

Valuation of Real Estate Assets and Declaration of NAV **(1)** The real assets held by a REMFS should be valued at cost price on the date of acquisition and at fair price on every 90th day from the date of its purchase in accordance with the norms specified below:

Direct Investment in Real Estate Assets **Fair value** means the amount for which an asset could be exchanged between knowledgeable parties in an arms' length transactions and certified by the real estate valuer. **Knowledgeable** means that both the buyer and the seller are reasonably informed about the nature and characteristics of the asset, its actual and potential uses and market conditions at the balance sheet date. A **real estate valuer** means a qualified valuer of real estate assets accredited by a SEBI-registered credit rating agency.

The REMFS should account for, separately, the portions of estate asset held to earn rentals or for capital appreciation if they can be sold/leased separately.

Initial Recognition A real estate asset should be recognised if it is probable that the future economic benefits associated with it would flow to the REMFS and its cost can be measured reliably. The REMFS should evaluate their costs including those incurred initially to acquire as well as those incurred subsequently to add to/replace part of or service a real estate asset at the time they are incurred. However, the cost of the day-to-day servicing of the asset should be recognised in the revenue account as incurred.

A REMFS should recognise the cost of replacing part of an existing real estate asset at the time of its incurrence. The carrying amount of the replaced parts should be derecognised (according to the derecognition provisions discussed later).

The asset should be recognised on the date of completion of the process of transfer of ownership, that is, the date on which an enforceable right including all significant risks and rewards of ownership are obtained by the REMFS.

Measurement at Initial Recognition A real estate asset (REA) should be measured initially at cost comprising purchase price, any other directly attributable expenditure such as professional fee for legal services/registration expenses and asset transfer taxes. In case of deferred payment, the cost of the REAs is the cash price equivalent. The difference between this amount and the total payments as internal expenses over the period of credit should be recognised.

The cost of the REAs acquired in exchange for non-monetary asset(s)/a combination of monetary and non-monetary assets should be measured at fair value unless the exchange transaction lacks commercial substance or the fair value of the assets received/given up is reliably measurable. If the acquired REA cannot be measured at fair value, its cost should be measured at the carrying cost of the asset given up. Whether an exchange transaction has commercial substance would depend on the extent to which its future cashflows are expected to change as a result of the transaction. An exchange transaction has commercial substance if **(i)** the risk, timing and amount of the cash flows of the assets received/transferred differ, **(ii)** the REMFS-specific value of the portion affected by the transaction changes as a result of the exchange, and **(iii)** the difference in **(i)** or **(ii)** is significant relative to the fair value of the asset exchanged.

The fair value of an asset for which comparable market transactions do not exist is reliably measurable if **(a)** the variability in the range of reasonable fair value estimates is not significant for that asset or **(b)** the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. If the fair value of either the asset received/given up can be reliably determined, the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Subsequent Measurement After initial recognition, a real estate held by a REMFS should be measured at its fair value. A gain/loss arising from a change in its fair value should be recognised in the revenue account of the period in which it arises. The gain arising from the appreciation in its value is an unrealised gain which should not be distributed.

The fair value should specifically exclude an estimated price inflated/deflated by specified terms/circumstances such as typical financing, sale and lease back arrangements, special considerations/concessions granted by any one associated with the sale. It should reflect market conditions on the balance sheet date. It reflects, inter-alia, rental income as also the expected cash outflows. The best evidence of fair value is given by the current prices in an active market for similar real estate assets in the same location/condition and subject to similar lease/other contracts. In the absence of current prices in an active market, information from a variety of sources should be considered including **(1)** current prices in an active market for properties of different nature, condition/location (or subject to different lease/other contracts) adjusted to reflect these differences, **(2)** recent prices of similar properties on less active markets, **(3)** discounted cash flow projections, using discount rates reflecting current market assessment of the uncertainty in the amount/timing of the cashflows.

Where the fair value of the real estate is not reliably determinable on a continuing basis, the REMFS should measure the real asset at cost as per **AS-10: Accounting for Fixed Assets**. Its residual value should be assumed to be zero. The **AS-10** should be applied until its disposal. The fair value would be considered to be not reliably determinable, if the variability in the range of fair value estimates is large and the probabilities of the various outcomes difficult to assess, such that the usefulness of a single estimate of fair value is negated.

In determining the fair value, there should be no double counting of assets/liabilities. The future capital expenditures and the related future benefits are not reflected in the real assets.

Where a REMFS expects that the present value of its payments will exceed the present value of the related cash receipts, it should apply the **AS-29: Provisions, Contingent Liabilities, and Contingent Assets** to determine whether to recognise a liability and how to measure it.

To determine the fair value of a real estate asset according to the above stipulations, a REMFS should use the services of two independent and approved valuers and use the lower of the two valuations.

For accounting for rental income, **AS-19: Leases** should be followed. Such income should accrue on a daily basis.

Where the rental income has accrued but has not been received for the specified period, provisions should be made by debiting to the revenue account the accrual income in the manner specified by the SEBI.

Derecognition of Real Estate Asset A real estate asset should be derecognised by a REMFS on disposal or when the asset is permanently withdrawn from use and no future benefits are expected from its disposal. The criteria in **AS-19: Revenue Recognition** should be applied for determining the date of disposal of the asset by way of sale. Gains/losses from the disposal/retirement of the asset would be the difference between the net disposal proceeds and its carrying amount, and recognised in the revenue account in the period of disposal/retirement. The consideration receivable on disposed is to be recognised initially at fair value. If, however, payment is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the normal amount of the consideration and the cash price equivalent should be recognised as interest revenue over the period of credit.

(2) The AMC/its directions/the trustees/the real estate valuer should ensure that the valuation of the assets held by a REMFS are done in good faith in accordance with the norms specified above and that its accounts are prepared according to the accounting principles specified by the SEBI.

(3) The NAV of every REMFS should be declared at the close of each business day on the basis of the most current valuation of the assets held and the accrued income.

Duties of Asset Management Company (AMC) The AMC of a mutual fund having a REMFS should **(i)** appoint a suitable number of qualified key personnel with relevant experience, **(ii)** appoint advisors to advise it on the acquisition of real estate assets, **(iii)** exercise due care while appointing the valuers and ensure that there is no conflict of interest, **(iv)** lay down an adequate system of internal controls and risk management, **(v)** put in place systems to ensure that all financial transactions are done through banking channels and exclude transactions in cash/accounted transactions, **(vi)** exercise due diligence in maintenance of the assets and ensure that there is no avoidable deterioration in their value, **(vii)** ensure that the assets held are adequately insured against impair, damage/destruction, **(viii)** ensure that the cost of maintenance/insurance is within reasonable limits and no funds are utilised towards development of the assets, and that a real estate valuer certifies compliance with this on an annual basis, **(ix)** ensure that no valuer **(a)** continues with the valuation of a particular asset for more than 2 years, **(b)** values the safe asset for at least 3 years thereafter, **(x)** record in writing the details of its decision-making process in buying/selling assets together with the justification for such decisions and forward the same to the trustees, and **(xi)** ensure that investment of funds is not made contrary to these provisions and the trust deed; **(xii)** obtain, wherever required under these regulations, prior in-principle approval from the stock exchange(s) where units are proposed to be listed.

Usage of Real Estate Assets The AMC may let out/lease the assets if the term of the lease/letting does not extend beyond the period of maturity of the REMFS. It should diligently collect the rents/other income in a timely manner. The assets may be let out to the sponsor/AMC associates at market price/on commercial terms. However, not more than 25 per cent of the total rental income of the REMFS should be derived from letting out the assets.

Duties of Trustees The trustees should:

- Ensure that the AMC has the necessary expertise, internal control systems and risk management mechanism to invest in, and manage, investments in real estates on a continuous basis,
- Monitor whether due diligence is exercised by the AMC in managing the investments,
- Review the market price of the units during the year and recommend proportionate buy-back of units from unitholders if the units are traded at deep discounted to the NAV. The magnitude of discount amounting to deep discount should be disclosed in the offer document,
- Ensure that only permissible investments are made by the AMC,
- Ensure that all financial transactions are made only through banking channels and systems exist to exclude transaction in cash/unaccounted transactions,
- Lay down the criteria for empanelment of real estate brokers,
- Lay down the broad procedures to be followed by the AMC while transacting in real estate assets,
- Require the AMC to set up such system and submit such reports to trustees as may be necessary for them to effectively monitor the performance and functioning of the REMFS. The trustees should include a confirmation on compliance with this stipulation in their half yearly reports to the SEBI.
- Obtain, wherever required under these regulations, prior in-principle approval from the stock exchange(s) where units are proposed to be listed.

Disclosure in Offer Document and Other Disclosures The offer document of REMFs should contain adequate disclosures for investors to make informed investment decisions and such further disclosures as are specified by the SEBI. The portfolio disclosures and financial results should contain such further disclosures as are specified by the SEBI. Advertisements in respect of REMFSs should conform to such guidelines as may be prescribed by the SEBI.

Transactions By Employees Etc. All transactions by the trustees/employees/directors of the AMC/trustee company in real estate assets should be disclosed by them to the compliance officer within a month. The compliance officer should make a report from the viewpoint of possible conflict of interest and submit it to the trustees with his recommendations. The trustees/employees/directors of the AMC may obtain the view of trustees before entering into transactions by making a suitable request to them.

Infrastructure Debt Fund Schemes

Infrastructure Debt Fund Schemes (IDFSs) means a mutual fund scheme that invests primarily (i.e. 90 per cent of the assets of the scheme) in debt securities/securitised debt instruments of infrastructure/infrastructure capital companies/projects or special purpose vehicles (SPVs) created for facilitating/promoting investment in infrastructure and other permissible assets or bank loans in respect of completed and revenue generating projects of infrastructure companies/projects/SPVs. Such schemes would be governed by the stipulations discussed below. **The other provisions of the SEBI mutual fund regulations/guidelines/circulars, unless the context otherwise require or repugnant to these stipulations would also apply to them/trustees/AMCs in relation to them.** The main elements of the **IDFSs** are: **(i)** eligibility criteria, **(ii)** conditions, **(iii)** permissible investments, **(iv)** valuation of assets and NAV, **(v)** duties of AMC, and **(vi)** disclosures.

Eligibility Criteria An existing mutual fund may launch an IDFS if it has adequate number of key personnel having adequate experience in infrastructure sector **(sectors included in infrastructure are discussed in Chapter 1**). The SEBI would grant a certificate of registration if the sponsor/its **parent company** (i.e. a company holding 75 per cent of the capital of the sponsor) **(a)** has been carrying on activities/business in infrastructure financing sector for at least 5 years and **(b)** fulfils the eligibility criteria applicable to other mutual funds (**discussed in an earlier Section**).

Offer Period The offer period for subscription in case of a public offer should not be more than 45 days.

Conditions An IDFS can be launched either as a close-ended scheme with a maturity exceeding 5 years or interval scheme with lock-in of 5 years and specific transaction period of a maximum of 45 days. The tenure may be extended to two years subject to approval of the two-thirds of the unitholders by value of their investment. Their units would be listed after being fully paid-up. The mutual fund(s) may disclose to its potential investors the indicative portfolio in terms of the type of assets in which the fund would be invested. The minimum number of investors in any IDFS would be five subject to a 50 per cent ceiling on holdings of one single investor. The minimum investment limit would be rupees five crore with a minimum size unit of rupees 10 lakh. Each IDFS should have firm commitment from **strategic investors** [i.e. an RBI-registered infrastructure finance company (as NBFC)/a bank/international multilateral financial institutions, RBI-registered systematically important NBFCs, and foreign portfolio investors] for contribution of at least rupees twenty five crore before the allotment of units to the other potential investors. Partly-paid units may be issued to investors subject to the conditions that **(i)** the AMC would call for the unpaid portion depending upon the deployment opportunities, **(ii)** disclosure in the offer document of the interest/penalty to be deducted in case of non-payment of call money by the investors within the stipulated time, and **(iii)** the interest/penalty would be retained in the scheme.

Private Placement The units of an IDF scheme may be offered through private placement to less than 50 persons subject to the approval of the trustees/AMC. The mutual fund should file a SEBI-specified placement memorandum together with the specified fee at least 7 days prior to the launch of the scheme.

Permissible Investments At least 90 per cent of the net assets of the IDFS should be invested in the specified debt securities/securitised debt instruments of infrastructure companies/projects of SPVs created to facilitate/promote in infrastructure or bank loans in respect of completed and revenue-generating projects of infrastructure companies/SPVs. Funds received on account of repayment of principal with respect to the underlying assets of the scheme should be similarly invested. They may also be invested in bonds of PFIs/IFCs. The balance amount may be invested in listed/unlisted equity shares/convertibles including mezzanine financing instruments or bank deposits and money market instruments. These restrictions would be applicable on the life-cycle and reckoned with reference to the total amount raised by the IDFSs. The maximum investment under all the IDFSs of a mutual fund in a single entity/bank loan would be restricted to 30 per cent of its net assets. The investment limit in the debt securities/assets of a single entity/bank loan rated below investment grade/unrated would be 30 per cent. This limit could be upto 50 per cent with the prior approval of the AMC/trustees. The IDFSs are prohibited from investing in any **(i) (a)** unlisted security of, **(b)** listed security issued by way of preferential allotment by the sponsor/its associate or group company, **(ii)** with the approval of the trustees and full disclosures to investors, **(a)** not more than 25 per cent of the net assets of the scheme in listed security of the sponsor/its associate/group/company or bank loan, and **(b)** any asset/securities owned by the sponsor/AMC/associates in excess of 30 per cent of the net assets if investment is not below investment grade, the sponsor/associate retains at least 30 per cent till the assets/securities and held in the scheme portfolio and trustees have approved and full disclosures made to the investors.

Valuation of Assets and Declaration of NAV The assets held by an IDFS should be valued in **good faith** by the AMC on the basis of appropriate valuation methods based on principles approved by the trustees. The valuation should be documented and the supporting data preserved for at least 5 years after the expiry of the scheme. The valuation method used should be periodically reviewed by the trustees/statutory auditors of the mutual fund. The valuation policy approved by the AMC should be disclosed in the scheme information document. The NAV of the IDFS should be calculated/declared at least once in every quarter.

Duties of AMC The AMC should: **(i)** lay down an adequate system of internal controls/risk management; **(ii)** exercise due diligence in maintenance of the assets of the IDFS and ensure that there is no avoidable deterioration in their value; **(iii)** record in writing the details of the decision-making process in buying/selling assets together with the justification for such decisions and forward them periodically to the trustees; **(iv)** ensure that the investments of funds is not contrary to the SEBI regulations/trust deed, **(v)** obtain prior in-principle approval from the stock exchange where units are proposed to be listed and **(vi)** institute mechanism to ensure proper care for collection/monitoring/supervision of the debt assets by appointing a service provider having extensive experience.

Disclosures in Offer Document and Other Disclosures The offer documents of IDFSs should contain **(i)** adequate disclosures for investors to make informed investment decisions and **(ii)** further disclosures specified by the SEBI. The portfolio disclosures and financial results should also contain further disclosures and advertisements should conform to the SEBI guidelines.

Transactions The trustees or the employees/directors of the AMC/trustee company should disclose within one month all their transactions in the investee company to the compliance officer who should submit a report with recommendation to the trustees from the viewpoint of conflict of interest. The person(s) concerned may obtain views of the trustees before entering into the transaction.

General Obligations

The general obligations of AMCs/mutual funds, stipulated by the SEBI regulation, are detailed below.

Maintain Proper Books of Accounts and Records Every AMC should keep, maintain and preserve proper books of accounts, records and documents, for eight years, for each scheme so as to explain its transactions and to disclose at any point of time the financial position and, in particular, give a true and fair view of the state of affairs of the mutual fund and intimate to the SEBI the place where such books of accounts, records and documents are maintained. Moreover, it should follow the accounting policies and standards, as specified below, so as to provide the appropriate details of the schemewise disposition of the asset at the relevant accounting date, and the performance during the period together with information regarding the distribution and accumulation of income accruing to the unitholders, in a fair and true manner.

Accounting Policies and Standards

(a) For the purpose of the financial statements, the mutual funds should mark all investments to the market and carry investments in the balance sheet at market value. However, since the unrealised gain arising out of appreciation on investments cannot be distributed, provisions have to be made for the exclusion of this item when arriving at distributable income.

(b) Dividend income earned by a scheme should be recongised, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments that are not quoted on the stock exchange, dividend income must be recognised on the date of declaration.

(c) In respect of all interest bearing investments, income must be accrued on a day to day basis, as it is earned. Therefore, when such investments are purchased, interest paid for the period from the last interest due date up to the date of purchase must not be treated as a cost of purchase but must be debited to interest recoverable account. Similarly, interest received at the time of sale for the period from the last interest due date upto the date of sale must not be treated as an addition to the sale value but must be credited to the interest recoverable account.

(d) In determining the holding cost of investment and the gains or loss on sale of investments, the 'average cost' method must be followed.

(e) Transactions for the purchase or sale of investments should be recognised as of the trade date not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, acquisitions through private placement or purchases or sales through private treaty, the transactions should be recorded in the event of a purchase, as of the date on which the scheme obtains an enforceable obligation to pay the price or, in the event of sale, when the scheme obtains an enforceable right to collect the proceeds of sale, or an enforceable obligation to deliver the instruments sold.

(f) Bonus shares to which the scheme becomes entitled should be recognised only when the original shares on which the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognised only when the original shares on which the rights entitlement accrues are traded on the stock exchange on an ex-rights basis.

(g) Where income receivable on investments has accrued and has not been received for the period specified in the SEBI guidelines, provision should be made by debiting to the revenue account the income so accrued, in the manner specified by SEBI guidelines.

(h) When units are sold, in the case of an open-ended scheme, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves, and if negative, they should be debited to the reserves, the face value should be credited to the capital account. Similarly, when in respect of such a scheme, units are repurchased, the difference between the repurchase price and face value of the unit, if positive, should be debited to reserve and, if negative, should be credited to reserves, the face value being debited to the capital account.

(i) In the case of an open-ended scheme, when units are sold, an appropriate part of the sale proceeds should be credited to an equalisation account, and when units are repurchased, an appropriate amount should be debited to the equalisation account. The net balance on this account should be credited or debited to the revenue account. The balance on the equalisation account debited or credited to the revenue account should not decrease or increase the net income of the mutual fund but is only an adjustment to the distributable surplus. It should, therefore, be reflected in the revenue account only after the net income of the mutual fund is determined.

(j) In a close-ended scheme launched prior to April 2009 that provides the unit-holders with the option for an early redemption or repurchase its own units, the par value of the unit has to be debited to the capital account and the difference between the purchase price and par value, if positive, should be credited to reserve, and if negative, it should be debited to the reserves. A proportionate part of the unamortised initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.

(k) The cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker's bought note. In respect of privately placed debt instruments, any front-end discount offered should be reduced from the cost of the investment.

(l) Underwriting commission should be recognised as a revenue only when there is no devolvement on the scheme. Where there is devolvement, the full underwriting commission received, and not merely the portion applicable to the devolvement, should be reduced from the cost of investment.

(m) In case of real estate mutual funds schemes, investments in unlisted equity shares would be valued as per the specified norms (**discussed earlier in this chapter***)*.

Financial Year The financial year for all the schemes should end as of March 31 of each year. However, for a new scheme commencing during a financial year, the disclosure and reporting requirements would apply for the period beginning from the date of its commencement and ending on March 31 of that financial year.

Credit of Exit Load The exit load charged should be credited to the scheme.

Limitations on Fees and Expenses on Issue of Schemes All expenses should be clearly identified and appropriated in the individual schemes. The AMC may charge the scheme with investment and advisory fees that should be fully disclosed in the offer document. In addition, it may charge the scheme with the following recurring expenses, including: **(i)** marketing and selling expenses, including agents' commission, if any; **(ii)** brokerage and transaction cost; **(iii)** registrar services for the transfer of units sold or redeemed; **(iv)** fees and expenses of trustees; **(v)** audit fees; **(vi)** custodian fees; **(vii)** costs related to investor communication; **(viii)** costs of funds transfer from location to location; **(ix)** cost of providing account statement and dividend/redemption cheques and warrants; **(x)** insurance premium paid by the mutual fund; **(xi)** winding up costs for terminating a mutual fund/scheme; **(xii)** cost of statutory advertisements, **(xiii)** recurring expenses incurred towards storage and handling of gold in case of gold exchange traded fund scheme, rating fee in case of capital protection oriented scheme; and insurance premia and costs of maintenance of the real assets (excluding cost of their development) to the extent declared in the offer document, **(xiv)** listing fee in case of schemes listed on a recognised stock exchange and **(xv)** such other costs as may be approved by the SEBI.

The total expenses (inclusive of investment management/advisory fee) of the scheme excluding issue/redemption expenses are subject to the limits specified below:

(A) In case of fund of funds scheme: Total expenses of the scheme including weighted average of charges levied by the underlying schemes, not to exceed 2.5 per cent of the daily net assets of the scheme;

(B) In case of index fund scheme/exchange traded fund: Upto a maximum of 1.5 per cent of the daily net assets;

(C) in case of other schemes (as per cent of daily net assets): on the **(i)** first ₹100 crore, 2.5, **(ii)** next ₹300 crore, 2.25, **(iii)** next ₹300 crore, 2.0 and **(iv)** balance 1.75. However, in a scheme investing in bonds, the limit would be at least 0.25 per cent lesser. Any expenditure in excess of the above limits should be borne by the AMC/trustees/sponsor.

In addition to the above, the following costs/expenses may be charged to a scheme: **(i)** brokerage/transaction costs incurred for execution of trade and including in cost of investment, upto 0.12 per cent and 0.05 per cent respectively in cash market and derivative transactions; **(ii)** expenses upto 0.30 per cent of daily net assets if the new inflows from the SEBI-specified cities are the higher of **(a)** 30 per cent of the gross inflow, **(b)** 15 per cent of the assets under management of the scheme. They should be charged on a proportionate basis if the inflows are less than these (30 and 15) percentages. Such expenses should be utilised for distribution expenses for bringing inflows from these cities. In case these inflows are redeemed within one year, the amount would be credited back to the scheme; **(iii)** additional expenses, upto 0.20 per cent of the daily net assets. Any expenditure in excess of the above limits would be borne by the AMC/trustees/sponsors.

Declaration of Dividends A mutual fund may declare dividends in accordance with the offer document are subject to any guidelines specified by the SEBI.

Despatch of Warrants and Proceeds Every mutual fund and AMC should **(a)** despatch to the unit-holders the dividend warrants, within 42 days of the declaration of the dividend and **(b)** despatch the redemption or repurchase proceeds within ten working days from the date of redemption or repurchase. In the event of failure to despatch the redemption/repurchase proceeds within the specified period, the AMC would be liable to pay interest to the unit-holders at such rate as may be specified by the SEBI for the period of such delay. It may also be liable for penalty for such failure.

Annual Report

Every mutual fund or the AMC must prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the mutual fund, as specified in **Appendix 15-A on the website. The website address is http://www.mhhe.com/khanifs10e.**

Auditor's Report The annual statement of accounts of mutual funds should be audited by an auditor who is not in any way associated with the auditor of the AMC. He should be appointed by the trustees and should forward his report to the trustees to form a part of the annual report of the mutual fund. The auditor's report should comprise of a certificate to the effect that:

(i) He has obtained all information and explanations that, to the best of his knowledge and belief, were necessary for the purpose of the audit;

(ii) The balance sheet and the revenue account give a fair and true view of the scheme, state of affairs and surplus or deficit in the mutual fund for the accounting period to which the balance sheet or the revenue account relates and

(iii) The statement of accounts has been prepared in accordance with accounting policies and standards, as specified by the SEBI.

Mailing of Annual Report The scheme wise annual report of a mutual fund or its abridged summary should be mailed to all unit-holders as soon as may be but not later than four months from the date of closure of the relevant accounting year. They may be sent in electronic form. They should contain all details as specified in **Appendix 15-A (on the website)** and as are necessary for the purpose of providing a true and fair view of the operations of the mutual fund. However, the abridged schemewise annual report mailed to the unit-holders should be in the format prescribed by the SEBI in this regard. If the full accounts are published in newspapers, the full portfolio disclosure is not required. The report mailed in abridged summary form should carry a note that for the unit-holders of a scheme, the full annual report would be available for inspection at the head office of the mutual fund and a copy would be made available to the unit-holders on payment of such nominal fees as may be specified by the mutual fund. The AMC should display the link of the full scheme-wise annual reports prominently on their website.

Every mutual fund should, within four months from the date of closure of each financial year, forward to the SEBI a copy of the annual report and other information, including the details of investments and deposits held so that the entire schemewise portfolio of the mutual funds is disclosed to it.

Half-yearly Disclosures A mutual fund/AMC should within one month from the close of each half-year (March 31/September 30) host a soft copy of the unaudited financial results on the website and advertise it in at least one English daily newspaper having nation-wide circulation and one newspaper with wide circulation in the regional language where the head office is situated.

Inspection and Audit

The SEBI may appoint an inspecting officer to undertake the inspection of the books of accounts, records, documents and infrastructure, systems and procedures or to investigate the affairs of a mutual fund, the trustees and AMC for any of the following purposes:

(a) to ensure that the books of accounts are being maintained in the manner specified in these regulations;
(b) to ascertain whether the provisions of the SEBI Act and these regulations are being complied with;
(c) to ascertain whether the systems, procedures and safeguards followed are adequate;
(d) to ascertain whether the provisions of the SEBI Act or any rules or regulations have been violated;
(e) to investigate into the complaints received from the investors or any other person on any matter having a bearing on their activities and
(f) to suo moto ensure that their affairs are being conducted in a manner that is in the interest of the investors or the securities market.

The SEBI also has powers to appoint an auditor to conduct inspection/investigation with the powers of the investigating officer and is entitled to recover the expenses/fee paid to the auditors from the party concerned.

Procedure for Action in Case of Default

Liability for Action in Case of Default A mutual fund which:

- contravenes any of the provisions of the SEBI Act and these regulations
- fails to furnish any information or furnish the wrong information relating to its activities
- fails to submit periodical returns
- does not cooperate in any inquiry/inspection
- fails to comply with directions
- fails to resolve investors complaints/to give satisfactory reply in this regard,
- indulges in insider practices in securities, in terms of the SEBI (Fraudulent and Unfair Trade Practices in Securities Market) Regulations, 1995,
- is guilty of misconduct/improper/unbusiness like/unprofessional conduct, inconsistent with EBI code
- fails to pay any fees
- violates the conditions of registration
- does not carry out its obligations
- fails to maintain net worth of the AMC

would be dealt with according to the **SEBI Intermediaries Regulations**.

Action Against Intermediaries The SEBI can also initiate action for the suspension/cancellation of registration of an intermediary holding a certificate of registration for failure to exercise due diligence or to comply with the obligations under these regulations.

Action Against Mutual Fund/AMC In addition to the liability for action in default, a mutual fund/AMC would be liable for action under the applicable provisions of the SEBI Act/

regulations in case the **(i)** issued advertisement is in contravention with the specified code and **(ii)** valuation of securities contravenes the principles of fair valuation.

SEBI REAL ESTATE INVESTMENT TRUSTS (REITS) REGULATIONS 2014

The main elements of the SEBI REITs regulations, namely, their registration, rights/responsibilities of the parties to the REIT, valuer and auditor, issue and listing of units, investment conditions/related party transactions/borrowing and valuation of assets, rights of unitholders/general obligations/disclosures and reporting, inspection and action in case of default, are discussed in this Section.

Registration of Real Estate Investment Trusts

To act as a REIT, a person should be registered with the SEBI. The application for the grant of certificate of registration as REIT should be made by the **sponsor** [i.e. the person(s) who set(s) up the REIT] in the specified form and accompanied by a non-refundable fee of ₹1,00,000. In order to protect the interests of the investors, the SEBI may appoint any person to take charge of records and documents of the applicant. For the purpose of the grant of certificate, the SEBI would consider all matters relevant to its activities as a REIT, including the following:

(a) The applicant is a trust and the instrument of trust is in the form of a deed duly registered in India,

(b) The trust deed has its main objective as undertaking activity of REIT and includes responsibilities of the trustee,

(c) Persons designated as sponsor(s)/manager/trustee are all separate entities,

(d) With regard to sponsor(s) **(i)** there are not more than 3 sponsors each holding/proposing to hold at least 5 per cent of the units of the REIT on post-initial offer basis; **(ii)** on a collective basis, they have a net worth of at least ₹100 crore; and **(iii)** he/associate(s) has not less than 5 years experience in development of real estate/fund management in the real estate industry. Where the sponsor is a developer, at least two of his projects have been completed. **Real estate**/property means a leasehold/free-hold land and permanently attached improvements to it including buildings/sheds/garages/fences/fittings/ fixtures/ warehouses/car parks/any other asset incidental to the ownership of real estate excluding mortgages and infrastructure.

(e) The manager: **(i)** has a net worth/net tangible assets of at least ₹10 crore if a body corporate/ company/limited liability partnership (LLP); **(ii)** he/associate/two key personnel has not less than 5 years experience in fund management/advisory service/property management in the real estate industry or in development of real estate; **(iii)** has not less than half of its directors in the case of a company or of members of the governing board (i.e. a group of members assigned to act in a manner similar to the Board of Directors of a company) in case of an LLP, as independent and not directors or members of the governing board of another REIT; and **(iv)** has entered into an investment management agreement with the trustee which provides for responsibilities of the manager.

(f) The trustee is registered with the SEBI and is not an associate of the sponsor(s)/manager and has the wherewithal with respect to infrastructure, personnel, etc. to the satisfaction of the SEBI and in accordance with the specified circulars/guidelines.

(g) No unitholder of the REIT enjoys preferential voting or any other rights over another unitholder;
(h) There are no multiple classes of units of REIT;
(i) The applicant has clearly described the details pertaining to proposed activities of the REIT;
(j) The applicant and parties to REIT are fit and proper persons based on the criteria specified by the **SEBI Intermediaries Regulation**;
(k) Whether any previous applicant for grant of certificate by the applicant/any **related party** (i.e. parties to the REIT/any unitholder directly/indirectly holding more than 20 per cent of the units/their associates, sponsors, directors, partners) has been rejected by the SEBI;
(l) Whether any disciplinary action has been taken by the SEBI/any other regulatory authority against the applicant/any related party under any Act/the regulations/circulars/guidelines.

An **associate** of any person includes: any person **(i)** directly/indirectly controlled by him/who directly/indirectly controls him, **(ii)** promoter of a company/body corporate, **(iii)** any relative, **(iv)** group companies, **(v)** related parties to the REIT, **(vi)** company/LLP under same management, **(vii)** holder of more than 15 per cent of the share capital/partnership interest.

On being satisfied that the applicant fulfils the specified requirements, SEBI would send intimation to the applicant and on receipt of the payment of registration fees of ₹10,00,000 and grant certificate of registration in the specified form subject to conditions including the following: **(a)** The REIT would **(i)** abide by the provisions of the SEBI Act/regulations, **(ii)** forthwith inform the SEBI in writing, if any information/particulars previously submitted are found to be false/misleading in any material particular/if there is any material change in the information already submitted; **(b)** The REIT and parties to the REIT would **(i)** satisfy the specified eligibility conditions at all times, **(ii)** comply with the code of conduct as specified below. **The parties to the REIT**, include sponsors, **redesignated sponsors** (i.e. any person who has assumed the responsibility from another sponsor), manager and the trustees.

Code of Conduct

- The REIT and parties to the REIT should: **(i)** conduct all affairs in the interest of all the unitholders, **(ii)** make adequate, accurate, explicit and timely disclosure of relevant material information to all unitholders, designated stock exchanges and the SEBI, **(iii)** try to avoid conflicts of interest, as far as possible, in managing the affairs of the REIT and keep the interest of all unitholders paramount in all matters; in case such events cannot be avoided, it should be ensured that appropriate disclosures are made to the unitholders and they are fairly treated, **(iv)** ensure that the fees charged by them should be fair and reasonable, **(v)** not use any unethical means to sell, market or induce any person to buy units and where a third party appointed by the manager fails to comply with this condition, the manager should be liable for the same, **(vi)** maintain high standards of integrity and fairness in their dealings and in the conduct of their business, **(vii)** render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment, **(viii)** not make any oral/written exaggerated statement about their qualifications/capabilities/experience/achievements, **(ix)** be liable to the unitholders for their acts of commission/omission, notwithstanding anything contained in any contract or agreement.
- Manager should carry out the business of the REIT and invest in accordance with the investment objectives stated in the offer document and take investment decision solely in the interest of the unitholders.

Rights and Responsibilities of Parties to the REIT, Valuer and Auditors

The rights/responsibilities of **(i)** trustees, **(ii)** manager, **(iii)** sponsor, **(iv)** valuer and **(v)** auditor are discussed below.

Rights and Responsibilities of Trustee

- The trustees should **(i)** hold the **REIT assets** (i.e. real estate/other assets owned directly or through SPV) in trust for the benefit of the unitholders in accordance with the trust deed and the SEBI regulations, **(ii)** enter into an investment management agreement with the **manager** (i.e. a company/LLP/body corporate to manage assets/investments of REITs and undertake its operational activities) on behalf of the REIT, **(iii)** oversee his activities in the interest of the unitholders, ensure that the manager complies with his rights and responsibilities (**discussed later**) and obtain compliance certificate from him in the specified form on a quarterly basis, **(iv)** ensure that he complies with the reporting and disclosures requirements and in case of any delay or discrepancy, require the him to rectify the same on an urgent basis, **(v)** review the transactions carried out between him and its associates and where he has advised that there may be a conflict of interest, obtain confirmation from a practicing chartered accountant that the transaction is on arm's length basis, **(vi)** periodically review the status of unitholders' complaints and their redressal undertaken by him, **(vii)** make distribution of 90 per cent of the net distributable cash flow of **(i)** the SPV to the REIT, **(ii)** the REIT to the unitholders and ensure that he makes timely declaration of distributions to the unitholders.
- The trustee may require the manager to set up such necessary systems and submit necessary reports to the trustees for effective monitoring of the performance and functioning of the REIT.
- The trustee should ensure that **(i)** subscription amount is kept in a separate bank account in the name of the REIT and is only utilised for adjustment against allotment of units or refund of money to the applicants till the units are listed, **(ii)** the remuneration of the valuer is not linked to or based on the value of the asset being valued, **(iii)** the manager convenes meetings of the unitholders in accordance with the SEBI regulations and oversee the voting by them and declare outcome of the voting.
- The trustee may take up with the SEBI/designated stock exchange any matter which has been approved in an annual/special meeting.
- In case of any change in manager due to removal/otherwise: **(a)** the trustee should **(i)** obtain prior approval from unitholders/the SEBI; **(ii)** appoint the new manager within 3 months from the date of termination of the investment management agreement; **(b)** the previous manager should continue to act at the discretion of trustee till the as new manager is appointed; **(c)** the trustee should ensure that **(1)** the new manager should stand substituted as a party in all the documents to which the earlier manager was a party; **(2)** the earlier manager continues to be liable for all its acts of omission and commissions.
- The trustee should **(a) (i)** obtain prior approval from the unitholders/the SEBI in case of change in control of the manager; **(ii)** not invest in units of the REIT in which it is designated as the trustee; **(b) (i)** ensure that the activity of the REIT is being operated in accordance with the provisions of the trust deed/SEBI regulations/offer document and should inform the SEBI/about any discrepancy immediately in writing, **(ii)** provide to the SEBI/the designated stock exchange information sought by them pertaining to the activity of the REIT, **(iii)** immediately inform the SEBI in case any act detrimental to the interest of the unit holders is noticed.

Rights and Responsibilities of Manager The manager should make the investment decisions with respect to the underlying assets of the REIT including any further investment/disinvestment. He should ensure that **(i)** the real estate assets of the REIT/SPV have proper legal and marketable titles and that all the material contracts including rental/lease agreements entered into on their behalf are legal, valid, binding and enforceable by and on their behalf, **(ii)** the investment made by the REIT are in accordance with the investment specified conditions (**discussed later in another** Section)/its investment strategy, **(iii)** undertake management of the REIT assets including lease management, their maintenance, regular structural/safety audits, directly/through appropriate agents.

The manager, in consultation with the trustee, should appoint the valuer(s), auditor, registrar and transfer agent, merchant banker, custodian and any other intermediary/service provider/agent for managing the assets of the REIT or for offer and listing of its units/any other activity pertaining to the REIT in a timely manner and in accordance with the SEBI regulations. He should appoint an auditor for not more than five consecutive years. A non-individual auditor may be reappointed for another 5 consecutive years, subject to the approval of unitholders. He should arrange for adequate insurance coverage for the real estate assets of the REIT and ensure that real estate assets of the SPV are adequately insured.

If the REIT invests in **under-construction properties** (i.e. a property of which construction is not complete and occupancy certificate not received), the manager **(a)** may undertake their development directly/through the SPV, or appoint any other person for their development; and **(b)** should oversee the progress of their development/approval status/other aspects upto completion.

He should also ensure that it has adequate infrastructure and sufficient key personnel with adequate experience and qualification to undertake management of the REIT at all times. He would be responsible for: **(a)** filing the draft and final offer document with the SEBI/designated stock exchange within the specified time period; **(b)** obtaining in-principle approval from the designated stock exchange; **(c)** dealing with all matters relating to issue and listing of the units of the REIT.

The manager should ensure that the disclosure in the offer/any other SEBI-specified document contain material, true, correct and adequate disclosures and are in accordance with the SEBI regulations/guidelines/circulars. He should **(i)** declare distribution to the unitholders, **(ii)** ensure adequate and timely redressal of all unitholders' grievances pertaining to activities of the REIT, **(iii)** ensure that the disclosures to the unitholders/SEBI/trustees/designated stock exchange are adequate, timely and in accordance with the SEBI regulations/guidelines/circulars, **(iv)** provide to the SEBI/designated stock exchanges any such information sought by them pertaining to the activities of the REIT, **(v)** ensure that adequate controls are in place to ensure segregation of its activity as manager of the REIT from its other activities.

The manger/its associates should not obtain any commission/rebate/any other remuneration, arising out of transactions pertaining to the REIT other than as specified in the offer/any other SEBI-specified document for the purpose of issue of units. He should submit to the trustee **(a)** quarterly reports on the activities of the REIT including receipts for all funds received/payments made, position on compliance with the SEBI regulations, specifically including compliance with regulations relating to **(i)** investment conditions, **(ii)** related party transactions and **(iii)** borrowings, performance report, status of development of under-construction properties, within 30 days of end of the quarter; **(b)** valuation report (**discussed later**) within 15 days of its receipt from the valuer; **(c)** decision to acquire/sell/develop any property or expand existing completed properties along with rationale for the same; **(d)** details of action(s) which requires approval from the unitholders; **(e)** details of any other material fact including change of its directors, any legal proceedings that may have a significant bearing on the activity of the REIT within 7 working days of the action.

In case the manager fails to timely submit the above information/reports, the trustee should intimate the same to the SEBI which may take action, as it deems fit. He should co-ordinate with trustee, with respect to operations of the REIT and ensure that the valuation of the REIT assets is done by the valuer(s) in accordance with the SEBI-specified norms (**discussed later**).

He should ensure that **(i)** computation of NAV of the REIT is based on the valuation done by the valuer every six months and is declared with 15 days from the date of valuation, **(ii)** the audit of accounts of the REIT by the auditor is done at least twice annually and the report is submitted to the designated stock exchange within 45 days of the end of each financial year ending March 31st and half-year ending September 30th.

The manager may **(a)** appoint a custodian in order to provide the custodial services authorised by the trustees and oversee their activities and also place, before its Board of Directors/Governing Board, a report on the activity and performance of the REIT every 3 months, **(b)** should **(i)** designate an employee/director as the compliance officer for monitoring of compliance with the SEBI regulations/circulars and intimating the SEBI in case of any violation, **(ii)** convene meetings of the unitholders and maintain records, **(iii)** ensure the compliance with applicable laws of the State/local body with respect to the activity of the REIT including local building laws, **(iv)** ensure that all activities of management of assets of the REIT/the intermediaries/gents/service providers appointed by him are in accordance with the SEBI regulations/circulars.

Rights and Responsibilities of Sponsor(s) The sponsor(s) should set up the REIT and appoint its trustees. They should transfer or undertake to transfer, subject to a binding agreement and adequate disclosures in the initial offer document, its entire shareholding/interest in the SPV or entire ownership of the real estate assets to the REIT prior to allotment of units of the REIT to the applicants. However, this would not apply to the extent of any mandatory holding of shares/interest in the SPV by the sponsor(s) as required any SEBI Act/regulations/circulars/guidelines or Government/regulatory authority as specified from time to time.

They should **(a)** hold a minimum of 25 per cent of the total units of the REIT after initial offer on a post-issue basis for atleast 3 years from the date of their listing; **(b)** together/individually hold atleast 15 per cent and 5 per cent of the outstanding units of the listed REIT at all times.

They can sell units below the above specified limit **(a)** only after a period of three years from the date of their listing, **(b)** prior to their sale, they should arrange for another person(s)/entity(ies) to act as the re-designated sponsor(s) who would satisfy the specified eligibility norms for the sponsor; the units may also be sold to an existing sponsor also, **(c)** the sponsor/proposed redesignated sponsor should obtain approval from the unitholders or provide to them option to exit in accordance with specified guidelines. This requirement would not apply where the units are proposed to be sold to an existing sponsor. The re-designated sponsor(s) can also sell units to any another person, who satisfies the eligibility conditions of sponsor.

Rights and Responsibilities of the Valuer The registered valuer appointed to undertake valuation of the REIT assets should comply with the following conditions:

- Ensure **(i)** that the valuation is impartial, true and fair and is in accordance with the SEBI-prescribed norms (**discussed later**), **(ii)** adequate and robust internal controls to ensure the integrity of its valuation reports, **(iii)** that it has sufficient key personnel with adequate experience and qualification to perform property valuations at all times and has sufficient financial resources to conduct its business effectively and meet its liabilities.

- The valuer(s)/employees involved in valuing of the assets of the REIT should not **(i)** invest in units of the REIT or in the assets being valued; and **(ii)** sell them prior to being appointed as the valuer, till he is designated as valuer and at least 6 months after ceasing to be its valuer.
- The valuer should **(i)** conduct the valuation with transparency and fairness and render, at all times, high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment, **(ii)** act with independence, objectivity and impartiality in performing the valuation, **(iii)** discharge its duties in an efficient and competent manner, utilising his knowledge, skills and experience in best possible way to complete the given assignment, **(iv)** not accept remuneration, in any form, from any person other than the REIT/ its authorised representatives, **(v)** before accepting any assignment, disclose to the REIT any direct/indirect consideration which the valuer may have in respect of such assignment, **(vi)** disclose to the trustee, any pending business transactions, contracts under negotiation and other arrangements with the manager or any other party whom the REIT is contracting with and any other factors that may interfere with his ability to give an independent and professional valuation of the property, **(vii)** not make false, misleading/exaggerated claims in order to secure assignments, **(viii)** not provide misleading valuation, either by providing incorrect information or by withholding relevant information, **(ix)** not accept an assignment that includes reporting of the outcome based on predetermined opinions and conclusions required by the REIT, **(x)** prior to performing a valuation, acquaint itself with all laws or regulations relevant to the valuation.

Rights and Responsibilities of the Auditor The auditor should **(i)** conduct audit of the accounts of the REIT and prepare the audit report based on the accounts examined by him and after taking into account the SEBI-specified relevant accounting and auditing standards, **(ii)** to the best of information and knowledge, ensure that the account and financial statements, including profit or loss and cash flow for the period and other specified matters, give a true and fair view of the state of the affairs, **(iii)** have a right to require such information and explanation pertaining to activities of the REIT as he may consider necessary for the performance of his duties as auditor from the employees of REIT or parties to the REIT or SPV or any other person in possession of such information.

Issue and Listing of Units

The main elements of the SEBI regulations, namely, issue/allotment of units, offer document and advertisements, listing/trading of units and delisting of units, are discussed below.

Issue and Allotment of Units A REIT should make an initial offer of its units by way of public issue only. **Public issue** means an initial or follow-on offer or any other SEBI-specified issue made to the public. Public means any person other than related party of the REIT (other than a QIB) or any other SEBI-specified person. The offer should be made if: **(a)** it is registered with the SEBI, **(b)** the **value** (i.e. the value of the specific portion of the holding of REIT in the underlying assets of the SPV) of all the assets owned by it is not less than ₹500 crore, **(c)** the units proposed to be offered is at least 25 per cent of the total of its outstanding units and the units being offered by way of the offer document, **(d)** the offer size is at least ₹250 crore.

Any subsequent issue of units by the REIT may be by way of **follow-on offer** (i.e. offer of units to the public for subscription by the public and includes an offer for sale by an existing unitholders), **preferential allotment** (i.e. allotment to any select person/groups on a private placement basis), qualified institutional placement, rights issue, bonus issue, offer for sale or any other SEBI-specified mechanism and manner.

The REIT, through the manager, should file a draft offer document with the designated stock exchange(s) and the SEBI, at least 21 working days before filing the final offer document with the designated stock exchange. It should be made public, for comments, to be submitted to the SEBI within at least 10 days, by hosting it on the website of the SEBI/designated stock exchanges/merchant bankers associated with the issue. The draft and final offer document should be accompanied by a due diligence certificate signed by the manager and lead merchant banker. The SEBI may communicate its comments to the lead merchant banker and, in the interest of investors, may require him to carry out modifications in the draft offer document as it deems fit. The lead merchant banker should ensure that all comments received from the SEBI are suitably taken into account prior to the filing it with the designated stock exchanges. In case no modifications are suggested with 21 working days from the date of the receipt of satisfactory reply from the lead merchant banker/manager, the REIT may issue the final/follow-up offer document to the public. The final offer document should be filed with the designated stock exchanges/SEBI at least 5 working days before opening of the offer and accompanied by the specified filing non-refundable fee of **(a)** 0.10 per cent in case of initial/follow-on offer and **(b)** 0.05 per cent in case of rights issue of the total size including intended oversubscription. The REIT may invite for subscription and allot unit to any resident/foreign person. In case of foreign investors, the investment would be subject to the RBI/Government guidelines.

The application for subscription should be accompanied by a statement containing the abridged version of the offer document, detailing the risk factors and summary of the terms of issue. Under both the initial and follow-on public offers, the REIT should not accept subscription of less than ₹2,00,000 from an applicant. Any offer would not be open for subscription for more than 30 days. In case of over-subscription, the REIT should allot units to the applicants on a proportionate basis. It should allot units/refund application money, within 12 working from the days from the date of closing of the issue and issue units only in dematerialised form.

The price of units issued by way of public issue should be determined through the book building/any other process in accordance with the circulars/guidelines issued by, and in the manner specified by, the SEBI. The REIT should refund money to **(a)** all applicants in case it fails to collect subscription amount of exceeding 75 per cent of the issue size, **(b)** applicants to the extent of over-subscription in case the moneys received is in excess of the extent of over-subscription. The right to retain over-subscription cannot exceed 25 per cent of the issue size; **(c)** all applicants in case the number of subscribers forming part of the public is less than 200.

If the manager fails to allot/list the units/refund the money within the specified time, he should pay interest to the unitholders at 15 per cent per annum, till such allotment/listing/refund which it would not be recovered in the form of fees or any other form payable to the manager by the REIT.

Units may be offered for sale to public: **(a)** if they have been held by the existing unitholders for at least one year prior to the filing of the draft offer document with the SEBI. The holding period for the equity shares/partnership interest in SPV against which units have been received would be considered for the purpose of calculation of the one-year period, **(b)** subject to other SEBI-specified circulars/guidelines in this regard.

If the REIT fails to make its initial offer within 3 years from the date of registration, it should surrender its certificate of registration to the SEBI and cease to operate as a REIT. The SEBI may extend the period by another one year. The REIT may later re-apply for registration.

Offer Document and Advertisement

The offer document of the REIT should contain material, true, correct and adequate disclosures to enable the investors to make an informed decision. It should **(a)** include all the specified information; **(b)** not be misleading and contain any untrue/mis-statements and provide for any guaranteed returns to the investors; **(c)** include other SEBI-specified disclosures.

Any advertisement material relating to any issue of units of the REIT should not be misleading and not contain any thing extraneous to the contents of the offer document. If it contains positive highlights, it should also contain risk factors with equal importance in all aspects including print size. It should also be in accordance with the offer document and any SEBI-specified circulars/guidelines.

Listing and Trading of Units

All units of REITs should be mandatorily listed on a stock exchange having nationwide trailing terminals within 12 working days from the date of closure of the offer. The listing should be in accordance with the listing agreement entered into between the REIT and the stock exchange. The listed units should be traded, cleared and settled in accordance with the bye-laws of the concerned stock exchanges and SEBI-specified conditions. The trading lot for trading of units would be ₹1,00,000. The REIT should redeem units only by way of a buy-back or at the time of delisting of units. They should remain listed unless delisted.

The minimum public holding for the units of the listed REIT should be 25 per cent the total number of outstanding units and the number of unit holders forming part of the public 200, failing which SEBI/stock exchange-specified action may be taken including delisting of units. However, in case of breach of the conditions, the trustees may provide six months to the manager to rectify the same, failing which he should apply for delisting. Any person other than the sponsor(s) holding units of the REIT prior to initial offer should hold them for at least one year from the date of their listing subject to SEBI-specified circulars/guidelines.

Delisting of Units The manager should apply for delisting of units of the REIT to the SEBI/designated stock exchanges if **(a)** the public holding falls below the specified limit (25 per cent); **(b)** the number of unit holders forming part of the public falls below 200; **(c)** if there are no projects/assets for more than six months and the REIT does not propose to invest in any project in future. The period may be extended by further six months, with the approval of unitholders in specified manner; **(d)** the SEBI-designated stock exchanges require delisting for violation of the listing agreement/regulation/the SEBI Act; **(e)** the sponsor(s)/trustee requests delisting after approval by unitholders; **(f)** unitholders apply for delisting; and **(g)** the SEBI/designated stock exchanges require delisting for violation of the listing agreement/these regulations/the SEBI Act or in the interest of the unit holders.

The procedure for delisting of units of REIT including provision of exist option to the unitholders should be in accordance with the listing agreement and SEBI/stock exchange-specified procedure. The SEBI may require it to wind up and sell its assets in order to redeem units of the unitholders for delisting of units. After delisting of it units, the REIT should surrender its certificate of registration to the SEBI and no longer undertake activity of a REIT. However, the REIT and parties to the REIT would continue to be liable for all their acts of omissions and commissions with respect to their activities.

Investment Conditions, Related Party Transactions, Borrowing and Valuation of Assets

The SEBI stipulations pertaining to **(i)** investment conditions and distribution policy, **(ii)** related party transactions, **(iii)** borrowings and deferred payment and **(iv)** value of assets are discussed below.

Investment Conditions and Distribution Policy

- A REIT can invest only in SPV/properties/securities/TDR (transferable development rights) in India in accordance with the investment strategy as detailed in the offer document. A **SPV** (special purpose vehicle) means any company/limited liability partnership (LLP) **(i)** in which the REIT holds **controlling interest** (i.e. direct/indirect interest to the extent of more than 50 per cent of voting rights/interest) and at least 51 per cent of the equity share capital/interest, **(ii)** which holds at least 80 per cent of its assets directly in properties and does not invest in other SPVs and **(iii)** which is not engaged in any activity other than holding/developing property and other activity incidental thereto. The **TDR** means development rights issued by the competent authority under relevant laws in lieu of the area relinquished/surrendered by the owner/developer or by way of declared incentives by the Government/Authority. It cannot invest in vacant/agricultural land (except land which is contiguous/extension of an existing project being implemented in stages)/mortgages other than mortgage backed securities. Its investment in properties through SPV would be subject to the following: **(a)** no other shareholder/partner of the SPV should have any rights that prevents the REIT from complying with the provisions of the SEBI regulations; **(b)** the manager **(i)** in consultation with the trustees, should appoint at least one authorised representative on the Board of Directors/Governing Board of the SPVs, **(ii)** ensure that in every meeting including annual general meeting of the SPV, the voting of the REIT is exercised subject to the provisions of Companies Act. At least 80 per cent of the value of the REIT assets should be invested proportionate to its holding in **completed** (i.e. for which occupancy certificate has been received from the competent authority) and **rent generating properties** (i.e. which has been leased/rented out) subject to the following: **(a)** if the investment has been made through SPV, only the portion of the direct investments in their properties would be considered, **(b)** if any project is implemented in stages, the part of the project which is completed and rent-generating should be considered.
- Not more than 20 per cent of the value of their assets should be invested proportionate to its holding in assets other than as provided **above** and they should only be in: **(a)** properties, in which not more than ten per cent of the value of the REIT assets should be invested, which are: **(i) under-construction properties** (i.e. construction is not complete and occupancy certificate not received) to be held by the REIT for three years after completion; **(ii)** under-construction properties which are part of the existing income generating properties owned by the REIT to be held for at least three years after completion; **(iii)** completed and not rent-generating properties to be held for at least three years from date of purchase; **(b)** listed/unlisted/debt of companies/body corporate (excluding SPVs) in real estate sector; **(c)** mortgage backed securities; **(d)** equity shares of listed companies in India which derive at least 75 per cent of their operating income from real estate activity as per the audited accounts of the previous financial year; **(e)** Government securities; **(f)** unutilised **FSI** (floor space index, that is, the buildable area on a plot of land specified by a competent authority) of a project where it has already made investment; **(g)** TDR acquired for utilisation with respect to a project where it has already made investment; and **(h)** money market instruments/cash equivalents.

- Not less than 75 per cent of the revenues of the REIT and the SPV, other than gains arising from disposal of properties, should be, from rental, leasing and letting real estate assets or any other income incidental to their leasing. At least 75 per cent of the value of the REIT assets proportionately on a consolidated basis should be rent-generating (i.e. properties leased/rented). A REIT should, directly or through SPV, hold **(i)** at least two projects, with not more than 60 per cent of the value of the assets, proportionately on a consolidated basis in one project, **(ii)** any completed and rent generating property at least three years from the date of their purchase. For any sale of property/shares/interest in the SPV by the REIT exceeding 10 per cent of the value of the REIT assets in a financial year, approval from the unitholders would be necessary. A REIT should not **(i)** invest in units of other REITs, **(ii)** undertake lending to any person. The manager should consider the remaining term of the lease, the objectives of the REIT, the lease profile of its existing real estate and other relevant factors, prior to making such investment in leasehold properties.

In case of any co-investment with any person(s) in any transaction: **(a)** the investment by them should not **(i)** be at terms more favourable than those to the REIT, **(ii)** provide any rights to them which would prevent the REIT from complying with the provisions of the SEBI regulations; **(b)** the agreement with them should include the minimum percentage of distributable cash flows and entitlement of the REIT to receive not less than *pro rata* distributions and mode for resolution of any disputes between them.

With respect to distributions made by the REIT and the SPV: **(a)** at least 90 per cent of net distributable cash flows of the SPV/REIT should be distributed/declared to the REIT/unitholders at least once every 6 months in every financial year and made within 15 days from the date of such declaration; **(b)** if the REIT or SPV: **(i)** if the REIT/SPV proposes to reinvest sale proceeds of a property into another property, it would not be required to distribute the sale proceeds from such sale to the unit holders/REIT. At least 90 per cent of the sales proceeds should be distributed if they are not reinvested, **(c)** if the distributions are not made within 15 days of declaration, the manager would be liable to pay interest to the unitholders at 15 per cent per annum till the distribution is made which would not be recovered in the form of fees/any other form payable to him by the REIT. No scheme would be launched under the REIT.

Related Party Transactions All **related party** (i.e. **(i)** parties to the REIT, **(ii)** any direct/indirect unitholder of more than 20 per cent units of the REIT, **(iii)** associates, sponsors, directors/partners of parties/unitholdes) transactions should be on an arms-length basis, in the best interest of the unitholders, consistent with the strategy and investment objectives of the REIT and disclosed to the stock exchange and unitholders periodically. Subject to the specified conditions, a REIT, may **(a)** acquire assets from, **(b)** sell assets/securities to, **(c)** lease assets to/from, **(d)** invest in securities issued by, and **(e)** borrow from related parties.

With respect to purchase/sale of properties both, prior to, and after initial offer, two valuation reports from two different independent valuers who should undertake a full valuation of the assets, should be obtained and transactions should be at a price not greater than the average of the two independent valuations.

Adequate disclosures about any related party transactions entered into prior to making the initial offer should be made in the initial offer document including a consolidated full valuation report of all the assets. The REIT should enter into proper/valid agreements with the related parties at the price/interest rate/rental value mentioned in the initial offer document. If the transactions are conditional upon the REIT receiving a minimum amount of subscription, adequate disclosures should be made in the offer document and the agreement.

In case of any related party transactions entered into after the initial offer, adequate disclosures should be made to the unitholders/designated stock exchanges. In case the total value of all the related party transactions/funds borrowed from them, in a financial year, pertaining to acquisition/sale of properties/investments into securities exceeds 10 per cent of the total the value/consolidated borrowings of the REIT, approval from the unitholders should be obtained prior to entering into any subsequent transaction with any related party.

The disclosures in the offer/transaction document should include the following: **(a)** identity of the related parties and their relationship with the REIT/parties to the REIT; **(b)** nature and details of the transactions entered/proposed to be entered into with them including description and location of assets; **(c)** the price/value of the assets/securities bought/sold/leased or proposed to be bought/sold/leased and if leased/proposed to be leased, value of the lease; **(d)** ready reckoner rate of the real estate assets being bought/sold. Where such ready reckoner rate are not available, property tax assessment value or similar published rates by Government authorities should be disclosed; **(e)** summary of the valuation report(s); **(f)** the current and expected rental yield; **(g)** the minimum amount of subscription to be received; **(h)** amount of borrowing and rate of interest in case of borrowing from any related party; **(i)** any other information that is required for the investor to take an informed decision.

If **(a)** lease area of properties leased to the related parties both before and after initial offer, **(b)** value of assets, **(c)** rental income obtained exceeds 20 per cent of the total area/value of assets/value of rental income of all underlying assets exceeds 20 per cent, fairness opinion from an independent valuer should be obtained by the manager and submitted to the trustee and approval of unitholders.

Adequate disclosures of all related party transactions that have been entered into prior to the follow-on offer should be made in the follow-on offer document. Transactions between two/ more REITs with a common manager/sponsor would be deemed to be related party transactions for each of them.

Details of any fees/commissions received/to be received by any person/entity which is an associate of the related party should be adequately disclosed to the unitholders/designated stock exchanges. Nor related party should retain cash/other rebates from any property agent in consideration for referring transactions in the REIT assets to him. Where any related party has an interest in a business which competes/likely to directly or indirectly compete with the activities of the REIT, the following details should be disclosed in the offer document: **(a)** details of the business including an explanation as to how it should compete with the REIT; **(b)** a declaration that **(i)** the related party would perform its duty in relation to the REIT independent of its related business; **(ii)** as to whether any acquisition of such business is intended with details.

Borrowing and Deferred Payments The aggregate consolidated borrowings and deferred payments (excluding refundable security deposits to tenants) of the REIT net of cash and cash equivalents should never exceed 49 per cent of the value of their assts. If it exceed 25 per cent, **(a)** credit rating should be obtained from a SEBI- registered credit rating agency; and **(b)** approval of unitholders should be obtained in the specified manner for further borrowing. If these conditions are breached on account of market movements of the price of the underlying assets/securities, the manager should inform the trustee and ensure that they are satisfied within 6 months of the breach.

Valuation of Assets The valuer should not be an associate of the sponsor(s)/manager/trustee and have at least 5 years of experience in valuation of real estate. The full valuation conducted by the valuer at least once at the end of the financial year ending March 31st within three months from the end of the year should include a detailed valuation of all assets including physical inspection of every property by him. The valuation report should include the mandatory minimum specified disclosures.

A half-yearly valuation of the REIT assets should be conducted by the valuer for the half-yearly ending on September 30 for incorporating any key changes in the previous 6 months and the valuation report should be prepared within 45 days from the date of end the half year. The valuation report received by the manager should be submitted to the designated stock exchange and unitholders within 15 days from their receipt. Prior to any issue of units to the public and any other SEBI-specified issue of units, the valuer should undertake full valuation of all the REIT assets and include a summary of the report in the offer document. For any transaction of purchase/sale of properties related party transaction, the valuation should be in accordance with the applicable norms (**discussed earlier**). If it is not a related party transaction **(i)** a full valuation of the specific property should be undertaken by the valuer, **(ii)** if **(1)** the property is proposed to be purchased/sold at a value greater than 110 per cent/less than 90 per cent of the value of the property as assessed by the valuer respectively, approval of the unitholders should be obtained. No valuer should undertake valuation of the same property for more than four years consecutively. He may be reappointed after at least two years from the date it ceases to be the valuer of the REIT.

Any valuation undertaken by any valuer should abide by international valuation standards and valuation standards be specified by Institute of Chartered Accountants of India (ICAI) for valuation of real estate assets. In case of any conflict, the standards specified by ICAI would prevail.

In case of any material development that may have an impact on the valuation of the REIT assets, the manager should require the valuer to undertake full valuation of the property within not more than two months from the date of the event and disclose the same to the trustee/ investors/ designated stock exchanges within 15 days. He should not value any assets in which it has either been involved with the acquisition/disposal within the last twelve months other than such cases where valuer was engaged by the REIT for the acquisition/disposal.

Rights of Unitholders, General Obligations, Disclosures and Reporting

The SEBI stipulations relate to **(i)** rights/meetings of unitholders, **(ii)** disclosures, **(iii)** submission of reports to the SEBI, **(iv)** power to call for information, and **(v)** maintenance of records.

Rights and Meetings of Unitholders The unitholders should have the rights to receive income/ distribution as provided for in the offer document/trust deed. With respect to any matter requiring their approval: **(a)** a resolution should be considered as passed when the votes cast by them in favour of the resolution exceed a certain percentage (**specified later**) of the votes cast against, **(b)** the voting may also be done by postal ballot or electronic mode, **(c)** a notice of at least 21 days either in writing or through electronic mode should be provided to them, **(d)** voting by any person who is a related party in such transaction as well as their associates would not be considered on the specific issue, and **(e)** the manager would be responsible for all the activities pertaining to conducting of meeting, subject to overseeing by the trustee. However, in respect of issues pertaining to the manager such as change including removal or change in his control, the trustee should convene and handle all activities pertaining to conduct of the meetings. In respect of issues pertaining to them such as change, the trustee should not be involved in any manner in the conduct of the meeting.

An annual meeting of all unitholders should be held atleast once a year within 120 days from the end of financial year and the time between two meetings should not exceed 15 months. Any information required to be disclosed to the unitholders and any issue that, in the ordinary course of business, may require their approval, may be taken up in the annual general meeting including **(i)** latest annual accounts and performance of the REIT, **(ii)** approval of auditor and his fees, **(iii)** latest valuation reports, **(iv)** appointment of valuer, and **(v)** any other issue. For approval from the unitholders, votes cast in favour should be at least one and a half times the votes cast against the resolution.

In case of any **(a)** approval from unitholders required pertaining to **(i)** investment conditions and distribution policy, **(ii)** related party transactions, **(iii)** valuation of assets; **(b)** any transaction, other than any borrowing, value of which is equal to or greater than 25 per cent of the REIT assets; **(c)** borrowing in excess of the specified limit, **(d)** issue of units after initial offer by the REIT, **(e)** increasing period for compliance with investment conditions to one year, **(f)** issue, in the ordinary course of business, which in the opinion of the sponsor(s) or trustee or manager, is material and requires approval of the unitholders, **(g)** issue for which the SEBI/ designated stock exchange requires approval, the votes cast in favour of the resolution should be a least one and a half times the votes cast against it.

In case of **(a)** any change in manager including his removal or change in his control; **(b)** any material change in investment strategy or any change in the management fees of the REIT; **(c)** the sponsor(s) or manager proposing to seek delisting of units of the REIT; **(d)** the value of the units held by a person along with its associates other than the sponsor(s) and its associates exceeding 50 per cent of the value of outstanding REIT units, prior to acquiring any further units; **(e)** any issue, not in the ordinary course of business, which in the opinion of the sponsor(s) or manager or trustee requires approval of the unitholders; **(f)** any issue for which the SEBI/the designated stock exchanges requires approval; **(g)** any issue taken up on request of the unitholders including: **(i)** removal of the manager/auditor/valuer and appointment of another manager/auditor/valuer to the REIT, **(ii)** delisting of the REIT if the unitholders have sufficient reason to believe that it would act in their interest; **(iii)** any issue which the unitholders have sufficient reason to believe that acts detrimental to their interest; **(iv)** change in the trustee if the unitholders have sufficient reason to believe that his acts are detrimental to their interest, approval from unitholders should be required where the votes cast in favour of the resolution would be at least three times the votes cast against the resolution. If in case of **(d)**, approval is not obtained, the person should provide an exit option to the unitholders to the extent and in the manner as may be specified by the SEBI.

With respect to the right(s) of the unitholders pertaining to issues to be taken up in the meeting upon their request, at least 35 per cent of the unitholders by value, other than any party related to the transaction and its associates, should apply, in writing, to the trustee. On receipt of the application, the trustee should require the manager to place the issue for voting in the specified manner. At least 60 per cent of the unitholders by value should apply, in writing, to the manager for the change in trustees.

In case of any change in sponsor/re-designated sponsor or change in control of sponsor/ re-designated sponsor, prior approval should be obtained from the unitholders with votes cast in favour being at least three times the votes cast against the resolution. If the change does not receive the required approval, the dissenting unitholders should be provided an option to exit. If on account of the sale, the number of unitholders forming part of the public falls below 200 or below 25 per cent of the total outstanding units, the trustee should apply for delisting of the units.

Disclosures The manager should ensure that the disclosures in the offer document are in accordance with the SEBI-prescribed requirements. He should submit an annual report to all unitholders with respect to activities of the REIT, within 3 months from the end of the financial year and a half-yearly report within 45 days from the end of the half year ending on September 30th containing the specified disclosures. He should also disclose to the designated stock exchanges any information having bearing on the operation/performance of the REIT as well as price sensitive information which includes but is not restricted to the following: **(a)** acquisition/disposal of any properties, value of which exceeds 5 per cent of value of the REIT assets; **(b)** additional borrowing, at level of SPV or the REIT, exceeding 5 per cent of the value of the REIT assets during the year; **(c)** additional issue of units of the REIT; **(d)** details of any credit rating and any change; **(e)** any issue which requires approval of the unitholders; **(f)** any legal proceedings which may have significant bearing on the functioning of the REIT; **(g)** notices and results of meetings of unitholders; **(h)** any instance of non-compliance with regulations including any breach of limits specified; **(i)** any material issue that in the opinion of the manager or trustee needs to be disclosed to the unitholders. The manager should submit the information to the designated stock exchanges and unitholders on a periodical basis as required under the listing agreement.

Submission of Reports to the SEBI The SEBI may at any time call upon the REIT/parties to the REIT to file reports, with respect to its activities.

Power to Call for Information The SEBI may at any time call for any information from the REIT/parties to the REIT/any unitholder/any other person with respect to any matter pertaining to activity of the REIT which should be furnished within the specified time.

Maintenance of Records The manager should maintain records pertaining to the activity of the REIT including: **(a)** decisions of the manager with respect to investments/divestments and supporting documents; **(b)** details of investments made by the REIT and supporting documents; **(c)** agreements entered into by, on behalf of, the REIT; **(d)** documents relating to appointment of valuers/auditors/registrar/transfer agent/merchant banker/custodian and so on; **(e)** insurance policies for real estate assets; **(f)** investment management agreement; **(g)** documents pertaining to issue and listing of units including initial/follow-on/other offer document(s), in-principle approval by designated stock exchanges, listing agreement with the designated stock exchanges, details of subscriptions, allotment of units, etc.; **(h)** distribution declared and made to the unitholdesr; **(i)** disclosures and periodical reporting made to the trustee, SEBI, unitholders and designated stock exchanges including annual/half-yearly reports, etc.; **(j)** valuation reports including methodology of valuation; **(k)** books of accounts and financial statements; **(l)** audit reports; **(m)** reports relating to activities of the REIT placed before the Board of Directors of the manager; **(n)** unitholders' grievances and actions taken including copies of correspondence with the unitholders and the SEBI; **(o)** any other material document.

The trustee should maintain records pertaining to **(a)** certificate of registration granted by the SEBI; **(b)** registered trust deed; **(c)** documents pertaining to application made to the SEBI for registration as a REIT; **(d)** titles of the real estate assets; **(e)** notices and agenda sent to unitholders for meetings held; **(f)** minutes of meetings and resolutions passed; **(g)** periodical reports and disclosures received by them from the manager; **(h)** disclosures, made to the SEBI/unitholders/designated stock exchanges; **(i)** any other material documents. The records may be maintained in physical or electronic form. Where records are required to be duly signed and are maintained in the electronic form they should be digitally signed.

Inspection

The SEBI may ***suo moto***/upon receipt of information/complaint appoint one or more persons as inspecting officers to undertake inspection of the books of accounts, records and documents relating to activity of the REIT for any of the following reasons: **(a)** to ensure that the books of account, records and documents are being maintained by the REIT or parties to the REIT in the specified manner; **(b)** to inspect into complaints received from unitholders, clients or any other person, on any matter having a bearing on the activities of the REIT; **(c)** to ascertain whether the provisions of the SEBI Act/regulations are being complied with; **(d)** to inspect ***suo moto*** into the affairs of the REIT, in the interest of the securities market or in the interest of the investors.

It would be the duty of every concerned REIT/parties to REIT and any other associate person who is in possession of the relevant information pertaining to conduct and affairs of the REIT, including representative of REIT, to **(i)** produce to the inspecting officer such books, accounts and other documents in his custody or control and furnish him with such statements and information as the inspecting officer may require for the purpose of inspection, **(ii)** give to the inspecting officer all such assistance and to extend all such co-operation as may be required in connection with the inspection and to furnish such information as may be sought in connection with the inspection.

The inspecting officer would have power **(i)** to examine on oath and record the statement of any employee /directors of the REIT/parties to the REIT/any person responsible for or connected with the activities of REIT or any other associated person having relevant information pertaining to the REIT, **(ii)** to obtain authenticated copies of documents, books, accounts of REIT, from any person having control or custody of such documents, books or accounts.

The inspecting officer should, as soon as possible, on completion of the inspection, submit an inspection report to the SEI. He may submit an interim report, if directed by the SEBI.

The SEBI may after consideration of the inspection report and after giving reasonable opportunity of hearing to the REITs or parties to the REIT or its representatives or any such person, issue directions as it deems fit in the interest of securities market or the investors in the nature of requiring the REIT to **(a)** delist its units from the designated stock exchanges and surrender its certificate of registration; **(b)** sell its assets; **(c)** take such action as may be in the interests of the investors; **(d)** prohibiting the REIT or parties to the REIT from operating in the capital market or from accessing the capital market for a specified period.

Liability for Action in Case of Default

A REIT or parties to the REIT or any other person involved in the activity of the REIT who contravenes any of the provisions of the SEBI Act/regulations/notifications/guidelines/circulars/instructions would be liable for one or more specified actions including any action provided under the **SEBI Intermediaries Regulations**.

SEBI INFRASTRUCTURE INVESTMENT TRUSTS (InvIT) REGULATION 2014

The main elements of the SEBI regulation are: **(i)** registration of InvIT, **(ii)** rights and responsibilities of parties to the InvITs, valuer and auditor, **(iii)** offer/listing of their units, **(iv)** investment conditions, related party transactions, borrowings and valuation of assets, **(v)** rights of unitholders, general obligations, disclosures and reporting, **(vi)** inspection and **(vii)** action in default. They are described in this Section.

Registration

Like the REITs (**discussed in the preceding Section**), the InvITs require a certificate of registration from the SEBI. The procedure in terms of application, non-refundable application fee, eligibility criteria with regard to the applicant, sponsors, investment manager (**manager in case of REITs**), trustees, conditions of certificates is mainly the same as applicable to the REITs. There are, however, some divergences regarding the **eligibility criteria** for **(i)** sponsors and **(ii)** investment managers. These are outlined below:

Sponsor A sponsor means a company/limited liability partnership (LLP)/body corporate which sets up the InvIT and in case of PPP projects (i.e. infrastructure projects undertaken on a public-private partnership between a public concessioning authority and a private SPV concessionaire selected on the basis of competitive bidding or on the basis of an MoU with the relevant athorities) the infrastructure developer/SPV holding concession agreement. Concession agreement means an agreement entered into by a person with a concessioning authority (i.e. a public sector conessioning authority in PPP projects) for implementation of the project as provided in the agreement. The SPV should hold at least 90 per cent (**compared to 80 per cent in REITs**) of the InvIT assets including all rights/interests/benefits arising from/incidental to their ownership. Each company/body corporate sponsor should have a networth of at least ₹100 crore and the LLP sponsor's net tangible assets should not be less than ₹100 crore.

Investment Manager The investment manager of InvIT should have at least on employee having 5 years experience in the relevant infrastructure sub-sector, in which it has invested/proposed to invest. He should also have an office in India from where its operations would be conducted.

A project implementation agreement should be entered into between the **project manager** (i.e. the designated person responsible for achieving execution of the specified project in case of PPP projects means the entity responsible for execution/achievement of project milestones in accordance with concession agreement/other relevant project management), the concessionaire SPV and the trustees on behalf of the InvIT setting and obligations of the project manager with respect to the execution of the project. In case of PPP projects, the obligation would be according to the concession/any other agreement entered into with the concessioning authority.

Rights and Responsibilities of Parties to the InvIT, Valuer and Auditor

Rights and Responsibilities of the Trustee **Their rights/responsibilities are primarily similar to those pertaining to the REITs**. However, the trustees of the InvIT ***vis-à-vis*** REITs would have some additional duties/responsibilities outlined below:

- They should also oversee the activities of the project manager other than relating to revenue streams from the project with respect to compliances with the SEBI regulations/project management agreement and obtain from him a quarterly compliance certificate in the specified form.
- They should make distributions and ensure that the investment manager makes timely declaration of dividends to unitholders in accordance with the investment conditions/dividends policy (**discussed later**).

- In case of any change in the project manager due to removal/otherwise **(i)** appoint new project manager within 3 months of the termination of the earlier project management agreement, **(ii)** either ***suo moto*** or on the advice of the concessioning authority, appoint an infrastructure project administrator on terms/conditions deemed fit, **(iii)** ensure that the new project manager is substituted as a party in all the documents in place of the earlier manager who should continue to be liable for all his acts/omissions/commissions during his tenure.
- In case of change of control of the project manager in a **PPP** project, ensure that prior written consent of the concessioning authority is obtained.

Rights and Responsibilities of the Investment Manager **The rights/responsibilities of the investment manager are mainly similar to those of the manager of REITs** (**discussed in the preceding Section of the Chapter**). In addition, he should oversee the activities of the project manager with respect to revenue streams from the project/project management agreement and obtain from him a quarterly specified compliance certificate.

Responsibilities of Project Manager The project manager should undertake operations/management of the InvITs assets including arrangements for direct/through appropriate agents for their appropriate maintenance and as required under any project agreement including a concession agreement in case of a **PPP** project. In respect of investment is under-construction projects, he should **(i)** undertake their operations/management directly or through appropriate agents, and **(ii)** oversee the progress of development/approval status/other aspects upto the completion of the project in case of appointment of agents for execution. **Under-construction project** means any infrastructure project (**PPP** or **non-PPP**) which has not achieved commercial operation date under the relevant project agreements (e.g. concession/power purchase/other agreements) entered into in relation to the operation of a project or in any agreement with lenders. He should also discharge all obligations in respect of timely completion of the infrastructure project, their implementation, operation, maintenance and management in terms of the project management agreement.

Rights and Responsibilities of Sponsor(s) In addition to the rights/responsibilities of sponsor(s) of REITs (**discussed in earlier Section**), any holding of unit by a sponsor in InvIT beyond 25 per cent on apost-issue basis should be held for at least one year from the date of their listing.

Rights/Responsibilities of Valuer/Auditor **Their rights and responsibilities are similar to those of the REITs**.

Offer/Listing of Units of InvITs

The main elements of the SEBI regulations relate to **(i)** issue of units and allotment, **(ii)** offer document/placement memorandum and advertisement, **(iii)** listing and trading of units, and **(iv)** delisting of units and winding up of the InvIT.

Issue of Units and Allotment Any initial offer of units by an InvIT can be made if **(a)** it is registered with the SEBI, **(b)** the value of the **assets** (i.e. value of the specific portion of its holdings in the underlying assets of the SPV) held by it is not less than ₹500 crore, and **(c)** the offer size is at least ₹250 crore. If it proposes to invest more than 10 per cent of the value of the InvIT assets in under-construction projets, it shold raise funds: **(a)** by away of private placement only through a placement memorandum; **(b)** from Indian/foreign qualified institutional buyers and body corporate only, **(c)** with minimum investment from any investor of ₹1 crore, and **(d)** from not less than 5 and not more than 100 investors. The InvIT should file the draft placement memorandum for making private placement of units with the SEBI along with the application for registration and the SEBI may communicate its comments, which should be incorporated in placement memorandum prior to the grant of registration.

The initial issue of units of the InvITs that hold at least 80 per cent of assets in completed and revenue generating infrastructure projects should be by way of initial offer only. Any subsequent issue of units may be by way of follow-on offer, preferential allotment, qualified institutional placement, rights issue, bonus issue, offer for sale or any other mechanism and in the SEBI-specified manner. The minimum subscription from any investor in initial and follow-on offer should be ₹10 lakh. The units proposed to be offered to the public are not less than 25 per cent of the total of the outstanding units of the InvIT and the units being offered by way of the offer document. Prior to initial/follow-on offer, the investment manager should file the draft offer document with the designated stock exchange(s) and the SEBI at least 21 working days before filing the final offer document with the designated stock exchange. the draft offer document filed with the SEBI should be made public, for comments, within at least 10 days, by hosting it on the websites of the SEBI, designated stock exchanges and merchant bakers associated with the issue. The SEBI may communicate its comments to the lead merchant banker and, in the interest of investors, may require him to carry out the modifications in the draft offer document as it deems fit. The lead merchant banker should ensure that all comments received from the SEBI on the draft offer document are suitably addressed prior to their filing with the designated stock exchange. The draft and final offer document should be accompanied by a due diligence certificate signed by the investment manager and lead merchant banker. The final offer document should be filed with the designated stock exchanges and the SEBI not less than 5 working days before opening of the offer accompanied by the specified fees. The InvIT may make the initial/follow-on offer within a maximum six months from the date of last issuance of observations by the SEBI/filing of final offer document with the designated stock exchanges. The InvIT may invite for subscription and allot units to any resident or foreign person. The application for subscription should be accompanied by a statement containing the abridged version of the offer document detailing the risk factors and summary of the terms of issue. The initial and follow-on offer should not be open for subscription for more than thirty days. In case of over-subscriptions, the InvIT should allot units to the applicants on a proportionate basis. It should allot units or refund application money, within 12 workings days from the date of closing of the issue. It should issue units only in dematerialised form to all the applicants. The price of the InvIT units issued by way of public issue should be determined through the book building/any other process. The InvIT should refund money **(i)** to all the applicants in case it fails to collect subscription of atleast 75 per cent of the issue size, **(ii)** to applicants to the extent of the over-subscription; the right to retain over-subscription cannot exceed 25 per cent of the issue size, **(iii)** to all the applicants, in case the number of subscribers to the initial offer forming part of the public is less than 20. If the investment manager fails to allot or list the units or refund the money within the specified time, he would pay interest to the unitholders at the rate of 15 per cent per annum, till such allotment or listing or refund and the interest should not be received in the form of fees or any other form payable to the investment manager by the InvIT. Units may be offered for sale to public **(i)** if they have been held by the sellers for at least one year prior to the filing of draft offer document with the SEBI, **(ii)** subject to other SEBI guidelines.

If the InvIT fails to make any offer of its units within 3 years from the date of registration, it should surrender its certificate of registration to the SEBI and cease to operate as an InvIT.

Offer Document/Placement Memorandum and Advertisement The offer document/placement memorandum of the InvIT should contain material, true, correct and adequate disclosures to enable the investors to make an informed decision. It should, ***inter-alia***, not **(i)** be misleading/contain any untrue statements/mis-statements; **(ii)** provide for any guaranteed returns to the investors; and **(iii)** include other SEBI-specified disclosures.

The offer document should include all the SEBI-specified information. The placement memorandum should contain all material information about the InvIT, parties to the InvIT, fees and all other expenses proposed to be charged, tenure of the InvIT, investment strategy, risk management tools and parameters employed, key service providers, conflict of interest and procedures to identify and address them, disciplinary history of the sponsor(s), investment manager, trustee and their associates, the terms and conditions on which the investment manager offers investment services, its affiliations with other intermediaries, manner of winding-up of the InvIT and such other information as may be necessary for the investor to take an informed decision on whether to invest in the InvIT.

No advertisement should be issued pertaining to issue of units by an InvIT which makes a private placement of its units. With respect to advertisement pertaining public issue of its units: **(i)** the advertisement material should not be misleading and not contain any thing extraneous to the contents of the offer document; **(ii)** if an advertisement contains positive highlights, it should also contain risk factors with equal importance in all aspects including print size; **(iii)** it should be in accordance with any SEBI-specified circulars/guidelines.

Listing and Trading of Units The stipulations to REITs are applicable to the InvITs also. The following additional conditions also apply. The minimum number of unitholders in an InvIT other than the sponsor(s) **(a)** in case of privately-placed InvIT, should be 5, each holding not more than 25 per cent of its units, **(b)** forming part of the public should be 20, each holding not more than 25 per cent of its units, at all times post-listing of the units, failing which action may be taken as may be specified by the SEBI/designated stock exchanges including delisting. The privately-placed units should be mandatorily listed within 30 working days from the date of final closing and the trading lot for trading would be ₹1 crore. The publicly-offered units should be mandatorily listed within 12 working days from the date of closure of the initial offer and their trading lot would be ₹25 lakh.

Delisting of Units and Winding up of the InvIT **The requirements applicable to delisting of units of REITs are also applicable in case of InvITs also**.

Investment Conditions, Related Party Transactions, Borrowing and Valuation of Assets

The investment conditions and dividend policy of the InvIT, their related party transactions, borrowings and deferred payments by them valuation of their assets are broadly similar to those applicable to the REITs and are discussed below.

Investment Conditions and Dividend Policy The investment by an InvIT should only be in SPV/infrastructure projects/securities in India in accordance with the SEBI regulations and the investment strategy as detailed in the offer document/placement memorandum. A **SPV** means any company/LLP (except **PPP** projects) **(i)** in which the InvIT holds **controlling** interest (to the extent of at least 50 per cent of the voting rights/interest) and a minimum 50 per cent of the equity share capital/interest, **(ii)** which holds at least 90 per cent of its assets directly in infrastructure projects and does not invest in other SPVs and is not engaged in any other activity other than those pertaining/incidental to the underlying infrastructure projects. In case of **PPP** projects, it should mandatorily invest in the infrastructure projects through the SPV subject to the following: **(a)** no other shareholder/partner of the SPV would have any rights that prevents the InvIT from complying with the provisions of the SEBI regulations and an agreement should be entered into with them to that effect prior to the investment, **(b)** in case the SPV is a company, the investment manager, in consultation with the trustee, should appoint at least one authorised representative on their Board of Directors/Government Board, **(c)** the investment manager should ensure that the in every meeting of the SPV, the voting of the InvIT is exercised.

Investments of InvIT in under-construction projects should be only in eligible infrastructure projects/securities of companies/partnership interests of **LLPs** in infrastructure sector. However, uninvested funds may be invested in liquid funds/Government securities/money market instruments/cash equivalents. **Companies/LLPs in infrastructure sector** mean those which derive at least 80 per cent of their operating income from infrastructure sector as per the audited accounts of the previous financial year. In case of InvITs investing in revenue generating projects: **(a)** at least 80 per cent of the value of the assets should be invested, proportionate to these holding, in completed and revenue generating infrastructure projects subject to the following; **(i)** if the investment has been made through a SPV, by way of equity/debt/equity linked instruments/ partnership interest, only the portion of **direct investments** in eligible infrastructure projects by the SPVs would be considered; **(ii)** if any project is implemented in stages, the part of the project which can be categorised as completed and revenue generating would be considered; **(b)** not more than 20 per cent of value of the assets, proportionate to their holding of the InvITs, should be invested in: **(i)** under-construction infrastructure projects, directly/through the SPVs (not exceeding 10 per cent of the value of their assets), **(ii)** listed/unlisted debt of companies/body corporates in infrastructure sector (excluding any investment in debt of the SPV), **(iii)** equity shares of listed companies in India which derive at least 80 per cent of their operating income from infrastructure sector as per the audited accounts of the previous financial year, **(iv)** Government securities, and **(v)** money market instruments, liquid mutual funds/cash equivalents; **(c)** if the above specified conditions are breached on account of market movements of the price of the underlying assets/securities, the investment manager should inform the trustees and ensure that they are satisfied within 6 months of the breach.

With respect to distribution by the InvIT and the SPV, not less than 90 per cent of distributable cash flows of the SPV/InvIT should be distributed to the InvIT/unitholders in proportion of its holding in the SPV/unitholder respectively. It should be declared and made within 15 days at least once every 6 months/year in every financial year of publicly-offered InvITs and privately-placed InvITs respectively. The sale proceeds of infrastructure assets/equity shares/interest may not be distributed to the InvIT/investors if they are reinvested in similar assets. If the distributions are not made within 15 days of declaration, the investment manager would be liable to pay interest to the unitholders at 15 per cent per annum which would not be recovered in the form of fees or any other form payable to him by the InvIT. An InvIT should not **(i)** invest in units of other InvITs, **(ii)** undertake lending to any person. The infrastructure assets (other than investment in securities of companies in infrastructure sector other than SPVs) should be held for at least 3 years from the date of purchase.

In case of any co-investment with any person(s) in any transaction: **(a)** the investment by the other person(s) should not **(i)** be at terms more favourable than those to the InvIT, **(ii)** provide any rights to them to prevent the InvIT from complying with the provisions of the SEBI regulations; **(b)** the agreement with them should include the minimum percentage of distributable cash flows and entitlement of the InvIT to receive at least the ***pro rata*** distributions and the mode for resolution of any disputes between them and the InvIT. No scheme should be launched under the InvIT.

Related Party Transactions The **related parties** of InvIT includes **(i)** its parties (i.e. sponsors/investment/project manager and trustees), **(ii)** holders of 20 per cent of its units and **(iii)** associates/promoters/directors/partners of **(i)** and **(ii)**. All related party transactions should be on an arms-length basis in accordance with the relevant accounting standards, in the best interest of the unitholders, consistent with the strategy and investment objectives of the InvIT. They should be disclosed **(a)** in the offer document/placement memorandum with respect to any such transactions entered into prior/subsequent to the offer; **(b)** to be designated stock exchanges and unitholders periodically. Related party transactions with respect to publicly offered InvITs entered into after initial offer would require prior approval from the unitholders, if their total value, in a financial year, pertaining to acquisition/sale of assets/investments in securities or value of borrowed funds from them exceeds 5 per cent of the total consolidated borrowings of the InvIT. Transaction between two or more of the InvITs, with a common investment manager/sponsor, would be deemed to be related party transactions including if they are different entities but are associates.

Details of any fees/commissions received/to be received from any party related transaction by any person/entity from an associate should be adequately disclosed to the designated stock exchanges. Where any related parties have an interest in a business which directly/indirectly competes/is likely to compete with the activities of the InvIT, the following details should be disclosed in the offer document/placement memorandum: **(a)** details of the business including an explanation as to how it would compete with the InvIT, **(b)** a declaration **(i)** that the related party would perform its duty independent of its related business, **(ii)** as to whether any acquisition of such business by the InvIT is intended with details.

Borrowings and Deferred Payments The aggregate consolidated borrowings and deferred payments of the InvIT net of cash and cash equivalents should never exceed 49 per cent of the value of their assets. If they exceeds 25 per cent limit for any further borrowings **(a)** credit rating should be obtained from a SEBI-registered credit rating agency, **(b)** approval of unitholders should be obtained in the specified manner.

Valuation of Assets The valuer should not be an associate of the sponsor(s)/investment manager/trustee and have at least 5 years of experience in valuation of infrastructure assets. The full valuation of assets includes a detailed valuation of all assets including physical inspection of every infrastructure project. The full valuation report conducted by the valuer not less than once in every financial year should include the mandatory minimum specified disclosures. A half-yearly valuation of the assets of the InvIT should be conducted for the half-year ending September 30th for a publicly-offered InvIT for incorporating any key changes in the previous 6 months and the report should be prepared within one month from the date of end of the half year. The valuation reports received by the investment manager should be submitted to the designated stock exchanges within 15 days from their receipt. Prior to any issue of units by publicly-offered InvIT other than bonus issue, the valuer should undertake full valuation of all the InvIT assets and include it in the offer document. It should not be more than 6 months old at the time of the offer. For any transaction of purchase/sale of infrastructure projects, whether directly or through SPVs for publicly-offered InvITs, **(a)** a full valuation of the specific project should be undertaken by the valuer; **(b)** if, **(1)** in case of a purchase/sale transaction, the asset is proposed to be purchased/sold at a value greater than 110/90 per cent of the value of the asset as assessed by the valuer, the approval of the unitholders should be obtained. No valuer should undertake valuation of the same project for more than four years consecutively. He may, however, be reappointed after at least two years from the date he ceases to be the valuer of the InvIT.

The valuation should be in compliance with by international valuation/valuation standards specified by the ICAI/SEBI. In case of any conflict, the standards specified by the ICAI should prevail.

In case of any material development that may have an impact on the valuation of the assets, the investment manager should require the valuer to undertake its full valuation within two months and disclose the same to the trustees/designated stock exchanges within 15 days. The valuer should not undertake valuation of any assets in which it has either been involved with the acquisition/disposal within the last twelve months other than cases where he was engaged by the InvIT.

Rights of Unitholders, General Obligations, Disclosures and Reporting

The SEBI requirements relating to (i) rights and meetings of the unitholders, (ii) disclosures, (iii) submission of reports to it, and (iv) maintenance of records applicable to the REITs are also applicable to the InvITs.

Inspection

The reasons and procedure for inspection of the InvITs, their obligations, submission of reports and communication of findings to the SEBI are the same as are applicable to the REITs.

Procedure for Action in Case of Default

The liability for action in case of default by an InvIT is also the same as in the case of REITs.

CONCLUDING OBSERVATIONS

- A mutual fund pools the savings, particularly of the relatively small investors, and invests them in a well diversified portfolio of sound investment. It issues units (securities) to unitholders (investors) according to the quantum of money invested by them. The profits/losses are shared by the unitholders in proportion of their investments.
- According to the SEBI, mutual funds are funds established in the form of a Trust to raise money through the sale of units to the public under various schemes for investing in securities including money market instruments or gold/gold related instruments or real estate assets.

- A mutual is set up in the form of a trust which has (i) a sponsor, (ii) trustees, (iii) an asset management company (AMC) and (iv) custodians. The sponsors set up the trust as promoters. The trustees hold the property in trust for the benefit of the unitholders. They are vested with general powers of superintendence and direction over the AMC and they monitor their performance and compliance with the SEBI regulations. The AMC manages the funds. The custodian holds the securities of the fund in its custody.
- The main elements of the regulatory mechanism for mutual funds in India in terms of the SEBI regulations are: **(i)** registration of mutual funds, **(ii)** constitution and management of mutual funds, **(iii)** constitution and management of AMCs/custodians, **(iv)** mutual fund schemes, **(v)** investment objectives/valuation policies, **(vi)** real estate mutual fund schemes, **(vii)** inspection and audit, **(viii)** general obligations, and **(ix)** action in case of default.
- To carry on their business, mutual funds must be registered with the SEBI, which registration is granted on the fulfilment of the prescribed eligibility criteria for the sponsors in terms of track record, contribution to the networth of the AMC; appointment of trustees, AMC and custodian; and so on.
- A mutual fund must be constituted in the form of a trust and the instrument of trust should be in the form of a deed duly registered and executed by the sponsor in favour of the trustees. The contents of the trust deed have been prescribed by the SEBI.
- A person can be appointed as a trustee on the fulfilment of the prescribed conditions, such as that he should be a person of ability, integrity and standing, who has not been guilty of moral turpitude/convicted of any economic offence/violation of any securities laws and so on. Two-thirds of the trustees of a mutual fund must be independent persons and not associated with the sponsors in any manner. The trustees should enter into an investment management agreement with the AMC for the purpose of making investments. The trustees would have the right to obtain from the AMC, all information concerning the operations of the various schemes of the mutual fund managed by it.
- The sponsor of the mutual funds/trustees would appoint the AMC, with the prior approval of the SEBI. Its appointment can be terminated by a majority of trustees or 75 per cent of the unitholders of the scheme. The eligibility criteria for the appointment of an AMC include sound track record, adequate professional experience, not guilty of moral turpitude, non-conviction of any economic offence/violation of any securities laws, inclusion of 50 per cent independent directors and networth of at least ₹10 crore.
- An AMC cannot act as a trustee of a mutual fund. It can undertake other business activities in the nature of portfolio management services, management and advisory services to offshore funds/pension funds/provident funds/venture capital funds, management of insurance funds, financial consultancy and exchange of research on a commercial basis, if any of these activities do not conflict with the activities of the mutual fund.
- It is obligatory for an AMC to take all reasonable steps and exercise due diligence to ensure that the investment of funds conforms to the provisions of the SEBI regulations and the trust deed. It can purchase/sell securities upto a maximum of 5 per cent of the total, through a broker associated with the promoter. It should disclose details of all transactions with/through the sponsor/associate companies. The AMC has to file details of securities transactions by its key personnel in their own name or on behalf of the AMC, to the trustees/SEBI. Details of transactions with associates should also be filed/reported. The AMC has to file details of its directors and transactions with sponsor/associate companies, with the trustees/SEBI. The AMCs are prohibited from appointing as a key personnel, any person found guilty of any economic offence or involved in a violation of securities laws.

- The mutual fund should appoint a custodian to carry out the custodial services for the scheme. A mutual fund cannot appoint a custodian in which 50 per cent or more of the voting rights/ directorships is held by the sponsor/associate companies. The custodian agreement, the service contract and terms of appointment require prior approval of the trustees.
- An AMC can launch a mutual fund scheme after its approval by the trustees and filing of the offer document with the SEBI. The offer document should contain adequate disclosures to enable the investors to make an informed investment decision. All advertisements pertaining to mutual fund schemes should conform to the advertisement code specified by SEBI. The advertisement should also disclose the investment objective of the scheme. The offer document and advertisement materials should not be misleading or contain incorrect/false information.
- A close-ended scheme is one in which the maturity period is specified. Every such scheme must be listed on a recognised stock exchange. A close-ended scheme may be converted into an open-ended scheme. All close-ended schemes should be fully redeemed on maturity, but they can be rolled over.
- Guaranteed returns can be provided in a scheme if they are fully guaranteed by the AMC. The name of the guarantor and the manner in which the guarantee is to be met should be disclosed in the offer document.
- Every mutual fund should compute the NAV of each scheme by dividing the net assets of the scheme by the number of unit outstanding on the valuation date.
- The sale and repurchase price of units should be made available to the investors. The repurchase price should not be lower than 93 per cent and the sale price should not be higher than 107 per cent of the NAV. The repurchase price cannot be lower than 95 per cent of the NAV in a close-ended scheme. The difference between the repurchase and sale price should not exceed 7 per cent of the sale price.
- Mutual funds can invest only in transferable securities in the capital/money market or in privately placed debentures or securitised debts in asset-backed securities (ABS) and mortgage-backed securities (MBSs).
- The restrictions on investments by mutual funds relate to ceilings in rated/unrated debt instruments, equity shares, inter-scheme transfers/investments, short-term deployment of funds, investment in unlisted/listed group companies, thinly traded securities and so on.
- The ceiling on investment in a rated debt instrument not below investment grade, is 15-20 per cent of the NAV in a single instrument. The limit for a single unrated debt instrument is 10 per cent and that for the total is 25 per cent. The Investments of a mutual fund in equity capital of a company, can be upto 10 per cent. Inter-scheme transfer of funds are permitted at the prevailing market price and the securities should fit into the investment objectives of the transferee scheme. The aggregate inter-scheme investment should not exceed 5 per cent of the NAV of the mutual fund. Mutual funds should buy/sell securities on the basis of delivery. Upto 25 per cent of the net assets of a mutual fund can be invested in unlisted securities/ securities issued by way of placement of an associate company of the sponsor/listed securities of the sponsor. Pending deployment of funds in securities, mutual funds can invest funds in short-term deposits with banks. The permitted investment in unlisted equity shares/related instruments in case of open-ended and close-ended schemes is 5 per cent and 10 per cent of the NAV of the mutual fund, respectively.
- Mutual funds can borrow only to meet temporary liquidity needs for repurchase/ redemption/ payment of dividend and so on, upto a maximum of 20 per cent of their net assets, for upto 6 months. They cannot advance any loans but they can lend securities under the stock lending scheme. They cannot enter into option trading/short selling/carry forward transactions. But

they can enter into derivative trading for hedging and portfolio balancing. They can also carry on underwriting business.

- The investment valuation norms for mutual funds relate to traded securities, non-traded securities and rights shares.
- Traded securities should be valued at the last closing price on a stock exchange. When a security is not traded on any stock exchange on a particular valuation day, the closing price on the available earliest previous day (i.e., 30 days in case of shares and 15 days in case of a debt security) may be used.
- A non-traded security/scrip means a security not traded for 30 days prior to the valuation date. Such securities should be valued 'in good faith' on the basis of the appropriate valuation models based on the valuation principle approved by the AMC. The selected method should be fair and reasonable. Included in this category are equity instruments, debt instruments, call money/bills/deposits, convertible bonds, warrants and repos.
- Equity instruments should generally be valued on the basis of capitalisation of earnings, using the P/E ratio of a comparable traded security, with an appropriate discount for lower liquidity. Debt instruments should generally be valued on the yield to maturity basis, using the capitalisation factor for a comparable traded security, with an appropriate discount for lower liquidity. Call money, bills and short-term deposits should be valued at cost plus accrual. Other money market instruments and Government securities should be valued at yield to maturity based on the prevailing market rate. The convertible and non-convertible components of a convertible instrument should be valued as an equity and debt instrument respectively. Warrants can be valued at the value of the share obtained on exercise of the warrant, minus the amount payable on exercise of the warrant. An instrument bought on repo basis should be valued at the resale price, minus the applicable interest upto the date of resale.
- Until they are traded, the value of the rights shares should be calculated as $Vr = n/m \times (P_{ex} - P_{of}))$, where Vr = value of rights, n = number of rights offered, m = number of original shares held, P_{ex} = Ex-rights price, P_{of} = rights offer price.
- All expenses and incomes accrued upto the valuation date should be considered for the computation of the net asset value.
- Thinly traded securities should be valued as per SEBI guidelines.
- The aggregate value of illiquid securities should not exceed 15 per cent of the total assets of the scheme. Any excess holding should be valued as per SEBI guidelines.
- The general obligations of AMCs/mutual funds relate to maintenance of proper books of accounts/records, fees and expenses on issue of schemes, despatch of warrants and proceeds and annual report.
- Every AMC should keep, maintain and preserve proper books of accounts/records/ documents for 8 years, for each scheme. It should follow the specified accounting policies and standards so as to provide the appropriate details of the schemewise disposition of the assets at the relevant accounting date and the performance during the period, together with information regarding the distribution and accumulation of the income accruing to the unitholders, in a fair and true manner.
- All expenses should be clearly identified and appropriated in the individual schemes. The AMC may charge the mutual fund with investment and advisory fees, which should be fully disclosed in the offer document. All other expenses would be borne by the AMC/trustees/sponsor. Initial issue expenses of floating a scheme cannot exceed 6 per cent of the initial resources raised and must be accounted in the books of account of the scheme. An AMC may launch schemes

on a ‘load’ or ‘partial load’ basis. In case of a no load scheme, the initial issue expenses should be borne by the AMC. A part of the load would be borne by the AMC and the balance by the scheme in a partial load scheme. In a load scheme, the entire expense would be borne by the scheme.

- The dividend warrants should be despatched by the AMC, within 42 days of the declaration of dividend and the redemption/repurchase proceeds, within 10 days, failing which it would have to pay interest for the period of delay and would also be liable for penalty for such failure.
- The books of accounts/records/documents and infrastructure, systems and procedures of a mutual fund/trustees/AMC can be inspected or their affairs investigated by an inspecting official/auditor appointed by SEBI. In case of default, the SEBI can suspend/cancel the registration of a mutual fund.
- A real estate mutual fund scheme (REMFS) invests directly/indirectly in real estate assets/other permissible assets. Real estate asset means an identifiable immovable property, which is located in India in a city notified by the SEBI/a special economic zone. It does not include a project under construction/vacant land, deserted property/agricultural land and property reserved/attached by government/other authority or pursuant to a court order or the acquisition of which is prohibited under any law. The REMFS cannot undertake lending/home finance activities.
- The permissible investments of a REMFS are: (i) at least 35 per cent of the net assets directly in real estate assets; (ii) 75 per cent of net assets in real estate assets, mortgage backed securities and equity shares/debentures of listed companies dealing in real estate assets and the balance in other securities, (iii) Not more than 30 per cent of its net assets in a single city, 15 per cent in a single project and 25 per cent of the issued capital of an unlisted company, (iv) Not more than 15 per cent of its net assets in shares/debentures of the unlisted company, (v) Not more than 25 per cent of its net assets in (a) unlisted securities of the sponsor/associated/group company, (b) listed security issued by way of preferential allotment by the sponsor/associate/group company and (c) any listed security of the sponsor/associate/group; (vi) No inter-scheme transfer of real estates assets and (viii) prohibition on investment in any real estate assets owned by the sponsor/associate/AMC during the last 5 years or in which they hold tenancy/lease rights.
- The real assets held by the REMFS should be valued at cost price on the date of acquisition and at fair price every 3 months.
- **IDFSs** means a mutual fund scheme that invests primarily (i.e. 90 per cent of the assets of the scheme) in debt securities/securitised debt instruments of infrastructure/infrastructure capital companies/projects or special purpose vehicles (SPVs) created for facilitating/promoting investment in infrastructure and other permissible assets or bank loans in respect of completed and revenue generating projects of infrastructure companies/projects/SPVs. The main elements of the **IDFSs** are: **(i)** eligibility criteria, **(ii)** conditions, **(iii)** permissible investments, **(iv)** valuation of assets and NAV, **(v)** duties of AMC, and **(vi)** disclosures.
- The SEBI would grant a certificate of registration if the sponsor/its **parent company** (i.e. a company holding 75 per cent of the capital of the sponsor) **(a)** has been carrying on activities/business in infrastructure financing sector for at least 5 years and **(b)** fulfils the eligibility criteria applicable to other mutual funds.
- An IDFS can be launched either as a close-ended scheme with a maturity exceeding 5 years or interval scheme with lock-in of 5 years and interval period upto one month. Each IDFS should have firm commitment from **strategic investors** [i.e. an RBI-registered infrastructure finance

company (as NBFC)/a bank/international multilateral financial institutions] for contribution of at least rupees twenty five crore before the allotment of units to the other potential investors.

- At least 90 per cent of the net assets of the IDFS should be invested in the specified debt securities/securitised debt instruments. The balance amount may be invested in listed/unlisted equity shares/convertibles including mezzanine financing instruments or bank deposits and money market instruments. The maximum investment under all the IDFSs of a mutual fund in a single entity/bank loan would be restricted to 30 per cent of its net assets. The investment limit in the debt securities/assets of a single entity/bank loan rated below investment grade/unrated would be 30 per cent. This limit could be upto 50 per cent with the prior approval of the AMC/trustees.
- The assets held by an IDFS should be valued in **good faith** by the AMC on the basis of appropriate valuation methods based on principles approved by the trustees.
- The trustees or the employees/directors of the AMC/trustee company should disclose within one month all their transactions in the investee company to the compliance officer who should submit a report with recommendation to the trustees from the viewpoint of conflict of interest. The person(s) concerned may obtain views of the trustees before entering into the transaction.
- The main elements of the SEBI REITs regulations are: their registration, rights/responsibilities of the parties to the REIT, valuer and auditor, issue and listing of units, investment conditions/related party transactions/borrowing and valuation of assets, rights of unitholders/general obligations/disclosures and reporting, inspection and action in case of default, are discussed in this Section.
- The application for the grant of certificate of registration as REIT should be made by the sponsor in the specified form and accompanied by a non-refundable fee of ₹1,00,000. For the purpose of the grant of certificate, the SEBI would consider all matters relevant to its activities as a REIT, including the following: **(a)** The applicant is a trust and the instrument of trust is in the form of a deed duly registered in India, **(b)** The trust deed has its main objective as undertaking activity of REIT and includes responsibilities of the trustee, **(c)** Persons designated as sponsor(s)/manager/trustee are all separate entities, **(d)** With regard to sponsor(s) **(i)** there are not more than 3 sponsors each holding/proposing to hold at least 5 per cent of the units of the REIT on post-initial offer basis; **(ii)** on a collective basis, they have a net worth of at least ₹100 crore; and **(iii)** he/associate(s) has not less than 5 years experience in development of real estate/fund management in the real estate industry. Where the sponsor is a developer, at least two of his projects have been completed. **Real estate**/property means a leasehold/free-hold land and permanently attached improvements to it including buildings/sheds/garages/fences/fittings/fixtures/warehouses/car parks/any other asset incidental to the ownership of real estate excluding mortgages and infrastructure. **(e)** The manager: **(i)** has a net worth/net tangible assets of at least ₹10 crore if a body corporate/company or; **(ii)** he/associate/two key personnel has not less than 5 years experience in fund management/advisory service/property management in the real estate industry or in development of real estate; **(iii)** has not less than half of its directors in the case of a company or of members of the governing board (i.e. a group of members assigned to act in a manner similar to the Board of Directors of a company) in case of an LLP, as independent and not directors or members of the governing board of another REIT; and **(iv)** has entered into an investment management agreement with the trustee which provides for responsibilities of the manager. **(f)** The trustee is registered with the SEBI and is not an associate of the sponsor(s)/manager and has the wherewithal with respect to infrastructure, personnel, etc. to the satisfaction of the SEBI and in accordance with the specified circulars/guidelines. **(g)** No unitholder of the REIT enjoys preferential voting or any other rights over another unitholder; **(h)** There are no multiple classes of units of REIT;

(i) The applicant has clearly described the details pertaining to proposed activities of the REIT; **(j)** The applicant and parties to REIT are fit and proper persons based on the criteria specified by the **SEBI Intermediaries Regulation**; **(k)** Whether any previous applicant for grant of certificate by the applicant/any **related party** (i.e. parties to the REIT/any unitholder directly/indirectly holding more than 20 per cent of the units/their associates, sponsors, directors, partners) has been rejected by the SEBI; **(l)** Whether any disciplinary action has been taken by the SEBI/any other regulatory authority against the applicant/any related party under any Act/the regulations/circulars/guidelines.

- The REIT and parties to the REIT should: **(i)** conduct all affairs in the interest of all the unitholders, **(ii)** make adequate, accurate, explicit and timely disclosure of relevant material information to all unitholders, designated stock exchanges and the SEBI, **(iii)** try to avoid conflicts of interest, as far as possible, in managing the affairs of the REIT and keep the interest of all unitholders paramount in all matters, in case such events cannot be avoided, it should be ensured that appropriate disclosures are made to the unitholders and they are fairly treated, **(iv)** ensure that the fees charged by them should be fair and reasonable, **(v)** not use any unethical means to sell, market or induce any person to buy units and where a third party appointed by the manager fails to comply with this condition, the manager should be liable for the same, **(vi)** maintain high standards of integrity and fairness in their dealings and in the conduct of their business, **(vii)** render at all times high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment, **(viii)** not make any oral/written exaggerated statement about their qualifications/capabilities/experience/achievements, **(ix)** be liable to the unitholders for their acts of commission/omission, notwithstanding anything contained in any contract or agreement.
- The rights/responsibilities pertains to **(i)** trustees, **(ii)** manager, **(iii)** sponsor, **(iv)** valuer and **(v)** auditor.
- The main elements of the SEBI regulations relating to issue and listing of units are: issue/allotment of units, offer document and advertisements, listing/trading of units and delisting of units.
- A REIT should make an initial offer of its units by way of public issue only. Any subsequent issue of units by the REIT may be by way of **follow-on offer.** The offer document of the REIT should contain material, true, correct and adequate disclosures to enable the investors to make an informed decision.
- All units of REITs should be mandatorily listed on a stock exchange having nationwide trailing terminals within 12 working days from the date of closure of the offer. The minimum public holding for the units of the listed REIT should be 25 per cent the total number of outstanding units and the number of unit holders forming part of the public 200, failing which SEBI/stock exchange-specified action may be taken including delisting of units.
- The manager should apply for delisting of units of the REIT to the SEBI/designated stock exchanges if **(a)** the public holding falls below the specified limit (25 per cent); **(b)** the number of unit holders forming part of the public falls below 200; **(c)** if there are no projects/assets for more than six months and the REIT does not propose to invest in any project in future. The period may be extended by further six months, with the approval of unitholders in specified manner; **(d)** the SEBI-designated stock exchanges require delisting for violation of the listing agreement/regulation/the SEBI Act; **(e)** the sponsor(s)/trustee requests delisting after approval by unitholders; **(f)** unitholders apply for delisting; and **(g)** the SEBI/designated stock exchanges require delisting for violation of the listing agreement/these regulations/the SEBI Act or in the interest of the unit holders.

- The SEBI stipulations pertain to **(i)** investment conditions and distribution policy, **(ii)** related party transactions, **(iii)** borrowings and deferred payment and **(iv)** valuation of assets.
- A REIT can invest only be in SPV/properties/securities/TDR (transferable development rights) in India in accordance with the investment strategy as detailed in the offer document. It cannot invest in vacant/agricultural land (except land which is contiguous/extension of an existing project being implemented in stages)/mortgages other than mortgage backed securities. At least 80 per cent of the value of the REIT assets should be invested proportionate to its holding in **completed** (i.e. for which occupancy certificate has been received from the competent authority) and **rent generating properties.** Not more than 20 per cent of the value of their assets should be invested proportionate to its holding in assets other than as provided **above** and they should only be in properties which are: under-construction properties, completed and not rent-generating properties, listed/unlisted/debt of companies/body corporates in real estate sector; mortgage backed securities, equity shares of listed companies, Government securities, unutilised floor space index of a project where it has already made investment, TDR acquired for utilisation with respect to a project where it has already made investment, and money market instruments/cash equivalents.
- At least 90 per cent of net distributable cash flows of the SPV/REIT should be distributed/declared to the REIT/unitholders at least once every 6 months in every financial year and made within 15 days from the date of such declaration.
- All **related party** transactions should be on an arms-length basis, in the best interest of the unitholders, consistent with the strategy and investment objectives of the REIT and disclosed to the stock exchange and unitholders periodically. A REIT, may **(a)** acquire assets from, **(b)** sell assets/securities to, **(c)** lease assets to/from, **(d)** invest in securities issued by, and **(e)** borrow from related parties.
- The aggregate consolidated borrowings and deferred payments (excluding refundable security deposits to tenants) of the REIT net of cash and cash equivalents should never exceed 49 per cent of the value of their assts. If it exceed 25 per cent, **(a)** credit rating should be obtained from a SEBI-registered credit rating agency; and **(b)** approval of unitholders should be obtained in the specified manner for further borrowing.
- The valuer should not be an associate of the sponsor(s)/manager/trustee and have at least 5 years of experience in valuation of real estate. The full valuation conducted by the valuer at least once at the end of the financial year ending March 31st within three months from the end of the year should include a detailed valuation of all assets including physical inspection of every property by him. The valuation report should include the mandatory minimum specified disclosures. A half-yearly valuation of the REIT assets should be conducted by the valuer for the half-yearly ending on September 30 for incorporating any key changes in the previous 6 months and the valuation report should be prepared within 45 days from the date of end the half year.
- The SEBI stipulations relate to **(i)** rights/meetings of unitholders, **(ii)** disclosures, **(iii)** submission of reports to the SEBI, **(iv)** power to call for information, and **(v)** maintenance of records. The unitholder should have the rights to receive income/distribution as provided for in the offer document/trust deed. With respect to any matter requiring their approval: **(a)** a resolution should be considered as passed when the votes cast by them in favour of the resolution exceed a certain percentage (**specified later**) of the votes cast against, **(b)** the voting may also be done by postal ballot or electronic mode, **(c)** a notice of at least 21 days either in writing or through electronic mode should be provided to them, **(d)** voting by any person who is a related party in such transaction as well as their associates would not be considered on the specific

issue, and **(e)** the manager would be responsible for all the activities pertaining to conducting of meeting, subject to overseeing by the trustee. However, in respect of issues pertaining to the manager such as change including removal or change in his control, the trustee should convene and handle all activities pertaining to conduct of the meetings. In respect of issues pertaining to them such as change, the trustee should not be involved in any manner in the conduct of the meeting.

- The manager should ensure that the disclosures in the offer document are in accordance with the SEBI-prescribed requirements. He should submit an annual report to all unitholders with respect to activities of the REIT, within 3 months from the end of the financial year and a half-yearly report within 45 days from the end of the half year ending on September 30th containing the specified disclosures. He should also disclose to the designated stock exchanges any information having bearing on the operation/performance of the REIT as well as price sensitive information.
- The SEBI may at any time call upon the REIT/parties to the REIT to file reports, with respect to its activities.
- The SEBI may at any time call for any information from the REIT/parties to the REIT/any unitholder/any other person with respect to any matter pertaining to activity of the REIT which should be furnished within the specified time.
- The manager should maintain records pertaining to the activity of the REIT including: **(a)** decisions of the manager with respect to investments/divestments and supporting documents; **(b)** details of investments made by the REIT and supporting documents; **(c)** agreements entered into by, on behalf of, the REIT; **(d)** documents relating to appointment of valuers/auditors/registrar/transfer agent/merchant banker/custodian and so on; **(e)** insurance policies for real estate assets; **(f)** investment management agreement; **(g)** documents pertaining to issue and listing of units including initial/follow-on/other offer document(s), in-principle approval by designated stock exchanges, listing agreement with the designated stock exchanges, details of subscriptions, allotment of units, etc.; **(h)** distribution declared and made to the unitholdesr; **(i)** disclosures and periodical reporting made to the trustee, SEBI, unitholders and designated stock exchanges including annual/half-yearly reports, etc.; **(j)** valuation reports including methodology of valuation; **(k)** books of accounts and financial statements; **(l)** audit reports; **(m)** reports relating to activities of the REIT placed before the Board of Directors of the manager; **(n)** unitholders' grievances and actions taken including copies of correspondence with the unitholders and the SEBI; **(o)** any other material document. The trustee should maintain records pertaining to **(a)** certificate of registration granted by the SEBI; **(b)** registered trust deed; **(c)** documents pertaining to application made to the SEBI for registration as a REIT; **(d)** titles of the real estate assets; **(e)** notices and agenda sent to unitholders for meetings held; **(f)** minutes of meetings and resolutions passed; **(g)** periodical reports and disclosures received by them trustee the manager; **(h)** disclosures, made to the SEBI/unitholders/ designated stock exchanges; **(i)** any other material documents. The records may be maintained in physical or electronic form. Where records are required to be duly signed and are maintained in the electronic form they should be digitally signed.
- A REIT or parties to the REIT or any other person involved in the activity of the REIT who contravenes any of the provisions of the SEBI Act/regulations/notifications/guidelines/circulars/instructions would be liable for one or more specified actions including any action provided under the **SEBI Intermediaries Regulations**.
- **The SEBI regulatory framework relating to the Infrastructure Investment Trusts is similar to the framework applicable to the real estate investment trusts**.

CHAPTER 16

Insurance Organisations

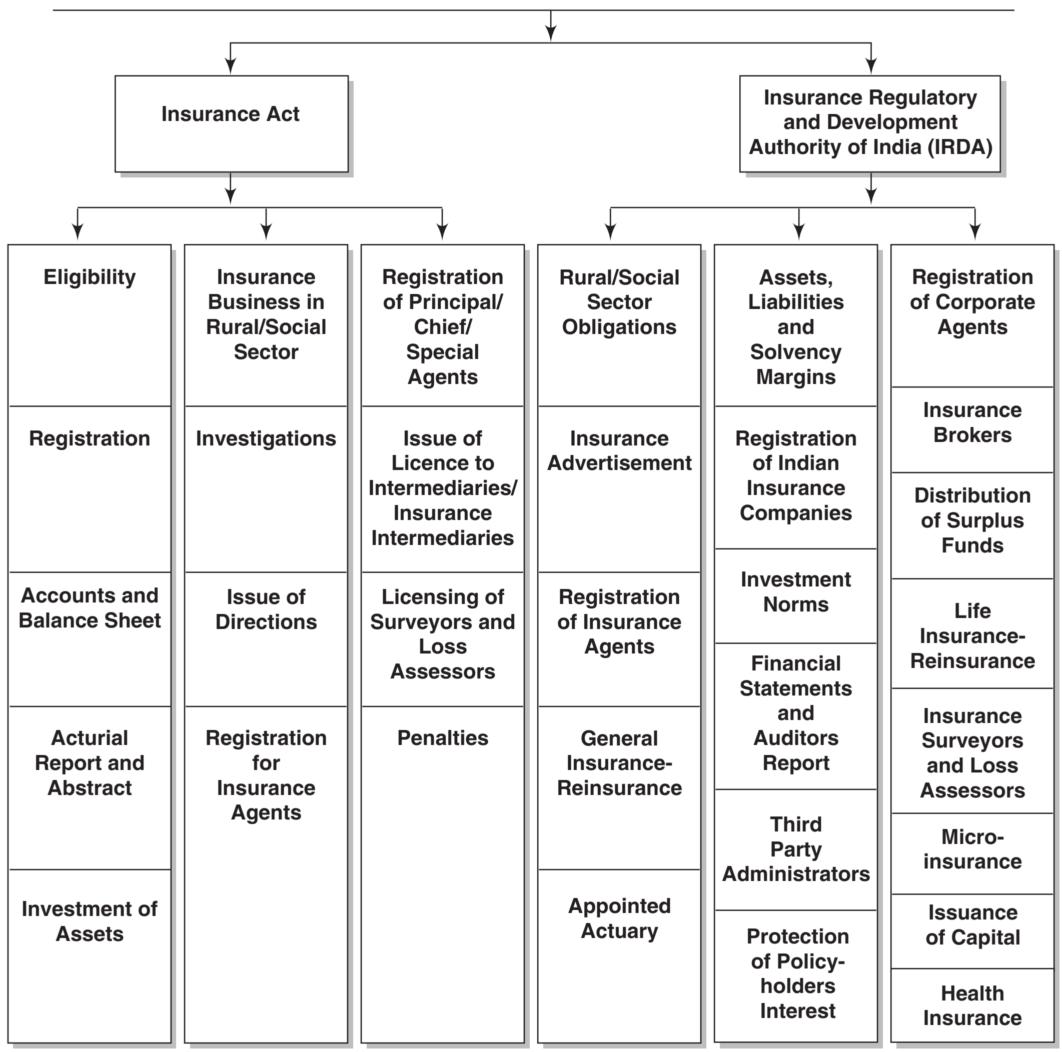
INTRODUCTION

Insurance organisations essentially invest the savings of their policyholders and in exchange promise them and/or their beneficiaries a specified sum either at a later stage or upon the happening of a certain event. They differ from unit trusts/mutual funds in that while the main business of the former is to provide protection against risk and investment in securities is incidental to the main function of providing protection against risk, in the case of the latter, investment is the only reason for their being. The operational implication of this feature of insurance organisations is that they are guided by the consideration of protecting the interest of policyholders whose money they hold in trust for which reason their investment policy is closely regulated with reference to the eligible investments for their portfolios. This chapter provides an analysis of the operations of insurance organisations in the system of industrial financing in India. Until 1999, the insurance organisation in India was comprised of two state-owned monolithic institutions, namely, the Life Insurance Corporation of India (LIC) and the General Insurance Corporation of India (GIC) and its four subsidiaries. In order to improve the quality of insurance services in the country, the Malhotra Committee (1993) had recommended a comprehensive framework of reform in the insurance sector. The insurance sector/industry in the country has emerged in response to the follow-up action on the recommendations of the Committee. **The main elements of the framework are the Insurance Act, 1938, Insurance Regulatory and Development Authority Act, 1999, and the regulations framed under it by the Insurance Regulatory and Development Authority (IRDA). The organisation of the insurance sector in India is portrayed in Exhibit 16.1.** Sections 1 – 3 discuss the different facets of the emerging scenario. The last Section contains some concluding observations.

INSURANCE ACT, 1938

The Insurance Act provides the broad framework for the insurance sector/industry/services in the country. This section focuses on some important aspects of the framework contained in the Act.

Exhibit 16.1 Insurance Services Organisation in India



Eligibility

Any class of insurance business in India can be carried out only by **(i)** a public company **(ii)** a cooperative society **(iii)** an insurance cooperative society, having paid-up capital of ₹100 crore, in which no body corporate holds more than 26 per cent of its paid-up capital and whose sole purpose is to carry on insurance business in India **(iv)** a body corporate other than a private company incorporated in any country outside India. However, only Indian insurance companies are permitted to carry out any class of insurance business after the enactment of the IRDA Act, 1999. An **Indian insurance company** is defined as a company formed/registered under the

Companies Act, in which the aggregate holding of equity shares by a foreign investor including portfolio investors does not exceed 49 per cent paid-up equity capital, which is Indian owned and controlled in the prescribed manner and whose sole purpose is to carry on life/general/reinsurance/health business. **Control** includes the right to appoint a majority of the directors or to control the management/policy decisions including by virtue of their shareholding/management rights/shareholders agreement/voting agreements. **Life business** means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death (except death by accident only) or the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life, and should be deemed to include **(a)** grant of disability and double/triple indemnity accident benefits, **(b)** grant of annuities upon human life and **(c)** grant of superannuation allowance/benefits payable out of any fund applicable solely to the relief and maintenance of persons engaged; or who have been engaged in any particular profession/trade/employment; or of the dependents of such persons. **General insurance** business is defined to mean fire, marine/miscellaneous insurance business whether carried on singly or in combination with one/more of them. **Fire insurance** business means the business of effecting, other than incidental, to some other class of insurance business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire insurance policies.

Marine insurance business means the business of effecting contracts of insurance upon vessels of any description including cargos, freights and other interests which may be legally insured in or in relation to such vessels, cargos and freights, goods/wares/merchandise/property of whatever description insured for any transit by land or water or both and whether or not including warehouse risks or similar risks in addition or as incidental to such transit, and includes any other risks customarily included among the risks insured in marine insurance policies.

Miscellaneous insurance business means the business of effecting contracts of insurance which is not principally or wholly of any kind/kinds included in fire, life, and marine insurance.

Health insurance business means contracts which provide for sickness/medical/surgical/hospital expenses benefits whether in/out-patient travel/personal accident cover.

Registration

To carry on business, insurance companies should be registered with the IRDA. The application for registration should be made in a manner and accompanied by documents as may be specified by its regulations.

On being satisfied that **(i)** the financial condition and the general character of the management of the applicant are sound; **(ii)** the volume of its business, capital structure and earnings prospects would be adequate; **(iii)** the interests of the general public would be served and **(iv)** it has complied with the provision of **Section 2–C** (eligibility of the applicant discussed earlier), **Section 5** (restriction on name of insurer) and **Section 31-A** (provision relating to managers) and has fulfilled all the requirements of registration applicable to him, may register the applicant and grant a certificate of registration. The IRDA will prefer that applicants carry on life/general insurance business for providing health cover to individuals/groups of individuals. The IRDA may refuse registration for recorded reasons. Within 30 days, and aggrieved party may appeal to the SAT. If satisfied that an insurer having joint venture with a person having its principal place of business outside India/a foreign company engaged in re-insurance business through an Indian branch has been debarred by law/practice of that country to carry on insurance business, the IRDA may withhold registration already made.

Cancellation of Registration The IRDA will suspend/cancel the registration of an insurer if **(i)** he is in liquidation or adjudged an insolvent, **(ii)** he fails to comply with the requirement relating to sufficiency of assets (in terms of excess of assets over liabilities), **(iii)** his business has been transferred to any other person/amalgamated with any other insurer, without the IRDA's approval **(iv)** he defaults in complying with or contravenes any requirement of the Insurance Act/any rule/regulation/order made or direction issued thereunder, **(v)** the IRDA has reasons to believe that any claim on the insurer in India under any insurance policy remains unpaid for three months after final court judgement, **(vi)** he carries on any other business, **(vii)** he defaults in complying with any directions issued/order made by the IRDA, and **(viii)** he fails to pay the required annual fee, and **(ix)** he is convicted for any offence, **(x)** he defaults in complying with the directions/orders of IRDA, and **(xi)** a cooperative society contravenes any provision of the applicable laws.

Payment of Fee The registered insurer(s) have to pay in the IRDA-specified manner the specified annual fee failing which the registration would be liable to be cancelled.

Restriction on Name An insurer cannot be registered in a name identical to that of an existing insurer. The restriction also applies when the name very nearly resembles the existing name to rule out deceipt except when the insurer in existence is in the course of being dissolved and signifies his consent to the IRDA.

Capital Requirement The paid-up equity capital of an insurance company applying for registration to carry on **(i)** life/general/health insurance and **(ii)** reinsurance business should be ₹100 crore and ₹200 crore respectively. The minimum net worth requirement of an insurer is ₹5,000 crore. The capital of life insurance companies should consist of only ordinary shares, each of which has a single face value and other forms of specified capital. The paid-up amount should be the same for all shares. The voting right of every shareholder should be restricted to equity shares. The company should, in addition to register of members, maintain a register of shares containing the name, occupation and address of the beneficial owner of each share, together with any change of beneficial owner within 15 days of declaration. For registering any transfer of share, the transferee should furnish a declaration in the prescribed form stating if he proposes to hold the shares for his own benefit or as a nominee, and address and the extent of beneficial interest of each. In a post-transfer scenario, the IRDA's prior approval would be essential if the holding of the transferee is likely to exceed 5 per cent of the paid-up capital. Similarly, prior approval of the IRDA would be required where the nominal value of shares intended to be transferred by any individual, firm, group, constituents of a group or body corporate under the same management, jointly or otherwise exceeds one per cent of the paid-up capital of the insurance company.

Accounts and Balance Sheet

At the end of each financial year, insurers are required to prepare a balance sheet, a profit and loss account, a separate account of receipts and payments and a revenue account in accordance with the IRDA regulations. They should keep separate accounts relating to the funds of shareholders and policy-holders.

Actuarial Report and Abstract

Every insurer carrying on life insurance business should have an investigation by an actuary into its financial conditions including a valuation of liabilities at least once every year. Depending on the circumstances of a particular insurer, the IRDA may allow him to have the investigation every two years. An abstract of the report of the actuary should be made in the manner specified by the IRDA. A statement in the form and manner specified by the IRDA should be appended to every such abstract at least once every three years.

Investment of Assets

The **assets** of insurers for investment purposes mean all the assets at their carrying value excluding **(i)** assets specifically held against any fund/a portion in respect of which the IRDA is satisfied that it is regulated outside India, **(ii)** miscellaneous expenditure and **(iii)** in respect of which the IRDA is satisfied that its inclusion would not be in the best interest of the insurer. Under Section 27 of the Insurance Act, the assets of all insurers equivalent to **(a)** liabilities to holders of life insurance policies in India on account of matured claims, **(b)** amount required to meet the liability on policies of life insurance maturing for payment in India less premiums due but not paid and loans within the surrender value of policies should be invested in the following manner: **(1)** 25 per cent in Government securities and additional not less than 25 per cent in Government securities/other **approved** securities (i.e., Government/guaranteed fully as regards principal and interest; securities; debentures/other securities issued under the authority of an Act by/on behalf of a port trust/municipal corporation/city improvement trust; shares of a corporation established by law and guaranteed fully by the Government), **(2)** the balance in any approved investments specified by the IRDA regulations. The applicable percentages for general insurance business are 20 per cent and 10 per cent respectively.

The assets specified by the IRDA would be deemed to be approved investments. However, any excess investment made with reference to any foreign currency to meet liabilities in the concerned currency would not be taken into account.

Where an insurer has accepted reinsurance of any life insurance policy issued by another insurer and maturing for payment in India or has ceded reinsurance to another insurer any policy issued by him, the above percentage shares would be increased by the amount of the liability involved in such acceptance and decreased to the extent of the liability involved in the cession.

The Government/other approved securities should be held by the insurer free of encumbrance/charge/hypothecation/lien.

The assets invested by an insurer incorporated/domiciled outside India (i.e., whose one-third capital is owned by, or one-third of members of whose governing body is, domiciled outside India) excluding foreign assets should be held in India in trust for the discharge of liabilities and vested in IRDA-approved resident trustees. The instrument of trust should be executed by the insurer with the IRDA's approval and define the manner in which alone the subject-matter would be dealt with.

Further Provisions Regarding Investments A life insurer can invest up to 15 per cent of his controlled fund in investments other than the approved investments. Such investments should be made with the consent of all the directors present at the meeting and with voting rights, special notice of which has been given to the letter. They should also report to the IRDA about any investments in which any director is interested. An insurer can invest in shares of a banking company or shares/debentures of a company upto the amount specified by the SEBI regulations. Investment in private limited companies is prohibited. All assets forming the controlled fund/assets other than government/other approved securities should be held free of any encumberance/charge/hypothecation/lien. However, 10 per cent of these assets may be offered as security for loan taken for any investment subject to the prescribed conditions/restrictions.

Controlled fund means (a) in case of an insurer carrying on life insurance business (i) all his funds, (ii) all the funds in India pertaining to his life insurance business if he carries on some class of insurance business, (b) in case of any other insurer carrying on life insurance business, (i) all his funds in India, (ii) all the funds in India pertaining to life business if he carries on other class of insurance business excluding any fund/portion in respect of which the IRDA is satisfied that it is regulated outside India/it would not be in the interest insurer to include.

If any of the investments, consisting of an insurer-controlled fund are considered unsuitable/undesirable by the IRDA at any time, the letter may, after hearing the insurer, direct him to realise the investment(s) and he should comply within such time as may be specified by the IRDA. However, moneys relating to the provident fund of an employee/security taken from any employee would be held under the respective Act governing their investments.

Provisions Regarding Investments of Assets of Insurers Carrying on General Insurance Business Under Section 27-B, all their assets would be deemed to invested subject to prescribed conditions in approved investments specified in Section 27 (**discussed above**). They should be held free of any encumbrance/charge/hypothecation/lien. However, subject to the prescribed conditions/restrictions, upto 10 per cent may be offered as a security for loan for investments/payment of claims or kept as security deposit with banks for acceptance of policies.

Investment by Insurer in Certain Cases Under Section 27-C, upto 5 per cent of the controlled fund/assets may be invested, subject to the IRDA-specified conditions, in companies belonging to the promoters.

Manner and Conditions of Investment Under Section 27-D**,** the IRDA may **(i)** in the interest of the policy-holders specify the time, manner and other conditions of investment by insurer, **(ii)** give specific directions applicable to all insurers for the time, manner and other conditions subject to which the policyholders' funds should be invested in the infrastructure and social sectors and **(iii)** after taking into account the nature of business and to protect the interest of the policy-holders, issue directions to insurers relating to time, manner and other conditions of investments provided the latter are given a reasonable opportunity of being heard.

Prohibition for Investment (Section 27-E) The funds of the policyholders are prohibited from being directly/indirectly invested outside India.

Statement and Return of Investments of Assets Every insurer should submit returns giving details of investments in the IRDA-specified form/time/manner including its authentication.

Prohibition of Loans Under Section 29, loans/temporary advances on hypothecation of property/personal security (except loans on life policies within their surrender value) to director/manager/actuary/auditor/officer of the insurer or to any other company/firm in which they hold similar position is prohibited. However, loans to banks and subsidiaries/holding companies with the IRDA's prior approval are permitted. Loans within the surrender value to a director of an insurance company can be granted on the security of a policy issued to him on his own life on which the insurer bears the risk.

Loans specified by the IRDA regulations including those sanctioned as part of salary package of full time employees duly approved by the Board of Directors may be granted by the insurer. Temporary advances upto the maximum renewal commission earned by him during the immediately preceding year may be granted to any insurance agent to facilitate his functions.

Liability of Directors If contravention of any of the provisions relating to investment of assets/ controlled fund contained in Sections 27/27-A/27-B/27-C/27-D or 29 results in loss to the insurer/policyholders, directors/ managers/officers/partners who are knowingly a party to such contravention would, in addition to other penalties under the Insurance Act, be jointly/severally liable to make good the loss.

Keeping Assets of Insurers The assets in India of an insurer, except those required to be vested in trustees, should be kept in the name of the IRDA-approved public officer/in the corporate name of the undertaking (company/cooperative society). However, endorsement in favour of a bank of any security/document solely for collection/realisation of interest/bonus/dividend are permitted.

Insurance Business in Rural/Social Sector

All insurers are required to undertake such percentage of their life/general insurance business, in the rural and social sector as specified by the IRDA. They should discharge their obligations to providing life/general insurance policies to persons residing in the rural sector, workers in the unorganised/informal sector or to economically vulnerable/backward classes of society and other categories of persons as specified by the IRDA.

Power of Investigation/Inspection

The IRDA may conduct an investigation in the affairs of an insurer (including all subsidiaries and branches), intermediary/insurance intermediary by any person(s) or investigating officer, who may employ any auditor or actuary or both for assisting him it. The investigating authority (officer) may also carry out inspection of any insurer and his books of accounts. A copy of the inspection report would be supplied by the investigating authority to the insurer. A manager or an officer of the insurer is duty-bound to produce for investigation all such books of accounts, registers, statements and information in his custody or power as date to the affairs of the insurer within the specified time. The investigating authority may also examine on oath any such manager or officer in relation to the insurer's business. On receipt of the investigation/inspection report, the IRDA may **(i)** require the insurer to take such action as it may think fit or **(ii)** cancel the registration or **(iii)** direct any person to go to court for its winding up. The investigation report may be published in part by the IRDA. It may be specify **(a)** the minimum information to be maintained by the insurers in their books, **(b)** the manner in which such information should be maintained, **(c)** the checks and other verifications to be adopted by insurers in that connection, and **(d)** all other matters incidental thereto as are necessary to enable the investigating authority to carry out its task.

Power to Issue Directions

The IRDA may, from time to time, issue such directions as it deems fit **(i)** in public interest, **(ii)** to prevent the affairs of any insurer being conducted in a manner detrimental to the interest of the policyholders/ insurers, **(iii)** generally to secure the proper management of any insurer, it is necessary to issue directions to insurers generally or to any insurer in particular. The insurers would be bound to comply with such directions.

Control Over Management The appointment, reappointment or termination of managing or fulltime director, manager or chief executive officer (CEO) (by whatever name called) would require prior approval of the IRDA. Any director or CEO may be removed from office by the IRDA **(i)** in public interest, **(ii)** for preventing the affairs of an insurer being conducted in a manner detrimental to the interest of the policyholders, or **(iii)** for securing proper management of the insurer after proposed order.

He would cease to be a director/CEO and should not in any way, directly/indirectly, be concerned with or take part in the management for such period not exceeding five years as specified in the order. However, if in its opinion, any delay is detrimental to the interest of the insurer/his policyholders, the IRDA may, pending consideration of such representation, direct the manager/CEO concerned to not **(i)** act as director/ CEO, **(ii)** in any way, directly/indirectly, be concerned with/take part in management of the insurer. Any contravention would be punishable with a fine of up to ₹1,00,000 for each day of contravention or ₹1 crore whichever is less.

The IRDA may appoint in consultation with the Government a suitable person as additional directors in place of the director/CEO removed from his office who would **(i)** hold office, subject to the pleasure of the IRDA for a period not exceeding three years or such further periods not exceeding three years at a time as specified by it and **(ii)** not incur any obligation/liability by reason only of his being a director/CEO or for anything done/omitted to be done in good faith in the execution of his duties, **(iii)** not be required to hold qualification shares of the insurer.

Appointment of Insurance Agents

An **insurance agent** is an agent who receives/agrees to receive payment by way of commission/other remuneration in consideration of his soliciting/procuring insurance business, including continuance, renewal or revival of policies. An insurer may appoint an insurance agent to solicit/procure insurance business. He can act only for one general/life/health insurer. The IRDA regulations must ensure that no conflict of interest is allowed to arise for any agent in representing two/more insurers.

Qualifications The agent should not **(i)** be minor, **(ii)** have been found of unsound mind by a court of competent jurisdiction, **(iii)** have been found guilty of criminal misappropriation/ breach of trust; or cheating/forgery; or an abatement of, or attempt to, commit any such offence by a court of competent jurisdiction. However, if at least five years have lapsed since the completion of the sentence imposed, the IRDA should ordinarily declare that the conviction of the person would cease to be a disqualification, **(iv)** have not been found in the course of **(a)** any judicial proceeding relating to any insurance policy/winding up of an insurance company **(b)** an investigation of the affairs of an insurer who has been guilty of, or has knowingly participated in or connived against committing fraud/dishonesty/misrepresentation against an insurer/insured. Moreover, they should **(a)** possess the requisite qualification and practical training for a period not exceeding 12 months, **(b)** have passed an examination prescribed by the IRDA, and **(c)** not violate the code of conduct as specified by the IRDA. If an individual or director/partner of a company/firm is unable to fulfill these requirements, the IRDA would, in addition to other penalty to which he may be liable under the Insurance Act, cancel his licence.

Any individual who acts as an agent in contravention of the provisions of the Insurance Act and the insurer who appoints him would be punishable with a fine of up to ₹10,000 and ₹1 crore respectively. The insurer will be responsible for all acts/omissions of the agents including code of conduct and liable to a penalty upto ₹1 crore.

Issue of Registration to Intermediary/Insurance Intermediary

The IRDA or an officer authorised by it issues a registration on payment of the prescribed fee to someone who wants to be an intermediary/insurance intermediary. The period of validity of registration, its renewal eligibility criteria (disqualification), penalty for contravention/violation and issue of duplicate licence are identical to those applicable to insurance agents (as discussed earlier). The IRDA may specify the requirements of their capital, form of business and other conditions.

Surveyors and Loss Assessors

To act as a surveyor/loss assessor, a person should **(a)** possess IRDA-specified academic qualifications under the Insurance Act, **(b)** be a member of the Indian Institute of Insurance Surveyors and Loss Assessors. In the case of a firm/company, all the partners/directors/other persons who may be called upon to make a survey or assess reported loss, should fulfil these requirements. the surveyors/loss assessors should comply with the IRDA-specified regulations in respect of their duties/responsibilities/other professional requirements.

No claim in respect of a loss which has occurred to be paid/settled in India equal to/exceeding an amount specified by the IRDA should be admitted for payment or settled by an insurer unless he has obtained a report on the loss from approved surveyor/loss assessor. However, the insurer would have the right to pay/settle any claim at any amount different from the amount assessed by him. The IRDA may in respect of such a claim call for an independent report from another surveyor/loss assessor within specified/reasonable time and the cost of, incidental to the report, would be borne by the insurer. On receipt of the report, it may issue necessary directions with regard to the settlement of the claim including settlement at a figure less/more than at which it was settled/is proposed to settled. The insurer would be duty-bound to comply with the direction.

Insurers can pay any fee/remuneration for surveying/verifying/reporting on a claim of loss only to approved surveyors/loss assessors. Where the IRDA is satisfied that in case of any class of claims, it is customary to entrust the work of survey/loss assessment to any other person or it is not practicable to make any survey/loss assessment, it may grant exemption from appointment of an approved surveyor/loss assessor.

Reinsurance

Every insurer should reinsure with Indian reinsurers such percentages, not exceeding 30 per cent, of the sum assured on each policy as may be specified by notification in the official gazette after consultation with the Advisory Committee by the IRDA with the previous approval of government. Different percentages may, however, be specified for different classes of insurance. The proportion in which the specified percentage should be allocated among the Indian reinsurers should also be notified. An insurer carrying on fire insurance business may alternatively reinsure such amount out of the first surplus as he thinks fit so that the aggregate premium in any year is not less than the specified percentage of the premium (without taking into account premiums on reinsurance ceded/accepted) in respect of such business during that year. The notification by the IRDA may also specify the terms and conditions in respect of any business of reinsurance which would be binding on Indian and other reinsurers. However, an insurer can reinsure the entire sum assured on any policy/any portion thereof in excess of the percentage specified by the IRDA.

Penalties

Penalties can be imposed for various offences under the Insurance Act as summarised below.

Default in Compliance with/Act in Contravention of the Insurance Act A person who fails to: **(i)** comply with the requirements under the Insurance Act to furnish any document, statement, return, report to the IRDA, **(ii)** comply with its directions, **(iii)** maintain solvency margin, **(iv)** comply with the directions on insurance treaties would be liable to a penalty of up to ₹1 lakh for each such failure or ₹1 crore whichever is less.

Carrying on Business in Contravention of Requirement of Registration The penalty for carrying on insurance business without registration certificate from the IRDA would be a fine upto ₹25 crore and imprisonment upto 10 years.

Penalty for Non-compliance If a person fails to comply with the provisions relating to **(i)** investment of assets, **(ii)** further provisions regarding investments, **(iii)** investment of assets of general insurers, **(iv)** manner/conditions of investments, and **(v)** prohibiting investment of funds outside India, he would be liable to a penalty of up to ₹25 crore.

Wrongfully Obtaining/Withholding Property The penalty for wrongfully obtaining possession of any property/applying to any purpose of the Insurance Act by any managing director/director/manager/other officer/ employee of an insurer would be up to ₹1 crore.

Offences by Companies Where any offence under the Insurance Act has been committed by a company (i.e. body corporate, including a firm and association of persons, or a body of individuals whether incorporated or not), every person who, at the time the offence was committed, was in charge of and responsible to, the company for the conduct of business of the company as well as the company, would be deemed to be guilty and liable to be proceeded against and punished. However, if he proves that the offence was committed without his knowledge or that he had exercised all diligence to prevent the commission of such offence, the person concerned would not be liable to any punishment. Where an offence has been committed by a company with the consent/connivance of or is attributable to any neglect on the part of any director (including partner in a firm and any member controlling the affairs of an association/body of individuals), manager, secretary, or other officer of the company, he/she would be deemed to be guilty and punished accordingly.

Failure to Comply With the provisions of the Insurance Act relating to insurance business in the social sector/rural or unorganised sector and backword classes would invite a penalty of up to a maximum of ₹25 crore.

Power to Call for Information The chairperson of the IRDA (Controller of Insurance) may require any insurer to supply him with any information relating to insurance business within a specified period certified by a principal officer/auditor.

Power of Government to Make Rules

The Government may makes rules to carry out the purpose of the Insurance Act to, *inter-alia*, prescribe:

- **(a)** The manner of ownership of Indian insurance company
- **(b)** The manner to determine which transactions of an insurer are deemed to be insurance business transacted in India
- **(c)** The form incorporating the declaration stating that all amounts received have been shown in the revenue amount
- **(d)** The manner in which the prospectuses and tables would be published and the form in which they would be drawn up
- **(e)** The contingencies on the happening of which money may be paid by provident fund societies
- **(f)** The matters on which provident fund societies would make rules
- **(g)** Fees payable and the manner of their collection
- **(h)** The conditions and the matters which may be prescribed relating to liquidation of a society
- **(i)** The manner of inquiry relating to adjudication
- **(j)** The form in which an appeal may be preferred with the Securities Appellate Tribunal, the fee payable and the procedure for filing/disposing of an appeal
- **(k)** Any other matter which is/may be prescribed

Power of IRDA to Make Regulations

The IRDA may make regulations (listed in the Act) consistent with the Insurance Act/rules/ regulations to carry out its provisions. The IRDA regulations are comprehensively covered in the next Section of the Chapter.

INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY OF INDIA (IRDA)

Following the recommendations of the Malhotra Committee, pending the enactment of a comprehensive legislation, on January 23, 1996, the Government of India to regulate the insurance sector approved the setting up of the interim Insurance Regulatory Authority (IRA) that would replace the controller of Insurance (COI) and be under the overall control of the Ministry of Finance. It had been entrusted with the task of preparing a comprehensive legislation to establish a statutory, autonomous IRA on the pattern of the Securities and Exchange Board of India (SEBI).

Salient Features of Interim IRA

The chairman of the IRA was the ex-officio COI under the Insurance Act, 1938, and exercised all powers vested with the COI. The interim IRA was authorised to examine the powers withdrawn from the COI or modified through government notifications issued from time to time or delegated to the LIC/GIC under nationalising enactments of the insurance business that needed to be restored to the COI. While undertaking this exercise, the IRA had to bear in mind the possibility of privatisation of the insurance industry, wholly/ partially and make appropriate recommendations regarding the role and powers which it would need in such a scenario. It could also examine the powers of the government under the Insurance Act, 1938, which could be transferred to the IRA as and when it would be set up. The government could assign such additional nonstatutory functions as may be considered necessary to the interim IRA to enable it to effectively regulate, promote and ensure the orderly growth of the industry.

Insurance Regulatory and Development Authority of India (IRDA) Act, 1999

In order to provide better insurance cover to citizens and also to augment the flow of long-term sources of financing infrastructure, the government reiterated its announcement of 1996 in its budget speech, 1998, to open up the insurance sector and also set up a statutory IRDA. The IRDA Act was enacted in 1999 to provide for the establishment of the IRDA to protect the interests of policy holders, to regulate, promote and ensure orderly growth of the industry and for matters connected therewith/incidental thereto and also to amend the Insurance Act, 1938, the LIC Act, 1956, and the General Insurance Business (Nationalisation) Act, 1972.

Composition of IRDA The IRDA would consist of a chairperson and not more than nine members of whom not more than five would be full-time members, to be appointed by the government from amongst persons of ability, integrity and standing who have knowledge/experience of life insurance/general insurance/actuarial service, finance/economics/law/accountancy/administration/any other discipline which in the opinion of the government would be useful to it. Between the chairperson and the full-time directors, at least one person each is required to have knowledge/experience of life, general insurance or actuarial science respectively.

Duties/Powers/Functions of IRDA ***Duties*** The duty of the IRDA is to regulate, promote and ensure orderly growth of the insurance and reinsurance businesses.

Powers and Functions The powers and functions of the IRDA, inter-alia, are stated below:

- **(a)** Issue to the applicant a certificate of registration; to renew, modify, withdraw, suspend or cancel such registration; preference in registration to be given to companies providing with health insurance
- **(b)** Protection of the interests of policyholders in matters concerning assigning of policy, nomination by policy-holders, insurable interest, settlement of insurance claim, surrender value of policy, and other terms and conditions of contracts of insurance
- **(c)** Specifying requisite qualifications and practical training for insurance intermediaries and agents
- **(d)** Specifying the code of conduct for surveyors and loss assessors
- **(e)** Promoting efficiency in the conduct of insurance business
- **(f)** Promoting and regulating professional organisations connected with the insurance and reinsurance business; levying fees and other charges for carrying out the purposes of the IRDA Act
- **(g)** Calling for information from, undertaking inspection of, conducting enquiries and investigations, including audit of insurers, insurance, intermediaries and other organisations connected with the insurance business
- **(h)** Control and regulation of the rates, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under Section 64U of the Insurance Act, 1938
- **(i)** Specifying the form and manner in which books of account would be maintained and statement of accounts rendered by insurers and insurance intermediaries
- **(j)** Regulating investment of funds by insurance companies; regulating maintenance of margin of solvency
- **(k)** Adjudication of disputes between insurers and intermediaries or insurance intermediaries (i.e., insurance brokers, reinsurance brokers, insurance consultants, corporate agents, third party administrators, surveyor and loss assessors, other IRDAI-notified entities)

(l) Supervising the functioning of the Tariff Advisory Committee
(m) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to above
(n) Specifying the percentage of life insurance and general insurance business to be undertaken by the insurer in the rural or social sector
(o) Exercising such other powers as may be prescribed

The powers and functions mentioned above would enable the IRDA to perform the role of an effective watchdog and regulator for the insurance sector in India.

Issue of Directions The IRDA would be bound by the directions of the Government on questions of policy, other than those relating to technical and administrative matters, in writing from time to time. The decision of the Government, whether a question is one of policy or not, would be final.

Supersession The government may, by notification and for specified reasons supersede the IRDA for a period not exceeding six months in circumstances specified below and during the period of supersession appoint a person to act as the Controller of Insurance (COI) under the Insurance Act, 1938:
(i) On account of circumstances beyond its control, the IRDA is unable to discharge its functions/ perform its duties
(ii) Persistent default by it in complying with any direction given by the government under the IRDA Act or in discharge of functions/performance of duties imposed on it by/under the provisions of IRDA Act and as a result of such default the financial position of the IRDA has suffered
(iii) Circumstances exist which render it necessary in public interest to do so

Insurance Advisory Committee The IRDA may constitute a 25-member Insurance Advisory Committee (IAC) to represent the interest of commerce, industry, transport, agriculture, consumer fora, surveyors, agents, intermediaries, including brokers, consultants and loss assessors, organisations engaged in safety and loss prevention, research bodies and employees' associations in the insurance sector, to advise it on matters relating to making regulations by it and on such other matters as may be prescribed.

Amendment of LIC Act, 1956 According to this amendment, the exclusive privilege (monopoly) of the LIC ceases so as to enable other Indian insurance companies to do life insurance business. An Indian insurance company is a company registered under the Companies Act, **(i)** in which the aggregate equity holdings of a foreign company as defined in Section 2(23-A) of Income-tax Act, 1961, by itself or through subsidiaries/nominees does not exceed 26 per cent of the paid-up capital, and **(ii)** whose sole purpose is to carry on general/life business.

Amendment of General Insurance Business (Nationalisation) Act, 1972 The amendment provides that the exclusive privilege (monopoly) of the GIC and its four subsidiaries would cease and the other Indian insurance companies can carry on non-life insurance business.

Amendments to Insurance Act, 1938 To update certain outdated provisions and for an efficient and smooth regulation of the opened up insurance sector, consequential amendments have been introduced in the Insurance Act. The main provisions relating to these amendments are listed below.

Transfer of Powers All the powers of the erstwhile COI under the IRDA Act are transferred to, and are now vested with, the IRDA.

Delegation of Powers The powers of the central government relating to the undermentioned activities/operations of insurance companies have been delegated to the IRDA.

- Investment of assets including additional provisions (Sections 27, 27-A and 27-B)
- Maintaining the assets of insurers (Section 31)
- Prohibition of common officers and requirements as to whole-time officers (Section 32-A)
- Limitation of expenditure on commission (Section 40-A)
- Provisions regarding directors (Section 48-B)
- Executive committees of the Life Insurance/General Insurance Councils (Section 64-F), resignation and filling of casual vacancies (64-G), powers of executive committees of the Life Insurance Council to hold examinations of insurance agents (64-1), functions of executive committees of Life Insurance Council (64-J), functions of the executive committee of the General Insurance Council (64-L), general powers of Life Insurance/General Insurance Councils (64-R), powers of advisory committees to regulate rates, advantage, terms and conditions (64-UC), and licensing of surveyors and loss assessors (64-UM)
- Acquisitions of surrender values by policy-holders (Section 113)
- Alteration of forms (Section 115)

Other Provisions/Amendments In addition to the above, some important amendments in the Insurance Act provide for the following.

Section 2-C (Prohibition of Transaction of Insurance Business) On or after the commencement of the IRDA, only Indian insurance companies can carry out any class of insurance business in India.

Section 3 (Registration)

(i) Every application for registration to carry on insurance business should be made in such manner as may be determined by regulations made by the IRDA; preference in registration would be given to companies providing health insurance

(ii) The registration fee would be determined by the IRDA regulations not exceeding ₹50,000 for each class of business

(iii) Registration can be cancelled if the insurer defaults in complying with or acts in contravention of any requirement of: **(a)** the Insurance Act or any rule/regulation/order made or any directions issued under it; **(b)** the Companies Act, LIC Act, General Insurance Business (Nationalisation) Act and Foreign Exchange Regulation (Management) Act; and **(c)** directions made/issued by the IRDA under the IRDA Act

(iv) The cancelled registration can be revived if the IRA is satisfied, inter alia, that the insurer has complied with any requirement of the Insurance Act or the IRDA Act or of any rule/regulations/order made or directions issued under these Acts,

(v) The IRA may suspend/cancel any registration in such manner as may be determined by the regulations made by it

(vi) The IRA may, on payment of fee not exceeding ₹5,000 as may be determined by the regulations, issue a duplicate certificate of registration to replace a certificate lost/destroyed/mutilated or in any other case where the IRDA is of the opinion that the issue of duplicate certificate is necessary

Section 3-A (Renewal of Registration) An insurer, who has been granted a certificate of registration, should have the registration renewed annually with each year ending on March 31 after the commencement of the IRDA Act. The application for renewal should be accompanied by a fee as determined by IRDA regulations, not exceeding one-fourth of one per cent of the total gross premium income in India in the preceding year or ₹5 crore or whichever is less, but not less than ₹50,000 for each class of business.

Section 6 (Requirements as to Capital) The minimum paid-up equity capital (excluding required deposits with the RBI and any preliminary expenses in the formation/registration of the company) requirement of an insurer would be ₹100 crore to carry on life/general insurance business and ₹200 crore to exclusively do reinsurance business.

Section 6-A (Requirements as to Capital Structure/Voting Rights/Registers of Beneficial Owners) Prior approval of the IRDA is must in the case of transfer of shares, where after transfer, the total paid-up holding of the transferee in the shares of the company is likely to exceed 5 per cent of its paidup capital and 2.5 per cent if the transferee is a banking/investment company. The IRDA's okay is also essential where the nominal value of the shares to be transferred by any individual/firm/group/constituents of a group/body corporate under the same management jointly or severally exceeds 1 per cent of paid-up capital of the insurer.

Section 6-AA (Divesting of Excess Shareholding) A promoter cannot hold more than 26 per cent or such other percentage as may be prescribed of the paid-up capital in an Indian insurance company. If, however, the promoters hold more than 26 per cent of the paid-up capital where an Indian company starts insurance business, they would have to divest the excess in a phased manner after a period of 10 years from the date of commencement of business or within such period as may be prescribed by the government. The manner and procedure for divesting the excess share capital would be specified by IRDA regulations. However, if the promoters are a foreign company, FIIs, NRIs/OBCs they will not be allowed to hold more than 26 per cent under any circumstance.

Section 7 (Deposits) Every insurer in India has to keep a deposit in respect of the insurance business with the RBI for and on behalf of the government in cash/approved securities estimated at the market value on the day of deposit. This is 1 per cent and 3 per cent of his total gross premium written in India in any financial year but not exceeding ₹10 crore in case of life insurance and general insurance businesses, respectively. In case of reinsurance business, the deposit requirement is ₹20 crore.

Section 27-C (Investment of Funds Outside India) The funds of policy-holders cannot be invested by insurers outside India.

Section 27-D (Manner and Conditions of Investment) In addition to the requirements of Sections 27, 27-A and 27-B, the IRDA may, in the interest of the policy-holders, specify the time, manner and other conditions of investment of assets held by an insurer for the purpose of the Insurance Act. Taking into account the nature of business and to protect the interest of the policy-holders, the IRDA may also issue directions to insurers relating to the time, manner and other conditions of investment of assets held by them.

Section 31-B (Power to Restrict Payment of Excessive Remuneration) The IRDA may issue appropriate direction to insurers who are paying remuneration by way of commission or otherwise on a scale disproportionate to normal standards prevailing in insurance business/resources of the insurer. The insurer has to comply with these directions within six months. Every insurer should, before the close of the month following every year, submit to it a statement in the form as specified by the IRDA in its regulations of remuneration paid to any person in excess of ₹5,000 in that year.

Section 32-B (Insurance Business in Rural/Social Sector) After the commencement of the IRDA Act, 1999, every insurer would have to undertake such percentage of life/general insurance business in the rural/ social sector as may be specified by the IRDA in this behalf. It is mandatory for the new companies to meet the obligations relating to the rural and unorganised sector.

Section 33 (Power to Investigation/Inspection) The IRDA may, at any time, order in writing a person as investigating authority to investigate the affairs of any insurer and report to it.

Section 40-A (Limitation of Expenditure on Commission) No person can pay to an insurance agent remuneration by way of commission an amount exceeding 15 per cent of the premium payable on the policy relating to fire/marine/miscellaneous insurance.

Section 102 (Penalty for Default) If any person required under the Insurance Act/rules/regulations fails to: **(i)** furnish any document/statement/account/return/report to the IRDA, **(ii)** comply with its directions, **(iii)** maintain solvency margin, **(iv)** comply with directions on the insurance treaties would be liable to a penalty of up to ₹25 lakh for each such failure and punishable with fine.

Section 103 (False Statement) If a person makes a false statement/furnishes any false document, statement, account, return or report knowingly or does not believe to be true, he would be: **(i)** liable to a penalty up to ₹25 lakh for each such failure; and **(ii)** punishable with imprisonment which may extend to three years or with fine for each such failure.

Section 104 (Penalty for Non-compliance) The penalty for non-compliance of the provisions of the Insurance Act relating to investment of assets is ₹25 lakh for each failure.

Section 105 (Wrongly Obtaining/Withholding Property) The penalty for each failure by any director/ managing director/manager/other officer(s)/employee(s) of an insurer wrongfully obtaining possession of any property or applying to any purpose of the Insurance Act would be up to ₹25 lakh.

Section 105-B (Failure to Comply) If an insurer fails to comply with the provisions of Section 32-B relating to insurance business in the rural/social sector, he would be liable to a penalty up to a maximum of ₹25 lakh for each such failure. He would also be punishable with imprisonment up to three years or with fine.

Section 114-A (Power to Make Regulations) The IRDA may make regulations consistent with the Insurance Act/rules/regulations to carry out its provisions to provide, in particular, for all or any of the following:

(i) Matters relating to registration of insurers

(ii) The manner of suspension or cancellation of registration

(iii) Such fee, not exceeding ₹5,000, as may be determined by the regulations for the issue of a duplicate certificate of registration

(iv) Matters relating to renewal of registration

(v) The manner and procedure for divesting excess share capital

(vi) Preparation of the balance sheet, profit and loss account and a separate account of receipt and payments and revenue account

(vii) The manner in which an abstract of the report of the actuary is to be specified

(viii) The form and the manner in which the statement of business in force should be appended

(ix) The time, manner and the other conditions of investment of assets held by an insurer

(x) The minimum information to be maintained by an insurer in their books, the manner in which such information should be maintained, the checks and other verifications to be adopted by insurers in that connection and all other matters incidental thereto

(xi) The manner of making an application, the manner and the fee for issuing a licence to act as an insurance agent

(xii) The fee and the additional fee to be determined for renewal of licence of an insurance agent

(xiii) The requisite qualifications and practical training to act as an insurance agent

(xiv) The passing of examination to act as an insurance agent

(xv) The code of conduct of an insurance agent

(xvi) The fee not exceeding ₹50 for the issue of a duplicate licence

(xvii) The manner and the fees for the issue of a licence to any intermediary or an insurance intermediary

(xviii) The fee and the additional fee to be determined for the renewal of licence of intermediaries or insurance intermediaries

(xix) The requisite qualifications and practical training of intermediaries or insurance intermediaries

(xx) The examination to be passed to act as an intermediary or insurance intermediary

(xxi) The code of conduct for an intermediary/insurance intermediary

(xxii) The fee for the issue of a duplicate licence

(xxiii) Such matters as relating to the Tariff Advisory Committee

(xiv) Matters relating to the licensing of surveyors and loss assessors, their duties, responsibilities and other professional requirements

(xxv) Such other asset or assets as may be specified for evaluating the purposes of ascertaining sufficiency of assets

(xxvi) The valuation of assets and liabilities

(xxvii) Matters relating to the sufficiency of assets

(xxviii) Matters relating to reinsurance

(xxix) Matters relating to the redressal of grievances of policy-holders to protect their interest and to regulate, promote and ensure orderly growth of the insurance industry

(xxx) Any other matter which is to be, or may be, specified by the IRDA regulations or in respect of which provisions are to be made or may be made by the regulations.

IRDA REGULATIONS

The IRDA regulations covered in this Section are:

- **(i)** Rural/social sector obligations
- **(ii)** Insurance advertisement and disclosures
- **(iii)** Licensing of insurance agents
- **(iv)** General insurance –reinsurance
- **(v)** Appointed actuary
- **(vi)** Asset, liabilities and solvency margins
- **(vii)** Registration of Indian insurance companies
- **(viii)** Investment norms
- **(ix)** Preparation of financial statements and auditors reports
- **(x)** Third party administrators
- **(xi)** Protection of policyholders interest
- **(xii)** Corporate/Composite corporate agents
- **(xii)** Insurance brokers
- **(xiv)** Distribution of surplus funds
- **(xv)** Life insurance-reinsurance
- **(xvi)** Insurance surveyors and loss assessor
- **(xvii)** Micro-insurance.
- **(xviii)** Corporate Governance Guidelines
- **(xix)** Issuance of Capital by Life Insurance Companies
- **(xx)** General Insurance-Reinsurance
- **(xxi)** Health Insurance
- **(xxii)** Issue of Capital by General Insurance Companies
- **(xxiii)** Licensing of Banks and Insurance Brokers
- **(xxiv)** Life-Insurance—Reinsurance
- **(xxv)** Linked Insurance Products
- **(xxvi)** Non-linked Insurance Products

Rural/Social Sector Obligations

The rural and social sector obligations of **(1)** new and **(2)** existing insurers are discussed below:

New Insurers Every new insurer, for the purposes of Sections 32-B and 32-C of the Insurance Act, has to undertake during the first five financial years the following obligations pertaining to persons in **(a)** rural and **(b)** social sectors.

Rural Sector The rural sector means the places/areas classified as rural by the population census of India. The percentages in respect of a life insurer and general insurer in the rural sector are specified below:

Life Insurer Of the total policies written in that year, **(i)** first financial year, 7 per cent, **(ii)** second financial year, 9 per cent, **(iii)** third financial year, 12 per cent, **(iv)** fourth financial year, 14 per cent **(v)** fifth financial year, 16 per cent., and **(iv)** sixth year, 18 per cent.

General Insurer The percentage share in the first two financial years should be 2 and 3 per cent respectively and thereafter 5 per cent of total gross premium income written direct in that year.

Social Sector The **social sector** includes unorganised sector, informal sector, economically vulnerable or backward classes (i.e. persons below the poverty line) and other categories of persons [i.e. persons with disability as defined in the Persons with Disabilities (Equal Opportunities, Protection of Rights and Full Participation) Act and who may not be gainfully employed and also includes guardians who need insurance to protect spastic persons/persons with disability.]

The unorganised sector includes self-employed workers such as agricultural labourers, bidi workers, brick-kiln workers, carpenters, cobblers, construction workers, fishermen, hamals, handicraft artisans, handloom and khadi workers, lady tailors, leather and tannery workers, papad makers, powerloom workers, physically disabled self-employed persons, primary milk producers, rickshaw pullers, safai karamcharis, salt growers, sericulture workers, sugarcane cutters, tendu leaf collectors, toddy tappers, vegetables vendors, washerwomen, working women in the hills or such other categories. Included in the informal sector are small scale, self-employed workers typically at low level of organisation and technology, with the primary objective of generating employment and income with heterogeneous activities like retail trade, transport, repairs and maintenance, construction, personal and domestic services, and manufacturing with the work mostly labour-intesive having often unwritten and informal employee-employer relationship. All categories of insurers are obliged to insure 5, 7, 10,15, 20 and 25 thousand lives in the first 6 financial years respectively. However, where an insurance company is in operation for more than 6 months in a financial year, no rural/social sector obligations would be applicable and the annual obligations would be reckoned from the next financial year (i.e. the first full year of operation). Where an insurance company commences cooperation in the first half of the financial year, the applicable obligations for the first year would be 50 per cent of the annual obligation. However, in the case of general insurers, these obligations would also include crop insurance.

Every new issuer should ensure that he undertakes the following obligations during the sixth financial year of operations: **(i)** in respect of life insurers, 18 per cent of the total policies written direct would be in the rural sector, **(ii)** in case of non-life insurance, 5 per cent of the total gross premium income written direct should be in the rural sector, and **(iii)** 25,000 new lives should covered in the social sector in respect of all insurers.

Obligations After the Sixth Financial Year: **(a) Rural Sector: (i)** in respect of life insurer, of the total written direct in that year, 18 per cent, 19 per cent and 20 per cent in the 7th, 8th, 9th, and 10th year and beyond respectively, **(ii)** in respect of general insurer, of the total gross premium income written direct in that year, 5 per cent, 6 per cent and 7 per cent in the 7th, 8th and 9th and 10th financial years and beyond respectively; **(b) Social Sector**: in respect of all insurers, 25,000, 35,000, 45,000 and 55,000 lines in 7th, 8th, 9th and 10th financial year and beyond respectively.

Existing Insurers The obligations of existing insurers (i.e. the LIC and GIC) would be decided by the IRDA in consultation with them but the quantum of insurance business to be done pertaining to rural and social sectors would not be less than what has been recorded by them for the accounting year ended March 31, 2002. The IRDA would review the quantum periodically and give directions to them for achieving the specified targets.

The obligations towards the rural/social sectors from the financial year 2007-08 to 2009-10 and beyond are as follows:

(a) **LIC**: The rural sector obligations are 24 per cent (2007-08) and 25 per cent (2008-09, 2009-10 and beyond, of the total policies written in that year. The social sector obligations are 20 lakh lives in the financial year 2007-08 and beyond.

(b) General Insurers: **(a) Rural Sector:** 6 per cent and 7 per cent of the total gross premium income written direct in that year respectively in 2007-08 and 2008-09 and beyond; **(b) Social Sector:** For the financial years 2008-09 and 2009-10 and beyond, the obligations would increase by 10 per cent over the previous year(s).

The term '**lives**' refer to human lives insured as at the end of each financial year. The re-insurance premium should not be included while calculating the obligations of the insurers in respect of the rural and social sectors. The IRDA may prescribe/revise these obligations from time to time. The compliance with these obligations towards the rural/social sectors should be based on the sale of products in a way that the stipulations as to the minimum amount of cover as laid down in the IRDA Micro-Insurance Regulations. Every insurer should submit a return to the IRDA disclosing the level of compliance during the year in respect of these obligations.

Insurance Advertisement and Disclosure

An **insurance advertisement** means/includes any communication directly/indirectly related to an insurance policy and intended to result in the eventful sale/solicitation of a policy from public. It includes all forms of printed/published materials or any material using the print and/or electronic medium for public communication such as **(i)** newspapers, magazines and sales talk; **(ii)** bill boards, hoardings, panels; **(iii)** radio, television, website, e-mail, portals; **(iv)** representations by intermediaries; **(v)** leaflets; **(vi)** description literature/ circulars; **(vii)** sales and flyers; **(viii)** illustrations from letters; **(ix)** telephone solicitations; **(x)** business cards; **(xi)** videos; **(xii)** faxes; **(xiii)** any other communication with a prospect (i.e. any party that enters/ proposes to enter into an insurance contract directly or through an insurance intermediary)/policy-holder who urges him to purchase/renew/increase/retain/modify a policy.

However, the following would not constitute an advertisement: **(i)** materials used by an insurance company within its own organisation and not meant for distribution to public; **(ii)** communication with policy-holders other than materials urging them to purchase/increase modify/surrender/retain a policy; **(iii)** material used solely for training, recruitment and education of an insurer's personnel, intermediaries, counsellors, solicitors; and **(iv)** any general announcement by a group policy-holder to members of the eligible group that a policy has been written/arranged. The insurance advertisement and disclosure requirements (regulations) by the IRDA are briefly analysed in this section

Compliance and Control Every insurer/intermediary/insurance agent should comply with the following:

(a) Have a compliance officer to oversee the advertising programme. His name and official position in the organisation should be communicated to the IRDA

(b) Establish and maintain a system of control over the content, form and method of dissemination of all advertisements concerning its policies

(c) Maintain a register at its corporate office which must include **(i)** a specimen of every advertisement disseminated/issued or a record of any broadcast/telecast and so on, **(ii)** a notation attached to each advertisement indicating the manner, extent of distribution and form number of any policy advertised

(d) Maintain a specimen of all advertisements for a minimum of three years

(e) File a copy of each advertisement with the IRDA as soon as it is first issued together with **(i)** an identification number for the advertisement, **(ii)** the form number(s) of the policy(ies) advertised and when the products were approved by the IRDA, **(iii)** a description of the advertisement and how it is used and **(iv)** the method/media used for dissemination of advertisement

(f) File a certificate of compliance with their annual statement to the effect that, to the best of its knowledge, the advertisements disseminated by the insurer/its intermediaries during the preceding year comply with the IRDA regulations and the advertisement code in terms of the recognised standards of professional conduct as prescribed by the Advertisement Standard Council of India (ASCI).

The advertisement register would be subject to inspection and review by the IRDA for content/ context/ prominence and position of required disclosures, omissions of required information and so on.

Changes in Advertisement Any change in an advertisement would be considered a new advertisement and all the provisions of regulations discussed above relating to an advertisement would apply mutatis mutandis to a change in an advertisement. The IRDA should be informed at the time of filing the advertisement of the extent of change in the original advertisement.

Insurance Company Advertisements Every insurance company is required to promptly disclose in the advertisement and that part of the advertisement which is to be returned to the company/ insurance intermediary/agent by any party that enters/proposes to enter into an insurance contract directly/through an insurance agent (i.e. prospect) or the insured the full particulars of the insurance company and not merely any trade name/monogram/logo. Where benefits are more than briefly described, the form number of the policy and the type of coverage should also be disclosed fully.

Advertisements by Insurance Agents All advertisements by insurance agents affecting an insurer must have its prior written approval from the insurance company. While granting approval, the insurer must ensure that all advertisements pertaining to it/ its products/its performance comply with the IRDA regulations and are not deceptive/misleading.

An unfair/misleading advertisement means/includes any advertisement that **(i)** fails to clearly identify the product as insurance; **(ii)** makes claims beyond the ability of the policy to deliver or beyond the reasonable expectation of performance; **(iii)** describes benefits that do not match the policy provisions; **(iv)** uses words or phrases in a way which hides or minimises the costs of the hazard insured against or the risks inherent in the policy; **(v)** omits to disclose or discloses insufficiently important exclusions, limitations and conditions of the contract; **(vi)** gives information in a misleading way; **(vii)** illustrates future benefits on assumptions which are not realistic nor realisable in the light of the insurer's current performance; **(viii)** does not guarantee the benefits nor says so as explicitly as stating the benefits or says so in a manner or form that it could remain unnoticed; **(ix)** implies a group or other relationships like sponsorship, affiliation or approval that does not exist; and **(x)** makes unfair or incomplete comparisons with products which are not comparable or disparages competitors.

However, written prior approval of the issuer need not be acquired for **(i)** advertisements developed by the insurer and provided to the agent; **(ii)** generic advertisements limited to information such as the agent's name, logo, address and phone number; and **(iii)** advertisements that consist only of simple and correct statements describing the availability of the lines of insurance, references to experience, service and qualifications of agents but making no reference to specific policies, benefits, costs or insurers.

Advertisement by Insurance Intermediaries Only properly licensed intermediaries are permitted to advertise/solicit insurance through advertisements.

Advertising on the Internet Every insurer or intermediary's website or portal should **(i)** include disclosure statements which outline the site's specific policies vis-a-vis the privacy of personal information for the protection of both their own business and the consumer they serve; and **(ii)** display their registration/licence number on their websites.

For the purposes of these regulations, except where otherwise specifically excluded or restricted, no form or policy otherwise permissible for use would be deemed invalid or impermissible if such form or policy accurately reflects the intentions of the parties as published or transmitted electronically between them.

Identity of Advertisers Every advertisement for insurance should state **(i)** clearly and unequivocally that insurance is a subjectmatter of solicitation; and **(ii)** the full registered name of the insurer/intermediary/insurance agent.

Endorsement and Other Third Party Involvement A third party, group or association should not:

- Distribute information about an insurance policy, intermediary or insurer on its letterhead
- Allow an insurance intermediary/insurer to distribute information about an insurance policy, insurance or insurance company on its letterhead
- Distribute information about an individual insurance policy, or about an intermediary or insurer in its envelopes, unless **(a)** the third party is providing only a distribution service for the insurance advertisement and is not itself soliciting the coverage, and **(b)** the insurance information is a piece separate from any other information distributed by the third party and clearly indicates its origin
- Recommend that its members purchase specific insurance products
- Imply that a person must become a member of its organisation to purchase the policy
- Imply that a purchaser of a policy, by becoming a member of a limited group of persons, would receive special advantages from the insurer not provided for in the policy.

A third party, group or association may, however, **(i)** enclose an insurance company's or intermediary's product and provide truthful statements, quotes, and testimonials endorsing the insurance products to the insurance company for use in the company's advertisements. The condition is that the language does not convey directly or indirectly a recommendation that members of the organisation purchase the products.

Procedure for Action in Case of Complaint If an advertisement is not in accordance with these regulations, the IRDA may make action in one or more of the following ways:

(i) Issue a letter to the advertiser seeking information within a specific time, not exceeding 10 days from the date of issue of the letter

(ii) Direct the advertiser to correct or modify the advertisement already issued in a manner suggested by the IRDA, with a stipulation that the corrected or modified advertisement would receive the same type of publicity as the earlier one

(iii) Direct the advertiser to discontinue the advertisement forthwith

(iv) Any other action deemed fit by the IRDA, keeping in view the circumstances of the case, to ensure that the interests of the public are protected

The advertiser may seek additional time from the IRDA to comply with the directions justifying the reasons there for. It may, however, refuse to grant such extension if it feels that the advertiser is seeking time only to delay the matter. Any failure on the part of the advertisers to comply with the IRDA directions may entail it to take such action as deemed necessary, including levy of penalty.

Adherence to Advertisement Code Every insurer or intermediary should follow recognised standards of professional conduct as prescribed by the Advertisement Standards Council of India (ASCI) and discharge its functions in the interest of the policyholders.

Statutory Warning Every proposal for an insurance product must carry the following stipulation, as prescribed in Section 41 of the Insurance Act, 1938: **"No person shall allow or offer to allow, either directly or indirectly, as an inducement to any person to take out or renew or continue an insurance in respect of any kind of risk relating to lives or property in India, any rebate of the whole or part of the commission payable or any rebate of the premium shown on the policy, nor shall any person taking out or renewing or continuing a policy accept any rebate, except such rebate as may be allowed in accordance with the published prospectus or tables of the insurer."** If any person fails to comply with the above, he would be liable to payment of a fine which may extend to ₹500.

Appointment of Insurance Agents Regulations 2016

The main elements of these regulations are: appointment of insurance agents, insurance agency examination, code of conduct, right to inspect, suspension/cancellation of appointment and general conditions of appointment.

Appointment of Insurance Agents An applicant seeking appointment as an insurance agent should submit an application in the prescribed form to the designated official of the insurer. **Insurance agent** means an individual appointed for soliciting/procuring insurance business including business relating to a continuance/renewal/revival of insurance policies. **Designated official** is an officer appointed by the insurer to make appointment of an individual as an insurance agent. The designated official would satisfy himself that the applicant has/does **(a)** furnished the prescribed agency application complete in all respects; **(b)** submitted the PAN details, **(c)** passed the specified insurance examination, **(d)** not suffer from any of the disqualifications, **(e)** the requisite knowledge to solicit and procure insurance business; and capable of providing the necessary service to the policyholder. The IRD may exempt, on fulfilment of certain conditions, one or more of the above conditions for applicants to be appointed to distribute only particular type insurance product(s) having fixed premium and/or benefits such as motor third party insurance.

The designated official should exercise due diligence in verifying the agency application and ascertaining that the applicant does not hold agency appointment for more than one life/general/health insurer and one each of the **mono-line insurers** (i.e. an insurer carrying on one particular specified line of business such as agricultural insurance/export credit guarantee business and is not in the centralised list of **black-listed agents** (i.e. list of agent maintained by the IRDA whose appointment is cancelled/suspended by a designated official of an insurer on ground of violation of code of conduct and/or fraud).He should also verify the centralised list of **(a)** agents maintained by the IRDA containing all details of agents appointed by all insurer with PAN number of the applicant to ascertain the above information, **(b)** black-listed agents maintained by the IRDA to ascertain that the applicant is not black listed. On satisfying himself that the applicant has complied with all the stipulated conditions and also does not suffer from any disqualification, may process the agency application and grant appointment as an insurance agent by issuing an appointment letter within 15 days of receipt of all the documents. He should allot an agency code number to the appointed agent prefixed by the abbreviation of the insurer's name. He may refuse/reject an application if he/she feels that the grant of appointment may be against public interest.

The agency appointment letter should lay down the terms of appointment covering all conditions governing appointment and functioning of the applicant as insurance agent and the specified code of conduct. The letter of appointment should be dispatched not later than 7 days after the appointment of the agent. The appointed applicant as an insurance agent should be provided an identity card, by the insurer to identify the agent with the insurer whom he/he is representing as an agent. The designated official should enter and update the agency data of the applicant appointed as an insurance agent in the agency portal maintained by the IRDA through online mode immediately after his/her appointment. The online updation of agency database records by the insurer is to maintain the updated centralised list of agents maintained by the IRDA. The designated official would be responsible to ensure that the centralised list of agents is up to date and accurate. He may refuse to grant agency appointment to any applicant if he does not fulfil any of the specified conditions. He should communicate the reasons for refusal for appointment as agent to the applicant in writing, within 21 days of receipt of the application. An applicant who is aggrieved by the decision of the designated official, may submit a review application to the appellate officer designated by the insurer for review of the decision. He should consider the application and communicate the final decision in writing within 15 days of receipt of the review application.

Appointment of Composite Insurance Agent An applicant seeking appointment as composite insurance agent should make an application to the designated official of the respective life, general, health insurer or mono-line insurer, in the prescribed composite agency application form. They should deal with the application in the manner and procedure outlined above. A **composite insurance agent** means an individual appointed as insurance agent by two/more insurers subject to the condition that he would not act as an agent for more than one life/general/health insurance and one each of mono-line insurers.

Insurance Agency Examination An applicant should pass in the insurance agency examination conducted by the examination body in the subjects of life, general, health insurance as per the syllabus prescribed by the IRDA to be eligible for appointment as an insurance agent. The insurer should provide the necessary assistance and guidance to the candidates to equip them with adequate insurance knowledge required to qualify in the agency examination. The applicant who has successfully passed the insurance agency examination should be issued a pass certificate by the examination body, which would be in force for 12 months, for the purpose of seeking appointment as an agent with any insurer for the first time. Only candidates who have qualified in the insurance agency examination and who hold a valid pass certificate issued by the examination body would be eligible to be considered for appointment as agents.

Disqualification to Act as an Insurance Agent The conditions for disqualification would be as stipulated under Section 42(3) of the Insurance Act **(discussed in Section of the Chapter 1).**

Code of Conduct Every agent should adhere to the code of conduct specified below.

- Every insurance agent should **(i)** identify himself and the insurer of whom he is an insurance agent; **(ii)** show the agency identity card to the prospect, and also disclose the agency appointment letter to the prospect on demand; **(iii)** disseminate the requisite information in respect of insurance products offered for sale by his insurer and take into account the needs of the prospect while recommending a specific insurance plan; **(iv)** where the insurance agent represents more than one insurer offering the same line of products, he should dispassionately advice the policyholder on the products of all insurers and the product best suited to the specific needs of the prospect; **(v)** disclose the scales of commission in respect of the insurance product offered for sale, if asked by the prospect; **(vi)** indicate the premium to be charged by the insurer for the insurance product offered for sale; **(vii)** explain to the prospect the nature of information required in the proposal form by the insurer, and also the importance of disclosure of material information in the purchase of an insurance contract; **(viii)** bring to the notice of the insurer every fact about the prospect relevant to insurance underwriting, including any adverse habits or income inconsistency of the prospect, within the knowledge of the agent, in the form of a report called **Insurance Agent's Confidential Report** along with every proposal submitted to the insurer wherever applicable, and any material fact that may adversely affect the underwriting decision of the insurer as regards acceptance of the proposal, by making all reasonable enquiries about the prospect; **(ix)** obtain the requisite documents at the time of filing the proposal form with the insurer, and other documents subsequently asked for by the insurer for completion of the proposal; **(x)** advise every prospect to effect nomination under the policy; **(xi)** inform promptly the prospect about the acceptance or rejection of the proposal by the insurer; **(xii)** render necessary assistance and advise to every policyholder introduced through him/her on all policy servicing matters including assignment of policy, change of address or exercise of options under the policy or any other policy service, wherever necessary; **(xiii)** render necessary assistance to the policyholders/claimants/beneficiaries in complying with the requirements for settlement of claims by the insurer.

- No insurance agent should **(a)** Solicit/procure insurance business without being appointed by the insurer; **(b)** induce the prospect to **(i)** omit any material information **(ii)** submit wrong information in the proposal form/documents submitted to the insurer; **(c)** resort to multilevel marketing for soliciting and procuring insurance policies and/or induct any prospect/policyholder into a multilevel marketing scheme; **(d)** behave in a discourteous manner with the prospect; **(e)** interfere with any proposal introduced by any other insurance agent; **(f)** offer different rates, advantages, terms and conditions other than those offered by his insurer; **(g)** demand/receive a share of proceeds from the beneficiary under an insurance contract; **(h)** force a policyholder to terminate the existing policy and to effect a new policy from him within three years from the date of the termination of the earlier policy; **(i)** apply for fresh agency appointment to act as an insurance agent, if his appointment was earlier cancelled by the designated official, before five years from the date of the cancellation; **(j)** become or remain a director of any insurer.
- Every insurance agent should, with a view to conserve the insurance business already procured through him, make every attempt to ensure remittance of the premium by the policyholders within the stipulated time, by giving notice to the policyholder orally and in writing.
- Any person who acts as an insurance agent in contravention of the provisions of the Insurance Act/regulations would be liable to a penalty which may extend to ₹10,000 and any

insurer/any person acting on his behalf, who appoints any person as an insurance agent not permitted to act/transact any insurance business in India through him would be liable to penalty which may extend to one crore rupees.

- The insurer would be responsible for all acts and omissions of its agents including violation of code of conduct and would be liable to a penalty which may extend to one crore rupees.

Right to Inspect The IRDA may appoint its officers as an investigating officer to undertake inspection of affairs of an insurance agent, to ascertain and see whether the business is carried on by him/her as per the Insurance Act/regulations and the instructions issued by it and also to inspect his books of account, records and documents.

The investigating officer may, during the course of the inspection, examine on oath the insurance agent/any person who is found to be in possession/control of books, accounts/other documents, and any statement made by the insurance agent/person during the examination may thereafter be used as evidence in any proceedings. The IRDA may also call for any information from the insurance agent which should be submitted within the specified limit time. The purpose of inspection may include but are not limited to: **(a)** monitoring compliance with the provisions of the Insurance Act/regulations etc. **(b)** investigation of complaints of serious nature received from any insured/insurers/other stakeholder/other individual on any matter having a bearing on his insurance-related activities; and **(c)** investigating into the affair of the insurance agent in the interest of orderly development of insurance business/in protection of policyholders' interest.

Suspension of Appointment of an Agent The appointment of an agent may be cancelled/suspended after due notice and after giving him/her a reasonable opportunity of being heard if he/she: **(a)** violates the provisions of the Insurance/IRDA Act/rules/regulations; **(b)** attracts any of the specified disqualifications; **(c)** fails to comply with the stipulated code of conduct and directions issued by the IRDA; **(d)** violates terms of appointment; **(e)** fails to furnish any information relating to his/her activities as an agent as required by the insurer or the IRDA; **(f)** fails to comply with the directions issued by the IRDA; **(g)** furnishes wrong/false information/conceals or fails to disclose material fact in the application submitted for appointment of insurance agent or during the period of its validity; **(h)** does not submit periodical returns as required by the insurer/IRDA; **(i)** does not co-operate with any inspection/enquiry conducted by the IRDA; **(j)** fails to resolve the complaints of the policyholders or fails to give a satisfactory reply to the IRDA in this behalf; **(k)** directly/indirectly involves in embezzlement of premiums/cash collected from policyholders/prospects on behalf of the insurer. An agent cannot collect cash/premium without specific authorisation by the insurer.

Manner of Holding Enquiry The appointment of an insurance agent would be cancelled on the basis of an enquiry in accordance with the specified procedure. The insurer should appoint an officer as an enquiry officer within 15 days of the issue of the suspension order who should issue a show cause notice to the insurance agent at his registered address calling for all information/data as deemed necessary to conduct the enquiry. The insurance agent may, within 21 days from the date of receipt of the notice, furnish to the enquiry officer a reply to the show cause notice together with copies of documentary or other evidence relied on by him or sought by the enquiry officer, who would give a reasonable opportunity of hearing to the insurance agent to enable him to make submission in support of his/her reply. He may appear in person or through any duly authorised person to present his case. However, the prior approval of the insurer should be obtained for the appearance of the 'authorised person'. If considered necessary, the enquiry officer may **(i)** require the insurer to present its case through one of its officers, **(ii)** call for **(a)** feedback/information from any other related entity during the course of enquiry, **(b)** additional papers from the insurance agent. He should make all necessary efforts to complete the proceeding at the earliest but in no case beyond 45 days of the commencement of the enquiry. The enquiry officer after taking into account all relevant facts and submissions made by the insurance agent, should furnish a report making him/her recommendations to the designated official, who would pass a final order in writing with reasons. On the issue of final order for cancellation, he/she would cease to act as an insurance agent from the date of the final order.

Publication of Order of Suspension/Cancellation The order of suspension/cancellation of appointment of the insurance agent should be displayed on the website of the insurer and updated in centralised list of agents maintained by the IRDA, so that registration of new business by the suspended/cancelled agent is stopped forthwith by the insurer.

On and from the date of suspension/cancellation of the agency, he would cease to act as an insurance agent. The insurer should **(i)** recover the appointment letter and identity card from the agent within 7 days of the issuance of final order, **(ii)** black list him and enter his detail into the black listed and the centralised list of agents database maintained by the IRDA, in online mode, immediately. The insurer should also inform other general/health insurer/mono-line insurers with whom he/she is acting as an agent, of the action taken against him for their records and necessary action. The IRDA may also initiate penal action keeping in mind the extent and level of violation as per the provisions of the Insurance Act/regulations/rules. An agent who is aggrieved by the order of cancellation can appeal to the insurer within 3 months. The insurer should appoint an appellate officer to examine the appeal and give his decision in the matter in writing within 30 days of the receipt of the appeal.

An insurance agent can surrender his appointment letter and identity card to the designated official of the insurer. The cessation certificate should be issued within 15 days from the date of registration/surrender of appointment.

General Conditions for Appointment of Agents by the Insurer The insurer should frame a `Board-Approved Policy' covering specified matter and file the same with the IRDA before March 31 every year. No individual can act as an insurance agent for more than one life/general/health insurer and one each of mono-line insurers. The penalty for contravention of the provisions of the Insurance Act may extend to ₹10,000. Any insurer/representative, who appoints an individual as an insurance agent not permitted to act as such or transact any insurance business in India would be liable to penalty which may extend to one crore rupees. No person should directly/indirectly allow or offer to allow or as an inducement, to any person to take out/renew/continue an insurance policy through multilevel marketing scheme. The IRDA may through an authorised officer, make a complaint to the appropriate police authorities relating to the entity/persons involved in the multi-level marketing scheme. Every insurer/designated official should maintain a register showing the name and address of every insurance agent appointed by him and the date on which his appointment began and the date, if any, on which his appointment ceased for 5 years from the cessation of appointment.

General Insurance—Reinsurance

The IRDA regulations relating to reinsurance are briefly examined in this Section.

Procedure for Reinsurance Arrangement

- The objective of reinsurance would continue to be **(a)** maximising retention within the country, that is, the amount which an insurer assumes for his own account. In proportionate contracts, the retention may be a percentage of the policy limit. In case of loss contracts, the retention is the amount of loss; **(b)** developing adequate capacity; **(c)** securing the best possible protection for the reinsurance costs incurred; and **(d)** simplifying the administration of business.
- All insurers should maintain the maximum possible retention, commensurate with its financial strength and volume of business. The IRDA may require them to justify their retention policy and may give such directions as considered necessary in order to ensure that the Indian re-insurer (i.e. an insurer who carries on exclusively reinsurance business and is approved as such by the government) is not merely fronting for a foreign insurer.
- They should cede such percentage of the sum assured on each policy for different classes of insurance written in India to the Indian insurer as specified by the IRDA according to the provisions of Part IVA of the Insurance Act. The term cession means the unit of insurance passed to a reinsurer by the insurer which issued a policy to the original insured and, accordingly, a cession may be the whole or a portion of a single risks, defined policies/ divisions of business as agreed in the reinsurance contract
- The reinsurance programme should commence from the beginning of every financial year and every insurer should submit to the IRDA his reinsurance programme for the forthcoming year, 45 days before the commencement of the financial year
- Within 30 days of the commencement of the financial year, every insurer should file with the IRDA a photocopy of every reinsurance treaty slip and excess of loss cover note in respect of that year together with the list of reinsurers and their shares in the reinsurance arrangement
- The IRDA may call for further information or explanation in respect of the reinsurance programme of an insurer and may issue such direction, as it may consider necessary
- The insurers should place their reinsurance business outside India with only those reinsurers who have over a period of five years, counting from the year preceding the one in which the business has to be placed, enjoyed a rating of at least **BBB** (with Standard & Poor) or equivalent rating of any other international rating agency. The placements with other reinsurers would require approval of the IRDA The insurers may also place reinsurances with Lloyd's syndicates taking care to limit placements with individual syndicates to such shares as are commensurate with the capacity of the syndicate
- The Indian reinsurer should organise domestic pools (i.e. joint underwriting operation of insurance/ reinsurance in which the participants assume a predetermined and fixed interest in all business written) for reinsurance surpluses in fire, marine, hull and other classes in consultation with all insurers on basis, limits and terms which are fair to all insurers and assist in maintaining the retention of business within India as close to the level achieved for the year 1999-2000 as possible. The arrangements so made should be submitted to the IRDA for approval
- The surplus, over and above the domestic reinsurance arrangements class-wise, can be placed by the insurer independently with any of the eligible reinsurers subject to a limit of 10 per cent of the total reinsurance premium ceded outside India being placed with any one reinsurer. Where it is necessary in respect of specialised insurance to cede a share

exceeding such limit to any particular reinsurer, the insurer may seek the specific approval of the IRDA giving reasons for such cession

- Every insurer should offer an opportunity to other Indian insurers, including the Indian reinsurer, to participate in its facultative and treaty surpluses before placement of such cessions outside India. The term facultative means the reinsurance of a part or all of a single policy in cession is negotiated separately and that the reinsurer and the insurer have the option of accepting or declining each individual submission, while the term treaty refers to a reinsurance arrangement between the insurer and the reinsurer usually for one year or longer which stipulates the technical particulars and financial terms applicable to the reinsurance of some class/classes of business
- The Indian reinsurer should retrocede at least 50 per cent of the obligatory cessions received by it to the ceding insurers after protecting the portfolio by suitable excess of loss covers. Such retrocession should be at original terms plus an over-riding commission to the Indian reinsurer not exceeding 2.5 per cent. The retrocession to each ceding insurer should be in proportion to its cessions to the Indian reinsurer. The term retrocession is defined as the transaction whereby a reinsurer cedes to another insurer/reinsurer all/part of the reinsurance it has previously assumed
- Every insurer would be required to submit to the IRDA statistics relating to its reinsurance transactions in such forms as it may specify, together with its annual accounts

Inward Reinsurance Business Every insurer wanting to write inward reinsurance business should have a well-defined underwriting policy for such business. He should ensure that decisions on acceptance of reinsurance business are made by persons with necessary knowledge and experience. He should file with the IRDA a note on its underwriting policy stating the class of business, geographical scope, underwriting limits and profit objective. He should also file any changes to the note whenever he makes then the underwriting policy.

Outstanding Loss Provisioning The insurers have to make provisions for outstanding claims for every reinsurance arrangement accepted on the basis **(i)** of loss of information advice received from brokers/cedants or **(ii)** actuarial estimation. In addition, they should make an appropriate provision for incurred but not reported (IBNR) claims on its reinsurance-accepted portfolio on actuarial estimation basis.

Appointed Actuary

To carry on insurance business, including reinsurance, in India, insurers should appoint an actuary. A life insurer can not transact without an appointed actuary. This Section dwells on the IRDA regulations relating to the appointed actuary.

Procedure for Appointment The insurer should seek the approval of the IRDA for the appointment of the actuary. An applicant is eligible to be appointed as actuary if he: **(i)** is ordinarily a resident in India, **(ii)** is a Fellow/Affiliate Member in accordance with the Actuaries Act with specialisation as evidence by qualification and/or working experience in life/general/health insurance. However, the syllabus and reading material constituting element of study for such specialisation and the requirements for issuing the certificate of practice for appointed actuaries should be to the satisfaction of the IRDA, **(iii)** is an employee of the life insurer in case of life insurance business, **(iv)** is a full time employee of the general insurer in case of general/health insurance business, **(v)** has not committed any breach of professional conduct, **(vi)** a person against whom no disciplinary action by the Acturial Society of India or any other acturial professional body is pending, **(vii)** is not an appointed actuary of another insurer, **(viii)** possesses a Certificate of

Practice issued by the Actuarial Society of India and **(ix)** is not over the age of 65 years, **(x)** has **(1)** minimum of 10 years relevant experience, of which at least two years of post-qualified (fellowship in the specialised subject) experience, **(2)** handled suitably responsible positions immediately prior to the application for appointed actuary and **(3)** at least two years of recent relevant experience out of the 10 years in the respective field for which the position is sought for.

Cessation of Appointment An appointed actuary would cease to be so, if he or she has been given notice of withdrawal of approval by the IRDA on the following grounds: **(a)** he or she ceases to be eligible in accordance with the eligibility conditions, **(b)** he or she has, in the opinion of the IRDA, failed to perform adequately and properly the duties and obligations of an appointed actuary under these regulations. The IRDA should give an appointed actuary a reasonable opportunity of being heard, if he or she has been given a notice of withdrawal of approval by it. If, however, a person ceases to be an appointed actuary of an insurer otherwise than on the grounds mentioned in above, the insurer and the appointed actuary should intimate the IRDA the reasons there for within 15 days of such a cessation.

Powers An appointed actuary should have access to all information or documents in possession, or under control, of the insurer if such access is necessary for the proper and effective performance of his functions and duties. He may seek any information for the above purpose from any officer or employee of the insurer. He should be entitled to **(a)** attend all meetings of the management, including the directors of the insurer; **(b)** speak and discuss on any matter, at such meeting that **(i)** relates to the actuarial advice given to the directors; **(ii)** may effect the solvency of the insurer; **(iii)** may effect the ability of the insurer to meet the reasonable expectations of policy-holders; or **(iv)** necessitates actuarial advice; and **(c)** attend **(i)** a meeting of the shareholders or the policy-holders of the insurer; or **(ii)** any other meeting of the members of the insurer at which the insurer's annual accounts or financial statements are to be considered or at which any matter in connection with the appointed actuary's duties is discussed.

Duties and Obligations The interests of the insurance industry and the policy-holders, the duties and obligations of an appointed actuary of an insurer include:

(a) Rendering actuarial advice to the management of the insurer, particularly in the areas of product design and pricing, insurance contract wording, investments and reinsurance
(b) Ensuring the solvency of the insurer at all times
(c) Complying with the provisions of Section 64-V of the Insurance Act in regard to certification of the assets and liabilities that have been valued in the required manner
(d) Complying with the provisions of Section 64-VA of the Insurance Act in regard to maintenance of required solvency margin in the required manner
(e) Drawing the attention of management of the insurer, to any matter on which he or she thinks that action is required to be taken by the insurer to avoid **(i)** any contravention of the Insurance Act or **(ii)** prejudice to the interests of policyholders
(f) Complying with the IRDA's directions from time to time
(g) If the insurer is also conducting life insurance business, he has:
  (i) to certify the actuarial report and abstract and other returns as required under Section 13 of the Insurance Act,
  (ii) to comply with the provisions of Section 21 of the Insurance Act in regard to further information required by the IRDA,
  (iii) to comply with the provisions of Section 40-B of the Insurance Act in regard to the bases of premium,

(iv) to comply with the provisions of the Section 112 of the Insurance Act in regard to recommendation of interim bonus or bonuses payable by life insurer to policy-holders whose policies mature for payment by reason of death or otherwise during the inter-valuation period,

(v) to ensure that all the requisite records have been made available to him or her for the purpose of conducting actuarial valuation of liabilities and assets of the insurer,

(vi) to ensure that the premium rates of the insurance products are fair,

(vii) to certify that the mathematical reserves have been determined taking into account the guidance notes issued by the Actuarial Society of India and any directions given by the IRDA,

(viii) to ensure that the policyholders' reasonable expectations have been considered in the matter of valuation of liabilities and distribution of surplus to the participating policyholders who are entitled to a share of the surplus, and

(ix) to submit the actuarial advice in the interests of the insurance industry and the policy-holders

(h) An insurer, carrying on general insurance business, has to ensure **(i)** that the rates are fair in respect of those contracts that are governed by the insurer's in-house tariff, **(ii)** that the actuarial principles, in determination of liabilities, have been used in the calculation of reserves for incurred but not reported claims (IBNR) and other reserves where actuarial advice is sought by the IRDA **(i)** Informing the IRDA, in writing of his or her opinion, within a reasonable time, whether **(i)** the insurer has contravened the Insurance Act or any other Acts, **(ii)** the contravention is of such a nature that it may affect significantly the interests of the owners or beneficiaries of policies issued by the insurer, **(iii)** the directors of the insurer have failed to take such action as is reasonably necessary to enable him to exercise his or her duties and obligations under this regulation or **(iv)** an officer/employee of the insurer has engaged in conduct calculated to prevent him or her exercising his or her duties and obligations under this regulation.

Absolute Privilege An appointed actuary should enjoy absolute privilege to make any statement—oral or written—so that he can perform his functions. This is in addition to any other privilege conferred upon him under any other regulations. Any provision of his letter of appointment which restricts or prevents his duties, obligations and privileges under these regulations, would be of no effect.

The regulation's relating to appointed actuary would apply to reinsurers carrying on business in India.

Conflict of Interest The appointed actuary should not function in any other capacity which could result in conflict of interest in performing his/her role.

Assets, Liabilities and Solvency Margins

This section discusses the valuation of assets, determination of amount of liabilities and solvency margin of insurers in India.

Valuation of Assets Every insurer has to prepare a statement of the value of its as detailed below.

Values of Assets The following assets should be placed with value zero: **(a)** agent's balances and outstanding premiums in India, to the extent they are not realised within a period of 30 days; **(b)** agent's balances and outstanding premiums outside India, to the extent they are not realisable;

(c) sundry debts, to the extent they are not realisable; **(d)** advances of unrealisable character; **(e)** furniture, fixtures, dead stock and stationery; **(f)** deferred expenses; **(g)** profit and loss appropriation account balance and any fictitious assets other than pre-paid expenses; **(h)** reinsurer's balances outstanding for more than three months; **(i)** preliminary expenses in the formation of the company.

The value of computer equipment, including software, should be computed as under: **(i)** 75, 50 and 25 per cents of its cost in the first, second, and the third year of purchase respectively and **(ii)** zero per cent thereafter.

All other assets of an insurer have to be valued in accordance with the IRDA Preparation of Financial Statements and Auditor's Report of Insurance Companies Regulations, 2000.

Statement of Assets Every insurer should prepare a statement of assets as given below.

Statement of Assets

Item (1)	*Category of assets* (2)	*Policyholders' funds* (3)	*Shareholders' funds* (4)
01	Approved securities		
02	Approved investments		
03	Deposits		
04	Non-mandated investments@		
05	Other assets (specify)		
06	Total		
07	Fair value change account		
08	Adjusted value of assets [(6) – (7)]		

@Investments that are neither approved investments nor approved securities.

Determination of Amount of Liabilities All insurers have to prepare a separate statement of the amount of liabilities for life insurance and general insurance.

Valuation of Liabilities—Life Insurance Business The main elements of the valuation of liabilities of a life insurer are specified below.

Method of Determination of Mathematical Reserves Such reserves should be determined separately for each contract by prospective method of valuation in accordance with the following:

The valuation method should take into account **(i)** all prospective contingencies under which any premiums (by the policy-holder) or benefits (to the policy-holder/beneficiary) may be payable under the policy, as determined by the policy conditions. The level of benefits should take into account the reasonable expectations of policy-holders (with regard to bonuses, including terminal bonuses, if any) and any established practices of an insurer for payment of benefits, **(ii)** the cost of any options that may be available to the policy-holder under the terms of the contract.

The determination of the amount of liability under each policy should be based on prudent assumptions of all relevant parameters. The value of each such parameter should be based on the insurer's expected experience and include an appropriate margin for adverse deviations (MAD) that may result in an increase in the amount of mathematical reserves.

The amount of mathematical reserve in respect of a policy, determined above may be negative ('negative reserves') or less than the guaranteed surrender value available ("guaranteed surrender value deficiency reserves") at the valuation date. The appointed actuary should, for the purpose of Section 35 of the Insurance Act, use the amount of such mathematical reserves without any modification and for the purpose of Sections 13, 49,64-V and 64-VA, set the amount of such mathematical reserve to zero, in case of negative service, or to the guaranteed surrender value, in case of such guaranteed surrender value deficiency reserves.

The valuation method outlined above should be called 'Gross Premium Method (GPM)'. If the appointed actuary feels another method (other than the GPM) is to be used, then other approximation (e.g. Retrospective Method) may be used. However, the amount of calculated reserve is expected to be at least equal to the amount that would be produced by the application of the GPM.

The method of calculation of the amount of liabilities and the assumptions for the valuation parameters should not be subject to arbitrary discontinuities from one year to the next.

The determination of the amount of mathematical reserves should take into account the nature the term of the assets representing those liabilities and the value placed upon them and include prudent provision against the effects of possible future changes in the value of assets on the ability of the insurer to meet its obligations arising under policies as they arise.

Policy Cash Flows The gross premium method of valuation should discount the following future policy cash flows at an appropriate rate of interest:

(a) Premiums payable, if any, and benefits payable, if any, on death; benefits payable, if any, on survival; benefits payable, if any, on voluntary termination of contract; and the following, if any: **(i)** basic benefits, **(ii)** rider benefits, **(iii)** bonuses that have already been vested at the valuation date, **(iv)** bonuses as a result of the valuation at the valuation date, and **(v)** future bonuses, (one year after valuation date) including terminal bonuses, (consistent with the valuation rate of interest)

(b) Commission and remuneration payable, if any, in respect of a policy be based on the current practice of the insurer. No allowance should be made for non-payment of commission in respect of the orphaned policies

(c) Policy maintenance expenses, if any, in respect of a policy, as provided above

(d) Allocation of profit to shareholders, if any, where there is a specified relationship between profits attributable to shareholders and the bonus rates declared for policy-holders. However, allowance must be made for tax, if any.

Policy Options Where a policy provides built-in options, that may be exercised by the policyholders, such as conversion or addition of coverage at future date(s) without any evidence of good health, annuity rate guarantees at maturity of contract, and so on, the cost of such options should be estimated and treated as special cash flows in calculating the mathematical reserves.

Valuation Parameters The valuation parameters should constitute the basis on which the future policy cash flows should be computed and discounted. Each parameter would have to be appropriate to the block of business to be valued. An appointed actuary must take into consideration the following:

(a) The value(s) of the parameter should be based on the insurer's experience study, where available. If reliable experience study is not available, the value(s) can be based on the industry study, if available and appropriate. If neither is available, the values may be taken from the basis used for pricing the product. In establishing the expected level of any parameter, and likely deterioration in, experience should be taken into account

(b) The expected level, as determined above, should be adjusted by an appropriate margin for adverse deviations (MAD), the level of MAD being dependent on the degree of confidence in the expected level, and such MAD in each parameter should be based on the Guidance Notes, issued by the Actuarial Society of India, with the concurrence of the IRDA

(c) The values used for the various valuation parameters should be consistent among themselves

The mortality rates should find their reference in a published table, unless the insurer has constructed a separate table based on his own experience. However, **(i)** such published table should be made available to the insurance industry by the Actuarial Society of India, with the concurrence of the IRDA, **(ii)** such rates determined by reference to a published table should not be less than 100 per cent of that published table; they may be less than 100 per cent of that published table if the appointed actuary can justify a lower per cent.

The policy maintenance expenses would depend on the manner in which they are analysed by the insurer, namely—fixed expenses and variable expenses. The variable expenses should be related to the sum assured or premiums or benefits. The fixed expenses may be related to the sum assured and premiums or benefits or per policy expenses. All expenses should be increased in future years for inflation, the rate of inflation assumed should be consistent with the valuation rate of interest.

The valuation rates of interest, to be used by an appointed actuary:

(a) Should be not higher than the rates of interest, for the calculation of the present value of policy cash flows referred to above, determined from prudent assessment of the yields from existing assets attributable to blocks of life insurance business, and the yields which the insurer is expected to obtain from the sums invested in the future, and such assessment shoud take into account **(i)** the composition of assets supporting the liabilities, expected cash flows from the investment on hand, the cash flows from the block of policies to be valued, the likely future investment conditions and the reinvestment and disinvestment strategy to be employed in dealing with the future net cash flows, **(ii)** the risks associated with investment in regard to receipt of income on such investment or repayment of principal and **(iii)** the expenses associated with the investment functions of the insurer

(b) Should not be higher than, for the calculation of present value of policy cash flows in respect of a particular category of contracts, the yields on assets maintained for the purpose of such category of contracts

(c) Should, respect of non-participating business, recognise the risk of decline in the future interest rates

(d) Should, respect of participating business, be based on the assumption (with regard to future investment conditions) that the scale of future bonuses used in the valuation is consistent with the valuation rate of interest

(e) Should, respect of single premium business, take into account the effect of changes in the risk free interest rates.

(f) Should, take into account other parameters, depending on the type of policy. In establishing the values of such parameters, the considerations set out above should be taken into account.

Applicability to Reinsurance The above stipulations also apply to the valuation of business in the books of reinsurers. As regards the business ceded by insurers, the stipulations are applicable to the net sums at risk retained by the insurer. The reinsurance arrangement with an element of borrowing in the form of deposit or credit of any kind, from insurer's reinsurers without the prior approval of the IRDA should not be treated as credit for reinsurance for the purpose of determination of required solvency margin.

Additional Requirements for Linked Business The reserves in respect of linked business should consist of two components, namely, unit reserves and general fund reserves. The unit reserve should be calculated in respect of the units allocated to the policies in force at the valuation date (i.e. in relation to an actual investigation, the date to which the investigation relates) using unit values at the valuation date. The general fund reserves (non-unit reserves) should be determined using a prospective valuation method set out in the preceding discussion, which should take into account the following, namely: **(a)** premiums, if any, payable in future, **(b)** death benefits, if any, provided by the general fund (over and above the value of units), **(c)** management charges paid to the general fund, **(d)** guarantees, if any, relating to surrender values or minimum death and maturity benefits, **(e)** fund growth rates and management charges, **(f)** negative reserves, if any.

Additional Requirements for Provisions Where it is not possible to calculate mathematical reserves for each policy, in the determination of mathematical reserves, the appointed actuary should make aggregate provisions in respect of the following:

(a) Policies in respect of which extra premiums have been charged on account of underwriting of under-average lives that are subject to extra risks such as occupation hazards, overweight, under-weight, smoking history, health, climatic or geographical conditions

(b) Lapsed policies not included in the valuation but under which a liability exists or may arise

(c) Options available under individual and group insurance policies

(d) Guarantees available to individual and group insurance policies

(e) The rates of exchange at which benefits in respect of policies issued in foreign currencies have been converted into Indian rupees and what provision has been made for possible increase in mathematical reserves arising from future variations in rates of exchange

(f) Others, if any.

Statement of Liabilities An insurer should furnish a statement of liabilities in accordance with the IRDA Actuarial Report and Abstract Regulations, 2000.

Valuation of Liabilities—General Insurance The main elements of the valuation of liabilities of general insurers are specified below.

Determination of Liabilities An insurer should:

(I) Place a proper value in respect of the following items, namely: **(a)** provision for bad and doubtful debts, **(b)** reserve for dividends declared or recommended, and outstanding dividends in full, **(c)** amount due to insurance companies carrying on insurance business, in full, **(d)** amount due to sundry creditors, in full, **(e)** provision for taxation in full, and **(f)** foreign exchange reserve.

(II) Determine the amount of following reserves, in the manner specified below:

(a) reserve for unexpire risks, in respect of **(i)** fire business, 50 per cent, **(ii)** miscellaneous business, 50 per cent, **(iii)** marine business other than marine hull business, 50 per cent; and **(iv)** marine hull business, 100 per cent of the premium, net of re-insurances, received or receivable during the preceding twelve months

(b) reserve for outstanding claims should be determined in the following manner: **(i)** where the amounts of outstanding claims of the insurers are known, the amount is to be provided in full; **(ii)** where the amounts of outstanding claims can be reasonably estimated according to the insurer, he may follow the 'case by case method' after taking into account the explicit allowance for changes in the settlement pattern or average claim amounts, expenses and inflation.

(c) reserve for claims incurred but not reported (IBNR) should be determined using actuarial principles. In such determination, the appointed actuary should follow the Guidance Notes issued by the Actuarial Society of India, with the concurrence of, and any directions issued, by the IRDA, in this behalf.

Statement of Liability Every general insurer should prepare a statement of liabilities as shown below, certified by an auditor approved by the IRDA in accordance with Section 64-A of the Insurance Act, and also certified by its appointed actuary in respect of IBNR reserves. The statement should be furnished to the IRDA along with the returns mentioned in Section 15 of the Insurance Act.

Statement of Liabilities:

Item (1)	*Description* (2)	*Reserves for unexpired risks* (3)	*Reserves for outstanding claims* (4)	*IBNR reserves* (5)	*Total reserves* (6)
01	Fire				
02	Marine: Marine cargo, Marine hull				
03	Miscellaneous: Motor engineering, Aviation, Rural insurance, Others				
04	Health insurance				
05	Total liabilities				

Determination of Solvency Margin The statement of solvency margin should be separately prepared for life insurance business and general insurance business.

For Life Insurance Business Every insurer should determine the required solvency margin, the available solvency margin (i.e. the excess of value of assets over the value of insurance liabilities and other liabilities of policy holders/shareholders funds) and the solvency rates (i.e. the ratio of the amount of available solvency margin to the amount of required solvency margin) as specified under the IRDA Actual Report and Abstract Regulations, 2000.

For General Insurance Business Every insurer is required to determine the required solvency margin, the available solvency margin and the solvency ratio as shown in Exhibits 16.2 and 16.3.

Exhibit 16.2 Solvency Margin-Based on Net Premium and Net Incurred Claims

Item (1)	*Description (class of business)* (2)	*Gross premiums* (3)	*Net premiums* (4)	*Gross incurred claims* (5)	*Net incurred claims* (6)	*RSM-1* (7)	*RSM-2* (8)	*RSM* (9)
01	Fire							
02	Marine: Marine cargo							
03	Marine hull							
04	Miscellaneous: Motor							
05	Engineering							
06	Aviation							
07	Liability							
08	Rural insurance							
09	Others							
10	Health insurance							
12	Total							

Notes: (1) RSM-1 means Required Solvency Margin based on net premiums, and should be determined as 20 per cent of the amount which is the higher of the gross premiums multiplied by Factor A as specified below and the net premiums.

(2) RSM-2 means Required Solvency Margin based on net incurred claims, and should be determined as 30 per cent of the amount which is the higher of the gross net incurred claims multiplied by a Factor B as specified below and the net incurred claims:

Item (1)	*Description (class of business)* (2)	*A* (3)	*B* (4)
01	Fire	0.5	0.5
02	Marine: Marine cargo	0.7	0.7
03	Marine hull	0.5	0.5
04	Miscellaneous: Motor	0.85	0.85
05	Engineering	0.5	0.5
06	Aviation	0.9	0.9
07	Liability	0.85	0.85
08	Rural insurance	0.5	0.5
09	Others	0.7	0.7
10	Health	0.85	0.85

(3) RSM means Required Solvency Margin and should be the higher of the amounts of RSM-1 and RSM-2.

Health Insurance Business Where the insurer transacts health insurance business, providing health covers, the amount of liabilities should be determined in accordance with the principles specified above under these regulations.

Exhibit 16.3 Available Solvency Margin and Solvency Ratio

Item (1)	*Description* (2)	*Notes* (3)	*Amount* (4)
01	Available assets in policyholders' funds		
	Deduct:		
02	Liabilities		
03	Other liabilities		
04	Excess in policyholders' funds (01 – 02 – 03)		
05	Available assets in shareholders funds		
	Deduct:		
06	Other liabilities		
07	Excess in shareholders' funds: (05 – 06)		
08	Total ASM (04) + (07)		
09	Total RSM		
10	Solvency ratio (Total ASM/Total RSM)		

Notes:
1. Item 01 is the amount of the adjusted value of assets in respect of policyholders' funds.
2. Item 02 is the amount of total liabilities.
3. Item 03 is the amount of other liabilities arising in respect of policyholders' funds.
4. Item 05 is the amount of the total assets in respect of shareholders' funds.
5. Item 06 is the amount of other liabilities arising in respect of shareholders' funds.

Business Outside India Where the insurer transacts insurance business in a country outside India, and submits statements or returns or any such particulars to a public authority of that country, he should enclose the same along with the details specified in accordance with these regulations and the IRDA Actuarial Report and Abstract Regulations, 2000. However, if the appointed actuary is of the opinion that it is necessary to set additional reserves over and above the reserves shown in the statements/returns/any such particulars submitted to the public authority of a country outside India, he may set such additional reserves.

Furnishing of Forms The details of assets and liabilities should be furnished separately for business within India and total business transacted by the insurer.

Personal Visit of Appointed Actuary The IRDA may, if considered necessary and expedient, ask the appointed actuary to make personal visits to its office to elicit from him any further information.

Registration of Indian Insurance Companies Regulations 2016

The registration of Indian insurance companies is discussed below with reference to **(i)** registration, **(ii)** application for registration, **(iii)** annual fee, and **(iv)** action in case of default.

Procedure for Registration of Indian Insurance Company/Statutory Body To Carry on Insurance Business To carry on insurance business, an application should be made to the IRDA for issuance of requisition for registration application. It may require the applicant to furnish further information/clarifications regarding the matters relevant to the application. It may, by recording the reasons in writing, reject the application. The applicant aggrieved by the decision of the IRDA may, within 30 days appeal to the Securities Appellate Tribunal (SAT). An applicant, whose requisition for registration application has been accepted should make an application in the prescribed form for grant of **certificate of registration**. The requisition for registration application should be for life/general/health insurance business exclusively or reinsurance business.

An applicant would not be eligible to apply for the requisition in the circumstances where **(i)** the requisition for registration application has been rejected by the IRDA or withdrawn; **(ii)** the foreign investors or Indian promoter of the exited venture have exited or application for registration has been rejected by the IRDA or withdrawn by the applicant for any reason at any time during the preceding two financial years from the date of requisition for registration application; **(iii)** certificate of registration has been cancelled by the IRDA; **(v)** the name of the applicant does not contain the words 'insurance' or 'assurance'.

The requisition for registration application should be accompanied by **(i)** a certified copy of the **(a)** memorandum and articles of association, where the applicant is a company or **(b)** Act of Parliament setting up the statutory body to carry on insurance business; **(ii)** the name, address and the occupation of the directors; **(iii)** a certified copy of the annual report of Indian promoters and the foreign investors for the last five years preceding the year of filing of requisition of registration application; **(iv)** a certified copy of the shareholders' agreement between Indian promoter and foreign investors of the applicant; **(v)** projections of business for 5 years duly approved by the Board of Directors of the applicant. **Indian promoter** means a **(i)** company which is not a subsidiary of another company, **(ii)** banks excluding foreign banks/branches functioning in India, **(iii)** core investment company, **(iv)** public financial institution, **(v)** cooperative society, **(vi)** limited liability partnership (LLP) and **(vii)** any other person/entity allowed by the IRDA. **Foreign investors** mean all eligible non-resident entities/persons resident outside India investing in equity shares of an Indian insurance company permitted through the foreign direct investment (FDI) and foreign portfolio investment (FPI) windows under the FEMA regulations. The **FDI** means/includes investment by non-resident entities/persons resident outside India and other eligible entities. It includes investment by foreign venture capital investors. The **FPI** means/includes by FIIs, FPIs, NRIs, QFIs and other eligible portfolio investor entities/persons.

The IRDA may require the applicant to furnish further information/clarification regarding the matter relevant to consider the requisition for registration application. It would take into account all matters relating to carrying on of the business of insurance by the applicant. In particular and without prejudice to the generality of the foregoing, it would consider the following matters: **(i)** general track record of conduct and performance of each of the Indian promoter and foreign investor in the fields of business/profession they are engaged in; **(ii)** record of conduct and performance of their directors and persons in management and the applicant; **(iii)** capital structure of the applicant; **(iv)** ability to meet the obligation to provide life/general/health insurance to the persons residing in the rural sector, workers in the unorganised sector or informal sector or for economically vulnerable or backward classes of the society and other categories of persons specified by the IRDA; **(v)** ability to meet the obligation to underwrite insurance business in third party risks of motor vehicles as specified by the IRDA in respect of general insurance companies; **(vi)** planned infrastructure of the applicant; **(vii)** proposed business expansion plan for 5 succeeding years, including establishment of place of business in rural areas, to effectively carry out the insurance business; and **(viii)** other relevant matters for carrying out the provisions of the Insurance Act. On being satisfied with the information submitted and on verification that the **(a)** requisition is complete in all respects and is accompanied by all the required documents; and **(b)** the applicant would carry on all specified functions in respect of the insurance business including management of investments within India, the IRDA may accept the requisition and issue the application for grant of certificate of registration to the applicant.

Where the above requirements are not complied with, the IRDA may, after giving the applicant a reasonable opportunity of being heard, reject the application. The order rejecting the application should be communicated within 30 days of such rejection to the applicant in writing stating the grounds on which the application has been rejected. An applicant aggrieved by the decision may appeal to the Securities Appellate Tribunal.

Application for Registration An applicant, whose requisition has been accepted, make an application in the prescribed form for grant of certificate of registration. The applicant should be accompanied by **(a)** evidence of having minimum **(i)** ₹100 crore and **(ii)** ₹200 crore paid-up equity share capital in case of applications respectively for life/general/health and re-insurance business; **(b)** an affidavit by the promoters and foreign investor certifying that the requirements of Insurance Act to the effect that the paid-up capital is adequate after excluding any **preliminary expenses** (i.e. expenses relating to its formation including legal/accounting/share issue expenses and expenses incurred prior to grant of CoR) of the company have been satisfied; **(c)** a statement indicating the distinctive numbers of shares issued to each Indian promoter and investor in respect of its share capital; **(d)** an affidavit by the managing director, chief executive officer or whole-time director of the Indian promoters and the foreign investors certifying that the holding of the prescribed foreign paid-up equity capital is calculated in accordance with the prescribed regulations and does not exceed 49 per cent of the total paid-up capital of the applicant-company. In case of Indian promoter being limited liability partnership, the affidavit should be signed by the designated partner; **(e)** in case of there being foreign investment in the applicant, an affidavit by the managing director, chief executive officer or whole-time directors and the Indian promoters and foreign investor certifying that the company is **Indian owned and controlled** (i.e. controlled by resident Indian citizens/Indian companies owned/controlled by the resident Indian citizens); **(f)** where the foreign direct investment is more than 26 per cent, a certified copy of the approval given by FIPB; **(g)** a certified copy of the published **(1)** prospectus **(2)** standard forms of the insurer and statements of the assured rates, advantages, terms and conditions to be offered in connection with insurance policies together with a certificate by an actuary in case of life insurance business that they are workable and sound, **(3)** memorandum of understanding/management agreement/shareholders agreement/voting rights agreements/any other agreements entered into between the Indian promoters and the foreign investors or amongst the promoters as a whole including details of the support/comfort letters exchanged between the parties; **(h)** proof in support of payment of the non-refundable fee of ₹5 lakh; **(i)** a certificate from a practicing chartered accountant/company secretary certifying that all the requirements relating to registration fees, equity shares capital, and other requirements of the Insurance Act have been complied with; **(j)** any other information required by the IRDA during the processing of the application for registration. The holding of equity shares by foreign investors in the applicant company would be aggregate of the **(i)** quantum of paid-up equity share capital held by them including foreign venture capital investors and **(ii)** proportion of the paid-up capital held/controlled by it either by itself or through its subsidiary companies in the Indian promoter(s)/investor(s).

Every insurer who has been granted registration should within 45 days of the end of every quarter, furnish to the IRDA a statement indicating changes exceeding 1 per cent of the paid-up capital of the promoter. However, any change in excess of 5 per cent should be reported immediately.

Consideration of Application The IRDA would take into account, for considering the grant of certificate, all matters relating to carrying on the business of insurance by the applicant. In particular and without prejudice to the generality of the foregoing and without in any manner affecting its powers, it would consider the **(a)** nature of insurance products; **(b)** level of actuarial, accounting and other professional expertise within the management of the applicant; **(c)** organisation structure of the applicant to carry on all functions in respect of the insurance business including management of the investments within its own organisation; **(d)** all other relevant matters for carrying out the provisions of the Insurance Act.

Where an application for registration is not complete in all respects and does not conform to the specified regulations/instructions in the prescribed form and after considering the relevant matters and on being satisfied that it is not desirable to grant a certificate, the IRDA, may reject the application. The rejection should be communicated to the applicant in writing stating the ground on which the application has been rejected. An aggrieved applicant may within 30 days appeal to the Securities Appellate Tribunal. The applicant, whose application for registration has been rejected, would not be entitled to a certificate of registration. The non-refundable fee of ₹5,00,000 for registration should be remitted to the IRDA.

Grant of Certificate of Registration The IRDA after making such inquiry as it deems fit and on being satisfied that the **(a)** application is eligible, and in its opinion, is likely to meet effectively its obligations imposed under the Insurance Act; **(b)** financial conditions of the promoters, foreign investors and the general character of the management of the applicant are sound; **(c)** volume of business likely to be available to, and the capital structure and earning prospects of the applicant, will be adequate; **(d)** interests of the general public will be served if the certificate is granted; and **(e)** applicant has complied with, and has fulfilled, all the requirements of the Insurance Act relating to **(i)** prohibition of transaction of insurance business by certain persons, **(ii)** restriction on name of insurer, **(iii)** provision pertaining to managers and **(iv)** prohibition of common officers and requirement as to whole-time officers, may register the applicant as an insurer for the class of business for which it is found suitable and grant of applicant the certificate in the prescribed form. It may impose such conditions as may be deemed fit. The applicant would be bound by them. The applicant granted the CoR should commence business within 12 months. This may be extended upto 24 months by the IRDA.

Annual Fee An insurer who has been granted CoR should pay for every financial year to the IRDA before January 31 of the preceding financial year the annual fee which would be the higher of **(a)** ₹5,00,000 or **(b)** one-twentieth of 1 per cent of total gross premium written direct by an insurer in India during the financial year preceding the year in which the annual fee is required to be paid, or rupees ten crore whichever is less. However, in the case of an insurer carrying on solely re-insurance business, the total premium in respect of facultative reinsurance accepted by it in India would be taken into account. If the insurer fails to deposit the annual fee before the specified date, the IRDA may accept the payment of annual fee along with an additional fee by way of penalty of **(a)** 2 per cent of the annual fee if the fee is paid within 30 days after the expiry of the last date of payment of annual fee; or **(b)** 10 per cent of the annual fee if the fee is paid after 30 days from the expiry of the last date of payment, but before the end of financial year in which the annual fee was required to be paid. Where the insurer has failed to pay the fee before the end of the financial year, its certificate of registration is liable to be cancelled.

Procedure for Action in Case of Default Without prejudice to any penalty which may be imposed/ action taken under the provisions of the Insurance Act, the registration of an Indian insurance company/insurer may be suspended for a specified period by the IRDA under the following circumstances: **(i)** the insurer fails, at any time, to comply with the provisions relating to the excess of the value of its assets over the amount of its liabilities, **(ii)** it is in liquidation or is adjudged as an insolvent, **(iii)** its business has been transferred to any person/amalgamated with the business of any other insurer without the approval of the IRDA, **(iv)** defaults in complying with, or acts in contravention of, any requirement of the Insurance Act/regulation, direction/order issued by the IRDA, particularly if the insurer **(a)** conducts its business in a manner prejudicial to the interest of the policyholders; **(b)**fails to furnish any information as required by the IRDA relating to its insurance business; **(c)** does not submit periodical returns as required under the Insurance Act or by the IRDA; **(d)** does not cooperate in any inquiry conducted by the IRDA; **(e)** indulges in manipulating practices; **(f)** indulges in unfair trade practices; **(g)** fails to make investment in the specified infrastructure or social sector, **(v)** the IRDA has reasons to believe that any claim upon the insurer arising in India under any policy of insurance remains unpaid for three months after final judgment in regular court of law, **(vi)** the insurer carries on any business other than insurance business or any prescribed business, **(vii)** the insurer defaults in complying with any direction issued or order made by the IRDA, under the IRDA Act, **(viii)** the insurer defaults in complying with, or acts in contravention of, any requirement of the Companies Act/the General Insurance Business (Nationalisation) Act/the Foreign Exchange Management Act/Prevention of Money Laundering Act, **(ix)** the insurer fails to pay the required fee, or **(x)** he is convicted for an offence under any law for. The IRDA for reasons to be recorded in writing may, in case of repeated defaults of the type mentioned above, may impose penalty of cancellation of CoR. On and from the date of suspension/cancellation of CoR, the insurer would cease to transact new insurance business. The IRDA may direct the insurer to continue to service the existing policyholders for specified period.

Investment Regulations/Norms

The IRDA norms relate to **(a)** regulation of investments and **(b)** exposure/prudential norms.

Regulation of Investments The regulations/norms pertain to investment assets of **(1)** life/pension/ group/annuity and unit linked business and **(2)** general insurance business. The investment assets in case of a life insurer means all investments made out of **(i) shareholders fund**, representing solvency margin, non-unit reserves of unit linked insurance business and participating/non-participating funds of policyholders at their carrying value and **(ii)** policyholders pension, annuity and group business at their carrying value and **(iii)** their unit reserves of unit linked business at market value.

Life Business Subject to the provisions of Section 27-A of the Insurance Act, a life insurer should invest its investment assets forming part of the controlled fund of life business, one-year renewable pure group term assurance business (OYRGTA) and non-unit reserves of unit linked insurance business as specified below:

Types of investment		*Percentage of fund*
(i)	Government securities, Not less than	25
(ii)	Government/other approved securities including (i) above, Not less than	50
(iii)	Approved investments@ specified in Section 27-A of the Insurance Act and other investments specified in Section 27-A(2) taken together subject to specified exposure/prudential norms not exceeding	50
(iv)	Other investments specified under Section 27-A(2) of the Insurance Act subject to exposure prudential norms, Not exceeding	15
(v)	Investment in housing and infrastructure by way of subscription/purchase of:	
	(A) Investment in Housing **(a)** Bonds/debentures of HUDCO and NHB, **(b)** Bonds/debentures of housing finance companies (HFCs) duly accredited by NHB/guaranteed by Government or carrying a minimum of **AA** rating by a SEBI-registered agency, and **(c)** Asset backed securities with underlying housing loans, satisfying the IRDA-specified norms.	
	(B) Investment in infrastructure (i.e. subscription/purchase of bonds/debentures, equity and asset backed securities with underlying infrastructure assets), categories **(i)**, **(ii)**, **(iii)** and **(iv)** taken together, not less than	15

@ List of Approved Investments Included in approved investments for life business are the following:

1. All investments specified in Section 27-A of the Insurance Act (**discussed in an earlier Section of this Chapter**) excepting **(a)** securities of, or guaranteed as to principal and interest by, the Government of the United Kingdom, **(b)** first mortgage on immovable property situated in India/any other country where the insurer is carrying on business provided the property mortgaged is not a leasehold property with an outstanding term of at least 30 years and the value of the property exceeding by one-third, or if it consists of buildings, exceeds by one-half, the mortgage money and **(c)** immovable property situated in India/any other country provided the property is free of all encumbrances.
2. The additional investments notified by the IRDA as approved investments under Section 27-A (1)(S) of the Insurance Act, namely:
   (a) All secured loans/debentures/bonds, and other rated debt instruments@@, equity/preference shares and debt instruments issued by all-India Financial Institutions (FIs) recognised by the RBI. Such investments should be made in terms of investment policy, guidelines, benchmarks, exposure norms, and limits approved by the Board of Directors of the insurer.
   (b) Bonds/debentures of companies rated not below **AA**/equivalent and **P1**/equivalent ratings for short-term bonds/debentures/CDs/CPs by a SEBI-registered rating agency.
   (c) Subject to norms/limits approved by the Board of Directors of the insurers, deposits (including CDs) with banks and Primary Dealers (PDs) duly recognised by the RBI.
   (d) Collateralised borrowing and lending obligations (CBLOs) created by the Clearing Corporation of India Ltd/recognised by the RBI, and exposures to Gilt, G-Sec and liquid mutual funds and money market instruments/investments.
   (e) Asset backed securities underlying housing loans/infrastructure assets.
   (f) Commercial papers of companies/FIs recognised by the RBI rated by a SEBI-registered agency.

(g) Money market instruments with maturity of less than one year comprising of rated CDs/CPs, Repos/Reverse repos, T-bills, Call/notice/term money, CBLOs and any other instrument prescribed by the IRDA.

@@ Rating of Instruments All investments in assets/instruments capable of being rated as per market practice should be made by an insurer only on the basis of their rating by a SEBI-registered rating agency. Investments in such unrated instruments are prohibited. The minimum acceptable rating for long-term debt instruments of companies/FIs would be **AA**/its equivalent and **P1**/its equivalent for short-term instruments. In case investments in FIs of this grade are not available to meet the requirements of the insurer, its Investment Committee, if fully satisfied, may approve investments in instruments carrying at least **A+**/equivalent rating. The reasons for such investments should be recorded in its minutes. The instruments downgraded below the minimum rating should be automatically reclassified under **other investment**. Investments in listed shares should be made only in actively traded and liquid instruments, that is, those other than thinly traded in terms of SEBI regulations and guidelines applicable to mutual funds. Not less than 75 per cent and 65 per cent of debt instruments (including Government and other approved securities in case of life business and in case of general business respectively) should be in sovereign debt having a rating of **AAA**/equivalent for long-term and **P1**+/equivalent for short-term instruments. This is applicable to segregated funds in case of unit linked funds also. Not more than 5 per cent (life insurer) and 8 per cent (general insurer) of funds in debt instruments should have a rating of **A**/below or equivalent rating for long-term. No investments on be made in other investments out of funds of the unit reserve position of all categories of unit linked funds. Investments in debt instruments rated **AA**-minus or below would be part of other investments.. Nevertheless, rating should not replace appropriate risk analysis and management on the part of the insurer. He should conduct risk analysis commensurate with the complexity of the product(s) and the materiality of their holdings. They could also refrain from such investments.

Pension and General Annuity Business Funds belonging to the pension and general annuity business should be invested in the following manner:

Type of investment	*Percentage of fund*
(i) Government securities, Not less than	20
(ii) Government/other approved securities including (i) above, Not less than	40
(iii) Approved investments, subject to exposure/prudential norms, Not exceeding	60

Investments in the category of **other investments** under Section 27-A(2) of the Insurance Act are prohibited for such funds. Funds pertaining to group insurance business excepting One-year Renewable Pure Group Term Assurance Business (**OYRGTA**) would form part of pension and general annuity fund. But the OYRGTA funds should be invested on the pattern of the life business.

Unit Linked Insurance Business The segregated fund of the unit linked business should be invested as per the pattern of investments offered to, and approved by, the policyholders where the units are linked to categories of marketable and easily realisable assets. However, the investment in approved investments should not be less than 75 per cent of such funds in each segregated fund.

General Insurance Business Subject to the provisions of Section 27-B of the Insurance Act, the investment assets (i.e. shareholders funds representing solvency margin and policyholders funds at their carrying value) of general insurance companies should be invested in the manner set out below:

	Type of investment	*Percentage*
(i)	Central Government securities, Not less than	20
(ii)	Government/Other approved securities including **(i)** above, Not less than	30
(iii)	Approved investments specified in Section 27-B and other investments specified in Section 27-B(3) taken together subject to exposure/prudential norms, Not exceeding.	
(iv)	Other investments specified under Section 27-B(3) subject to a exposure/prudential	70
	norms, Not exceeding	25
(v)	Housing and loans to state Governments for housing/fire fighting equipment by way of subscription to/purchase of:	
	(A) Investment in Housing: **(a)** Bonds/debentures of HUDCO/NHB, **(b)** Bonds/debentures of HFCs duly accredited by NHB/ guaranteed by Government or carrying a minimum **AA** rating from a SEBI-registered agency, and **(c)** Asset backed securities (ABS) with underlying housing loans satisfying the specified norms, Total investment in categories **(i)**, **(ii)**, **(iii)** and **(iv)** taken together, Not less than	5
	(B) Investment in infrastructure including subscription/purchase of bonds/ debentures, equity shares and ABS with underlying infrastructure assets, Total investment in categories **(i)**, **(ii)**, **(iii)** and **(iv)** taken together, Not less than	10

@@List of Approved Investments The approved investments for general business comprise of the following two categories.

1. All investments specified in Section 27-B (**discussed earlier in this Chapter**) excepting **(a)** United Kingdom Government/Government guaranteed securities, **(b)** immovable property situated in another country, and **(c)** first mortgage on immovable property situated in India/any other country provided the property mortgaged is not leasehold property with outstanding term of less than 15 years and the value of the property exceeds by one-third or if it consists of buildings, exceeds by one-half the mortgage money.
2. The additional approved investments specified by the IRDA under Section 27-B(1) of the Insurance Act are the same as under Section 27-A(1) applicable to life business (**discussed earlier**). All other conditions are also similarly applicable.

Re-insurance Business Until separate norms/regulations are prescribed by the IRDA, the investment assets of re-insurance business should be invested on the pattern of general business.

Exposure/Prudential Norms Subject to provisions of Sections 27-A and 27-B of Insurance Act, investments of insurance companies should be based on the exposure/prudential norms set out below. The maximum exposure limit for a single investee company from all investment assets should not exceed the lower of the following: **(i)** 10 per cent of investment assets of life/ general insurers and **(ii)** aggregate amount calculated under **(a)** and **(b)** of the following table:

Types of investment	*Limits for investee company*	*Limit for the entire "group" of the investee company*	*Limits for industry sector (other than infrastructure sector) to which the investee company belongs*
(1)	*(2)*	*(3)*	*(4)*
(a) Investments in equity/preference shares/debentures	10@ per cent of outstanding equity shares (face value) or 10 per cent of the amount under **(1)** all funds of life insurance/pension, annuity and group business and unit reserve portion of all categories of unit linked funds, **(2)** general/insurance/reinsurance business which ever is lower.	Not more than **(i)** 15 per cent of the amount under life/pension/unit linked business or general business or **(ii)** 15 per cent of investment assets in all companies belonging the group whichever is lower.	Not more than **(i)** 15 per cent in case of life/pension/unit linked business or general insurance or **(ii)** 15 per cent of the investment assets whichever is lower.
(b) Investments in debt/loans/any other permitted investment by the Insurance Act/regulations other than item **(a)** above	10@ per cent of the paid-up capital, free reserves (excluding revaluation reserves) and debentures/bonds of the investee company or 10 per cent of respective fund/investment assets whichever is lower	—	Exposure to infrastructure investments are subject to Notes 1, 2, 3 and 4 given below

@In case of life and general insurers having assets of the undermentioned size, the limit would be as mentioned below:

Investment assets	*Limit for investee company*			
	Equity		*Debt*	
1. ₹2,50,000 crore or more	15 per cent	[of outstanding equity shares (face value)]	15 per cent	[of paid up capital, free reserves (excluding revaluation) and debentures/bonds]
2. ₹50,000 – ₹2,50,000 crore	12 per cent		12 per cent	
3. Less than ₹50,000 crore	10 per cent		10 per cent	

Notes:

1. Industry sector norms would not apply for investment made in **infrastructure** facility.
2. Investments in infrastructure debt fund approved by the IRDA would be reckoned on a case to case basis for investments in infrastructure.
3. Exposure to a public limited infrastructure investee company would be the lower of **(i)** 20 per cent of equity shares (face value) in case of equity or **(ii)** 20 per cent of equity plus free reserves (excluding revaluation reserves) plus debentures/bonds taken together in case of debt. With the prior approval of the Board of Directors, an additional 5 per cent can be invested in debt instruments alone. The outstanding tenure of debt instruments beyond the permissible exposure should be at least five years at the time of investment. The dividend track record as per Sections 27-A(1)(l) and

27-B(1)(h) of the Insurance Act in the case of primary issuance of a wholly owned subsidiary of a corporate/PSU would apply to the holding company. However, all investments in infrastructure investee company would be subject to **group** (two/ore individuals, associations of individuals, firms, trusts, trustee, body corporates/any combination which exercises/is established to be in a position to exercise significant influence/control, use of common brand names directly/indirectly over any associate in Accounting Standard (AS-23), body corporate, firm/trust/associated person as stipulated by the IRDA) and promoter group exposure norms.

4. Subject to group/promoter group exposure norms, an insurer can invest a maximum of 20 per cent of the project cost of a public limited special purpose vehicle (SPV) engaged in infrastructure sector as part of approved investment provided **(i)** such investment is in debt, **(ii)** the parent company guarantees the entire debt and the interest of the SPV. Such guarantee should be limited to 20 per cent of the networth, **(iii)** the principal/interest if not paid within 90 days of the due date would be classified as other investment, **(iv)** the latest instruments of the parent company has rating not below **AA** grade, **(v)** the networth of the parent company should not be less than ₹500 crore (if unlisted) and ₹250 crore (if listed).
5. Investments in securitised assets (mortgage/asset based, securing receipts) in total (both approved and others) should not exceed 10 per cent and 5 per cent of investment assets in case of life and general insurance companies respectively. Similar limits would also apply to approved mortgaged/asset based investments with underlying housing/infrastructure assets. If downgraded below **AAA**/equivalent, they should be reclassified as other investments.
6. Investment in immovable property would be limited to 5 per cent of investment assets in case of all insurers.
7. Subject to exposure limits, total investments of all insurers in all companies belonging to the promoter group should not be more than 5 per cent in aggregate. Such investments cannot be by way of private placement or in unlisted instruments.
8. The exposure limits for financial/insurance activities should stand at 25 per cent of investment assets of all insurers. Investments in certificate of deposit/fixed deposit would not be deemed as a part of this exposure.

Additional Information The IRDA may, by general/special order, require from the insurers specified information in the specified manner at specified intervals and time limit.

Reporting of Extraordinary Events Every insurer should report to the IRDA immediately the effect/probable effect of any event coming to his knowledge which could have material impact on the investment portfolio and consequently on the security of policyholders benefits/expectations.

Investment Management ***(A) Constitution of Investment Company*** Every insurer should constitute an investment committee consisting of a minimum of two non-executive directors of the insurer, the CEO, the Chiefs of finance/investment division and the Appointed Actuary. Its decisions should be recorded/open to inspection by the IRDA.

(B) Investment Policy All insurers should **(i)** draw up an annual investment policy (fund-wise in case of unit linked business), **(ii)** have a model code of conduct to prevent insider/personal trading of officers involved in various levels of investment operations in compliance with the SEBI Prohibition of Insider Trading Regulation approved by its Board of Directions who should, while formulating such policy, ensure compliance with the following:

- Issues relating to liquidity, prudential norms, exposure limits, stop loss limits including securities trading, management of all risks/assets and liabilities, scope of internal/concurrent audit of investments and investment statistics and all other internal controls of investment operations, the provisions of the Insurance Act, IRDA investment regulations/guidelines/circulars;

- Ensuring adequate return on policyholders/shareholders funds consistent with the protection, safety and liquidity of the fund(s).
- The investment policy approved by the Board of Directors should be implemented by the investment committee and the Board should review on a quarterly basis the monitoring of fund-wise product-wise performance.
- The Board should review the investment policy and its implementation on an half-yearly basis or at short intervals and make necessary modifications to bring it in line with the investment provisions in the Insurance Act/regulations keeping in mind protection of policyholders interest and pattern of investment laid down in these regulations or in terms of the agreement with the policyholders in the case of unit linked business. The details of the investment policy/its periodical review should be made available to the internal/concurrent auditors whose comments on the review and its impact on the investment operations, systems and procedures should be placed before the Audit Committee of the Board.

(C) Investment Operations The funds should/continue to be invested in equity shares/equity-related instruments and debt instruments rated by a SEBI-registered agency. The Board of Directors should lay down clear norms for investing in **other investments** specified in Sections 27-A(2) and 27-B(3) of the Insurance Act by the investment committee taking into account the safety and liquidity of the policyholders funds and protection of their interest. In order to ensure proper internal control of investment functions/operations, the insurer should clearly segregate the functions/operations of front, mid and back office and no function should be outsourced. Also the primary data server of the computer application used for investment management should remain within the country.

(D) Processing of Unit Linked Business Applications and Delcaration of NAV

- All applications received for premium payment (as also other than premium payment) switches, redemption, surrender, maturity claim and so on should be time-stamped and dated.
- Whereas for applications with local cheques/cash/demand draft payable at the place of the receipt of the premium received **(a)** before **(b)** after cut-off time (3 P.M.), the applicable NAV would be the closing NAV of the same day and the next business day respectively, the NAV of the day on which the cheque/demand draft is reclaimed would be applied.
- Every insurer should reconcile the premium received net of charges and benefits paid under each product (Unique Identification Number – UIN) with value of all the segregated funds (segregated fund identification number – SFIN) net of fund management charges held under a single UIN on a day-to-day basis. The UIN-wise reconciliation and the value of policy-wise units held by the policyholders should be disclosed on the insurers website and the fund-wise NAV (SFIN-wise) on the website of the insurers as well the life council website on the same day. The internal/concurrent auditor should submit a report on a quarterly basis.
- The applicable NAV for applications received before and after 3 P.M. on the last business day of the financial year would be of the last business day or the immediate next business respectively.
- For allotment of units, the applicable NAV would be as per the date of commencement of policy for new policy contracts and date of receipt of premium for renewals.

(E) Risk Management Systems

- The Board of Directors should implement the IRDSAI-mandated investment risk management system and process. Its implementation should be certified by a CA firm.
- The system should be reviewed in the beginning of every second financial year/or at shorter frequency by a CA firm and the certificate should be filed with the IRDA along with the first quarter return.

(F) Audit and Reporting to Management

- The audit committee constituted by the Board of Directors of the insurer should be headed by a chartered accountant (CA) member.
- The investment transactions covering the shareholders/policyholders funds should be audited through internal/concurrent auditor on a quarterly basis. The details of investment policy, implementation status of investment risk management system/process or its review should be available to them who should comment on them in their report to the audit committee of the Board of Directors.

(G) Category of Investments Funds of insurers should be invested only within the exhaustive category listed in the IRDA guidelines.

(H) The IRDA may call for further information from time to time as it deems necessary and in the interest of policyholders and issue directions to insurers as it thinks fit.

Dealings in Financial Derivatives All insurers may deal in **financial derivatives** [i.e. a derivative defined by the Securities Contracts (Regulation) Act and includes a contract which derives its value from interest rates of underlying debt securities and other derivatives contracts stipulated by the IRDA] only to the extent permitted and in accordance with the IRDA guidelines. Any margin/unamortised premium paid by an insurer in connection with the financial derivatives to the extent they are reflected as asset position in the balance sheet of the insurer in accordance with the IRDA guidelines would be treated as **Approved Investments** only to the extent the derivative position constitutes a hedge for the underlying investment/portfolio which itself is treated as an approved investment. All other margins/unamortised premium paid to the extent reflected in the balance sheet of the insurer in accordance with the IRDA guidelines would be treated as other investment.

PREPARATION OF FINANCIAL STATEMENTS AND AUDITOR'S REPORT

The IRDA regulations relating to the preparation of financial statements, management report and auditor's report of insurance companies are examined in this section for life and general insurance companies.

Life Insurance Companies The compliance requirements are detailed in **Appendix 16-A on the website. The website address is http://www.mhhe.com/khanifs10e.**

General Insurance/Reinsurance Companies The compliance requirements for general insurance companies are detailed in **Appendix 16-B on the website. The website address is http://www.mhhe.com/khanifs10e.**. Until separate regulations are made, the requirements applicable to general insurance companies would apply mutatis mutandis to reinsurers.

Auditors' Report The matters to be specified by the auditors' report in their report are given in **Appendix 16-C on the website. The website address is http://www.mhhe.com/khanifs10e.** The IRDA may from time to time issue separate guidelines in matters of appointment continuance/ removal of auditors, their qualification and experience, periods of appointment and rotation and so on.

Third Party Administrators (TPAs)—Health Services

The main elements of the IRDA regulations are: **(1)** licensing of TPAs, **(2)** revocation/cancellation of their licence, **(3)** code of conduct for them, **(4)** maintenance/confidentiality of information and **(5)** miscellaneous provisions.

Licensing of TPAs An IRDA-licensed **TPA** registered as a company under the Companies Act provides health services for fee/ remuneration specified in an agreement entered into with an insurance company. It prescribes the terms/ conditions of health services which may be rendered to and/or received by each of the parties to the agreement. The main/primary objective of the company should be to carry on business as a TPA in health services and it should not engage itself in any other business. It should have a minimum **(i)** paid-up equity capital and **(ii)** working capital (i.e. current assets less current liabilities) of ₹1 crore. At least one of its Directors should be a qualified medical doctor registered with the Medical Council of India. Not more than 26 per cent of its equity shares can be held by a foreign company. It should seek prior approval of the IRDA for change in shareholding exceeding 5 per cent of its paid-up capital by way of transfer of existing shares or fresh issue of shares to new/existing shareholders.

The application for licence as TPA to the IRDA should be in the specified form together with a nonrefundable processing fee of ₹20,000. It would be incumbent on applicant-TPA to furnish within the specified time such information/document(s) as the IRDA may deem fit. On being satisfied that the applicant is eligible to function as TPA, it would issue a licence on payment of a licence fee of ₹30,000. An applicant whose application is rejected can apply again after two years.

Within 15 days of the execution of the agreement between TPA and the insurance company or its modification, a copy should be filed with the IRDA. However, a TPA can serve more than one insurance company. Similarly, an insurance company can engage more than one TPA. The parties to the agreement should agree on the scope of the contract and the facilities that have to be provided. The agreement should also provide the remuneration payable to the TPA by the insurance company. An insurance company can cancel or modify for good and sufficient reasons an agreement entered into by it with a TPA.

For proper day to day administration of its activities, the TPA should appoint, with due intimation to the IRDA, a Chief Administrative Officer (CAO) or Chief Executive Officer (CEO) from amongst its Directors/senior employees and inform the IRDA within 30 days of the date of appointment. It should also intimate the opening/closing of branches or change of registered/branch office within 15 days from the date of change. He should possess the following educational qualifications, namely, **(a)** degree in arts/ science/commerce/management/health/ hospital administration/medicine, **(b)** a pass in the Associateship examination conducted by the Insurance Institute of India/an equivalent examination recognised by the IRDA, and **(c)** completion of practical training specified by the IRDA not exceeding 1100 hours with an institution recognised by the IRDA for the purpose. In addition, he should also undergo a specified period

' of training with an institution recognised by the IRDA. Moreover, the CEO/CAO should not be: **(i)** a person of unsound mind, **(ii)** an undischarged insolvent, and **(iii)** a person subjected to imprisonment for a term of 3 months by a court of competent jurisdiction on grounds of misconduct, misfeasance, forgery and so on.

Any licence granted to a TPA or its renewal would be valid for 3 years unless revoked/ cancelled earlier by the IRDA. The licence would be renewed on payment of a renewal fee of ₹15,000 on an application submitted at least 30 days before its expiry. A delayed application, stating the reasons for the delay and accompanied by a late fee of ₹100, may also be accepted by the IRDA. A lost/multilated license may be replaced by the IRDA on payment of ₹1,000.

Revocation/Cancellation of Licence The licence granted to any TPA may, after due notice, be revoked or cancelled by the IRDA for one/more of the following reasons:

- On the basis of **(i)** information received, **(ii)** its own enquiry/investigation, IRDA is of the opinion that the TPA is functioning improperly and/or against the interest of the insured/ policyholders/insurance company;
- On the basis of information in its possession, it is of opinion that the financial condition of the TPA has deteriorated and it cannot function effectively or it has committed breach of the regulations pertaining to **(i)** its character and ownership, **(ii)** obtaining of licence on the basis of fraud/misrepresentation of facts, **(iii)** breach in following the procedure/ acquiring qualification laid down for CAO/ CEO, and **(iv)** any violation of any directions issued by the IRDA;
- After enquiry/upon information, it is of the pinion that the character/ownership of the TPA has changed significantly;
- The licence/its renewal was on the basis of fraud/misrepresentation of facts;
- There is a breach on the part of the TPA in following the procedure or acquiring qualifications laid down for CAOs/CEOs;
- The TPA is subject to winding up proceedings;
- There is breach of code of conduct (discussed subsequently);
- There is violation of any directions issued by the IRDA under the Insurance Act/Regulations.

Before revoking/cancelling the licence of a TPA, the IRDA would give it a reasonable opportunity of being heard. The aggrieved TPA may file a review application with the IRDA within 30 days of the revocation/cancellation of the licence. The IRDA would dispose it of within 90 days.

Code of Conduct A TPA should, as far as possible, act in the best possible professional manner. In particular, every TPA/its CAO/its CEO/its employees or representatives would be duty bound to:

(a) Establish its/his/their identity to the public and the insured/policyholder and that of the insurance company with which it has entered into an agreement;

(b) Disclose its licence to the insured/policyholder/prospect;

(c) Disclose the details of the services it is authorised to render in respect of health insurance products under an agreement with an insurance company;

(d) Bring to the notice of the insurance company with whom it has an agreement, any adverse report on inconsistencies or any material fact that is relevant for the insurance company's business;

(e) Obtain all the requisite documents pertaining to the examination of an insurance claim arising out of insurance contract concluded by the insurance company with the insured/ policyholder;

(f) Render necessary assistance specified under the agreement and advice to policyholders/ claimants/ beneficiaries in complying with the requirements for settlement of claims with the insurance company;

(g) Conduct itself/himself in a courteous and professional manner;

(h) Refrain from acting in a manner, which may influence directly or indirectly the insured/ policyholder of a particular insurance company to shift the insurance portfolio from the existing one to another one;

(i) Refrain from trading on information and the records of its business;

(j) Maintain the confidentiality of the data collect by it in the course of its agreement;

(k) Refrain from resorting to advertisements of its business or the services rendered by it on behalf of a particular insurance company, without its prior written approval;

(1) Refrain from including an insured/policyholder to omit any material information, or submit wrong information;

(m) Refrain from demanding/receiving a share of the proceeds/indemnity from the claimant under an insurance contract;

(n) Follow the guidelines/directions issued by the IRDA from time to time.

Maintenance and Confidentiality of Information Every TPA is required to maintain, in accordance with the accepted professional standards of record keeping for at least 3 years, proper records/ documents/evidence and books of all transactions carried out by it on behalf of an insurance company in terms of its agreement. They should be available to the insurance company(ies)/ IRDA and access cannot be denied by the TPA on any ground. While maintaining the records, the TPAs should follow strictly the professional confidentiality between the concerned parties. However, they can part with the relevant information to any court/tribunal/government/IRDA **(i)** in case of any investigation by the IRDA against the insurance company/TPA/any other person or **(ii)** for any reason.

On cancellation/revocation of its licence, the data collected and books/records/documents and so on relating to its business, complete in all respects should be handed over by the TPA to the insurance company immediately.

Miscellaneous To look into proper and efficient performance of any TPA(s), the IRDA may from time to time constitute committees consisting of members from various sources including the TPA(s)/insurance companies/IRDA or any other person. Every TPA should furnish to the insurance company(ies)/IRDA **(i)** an annual report duly verified by a Director/CAO/CEO within 60 days of the end of its financial year/or such extended time as it may grant and **(ii)** any other return on its activities as required by the IRDA. It should file monthly information relating to claims data within 15 days from end of each month. The TPAs should also make available to the IRDA for inspection copies of all contracts with the insurance company(ies).

General Any change in the agreement between a TPA and an insurer should be filed with the IRDA. The TPA should not charge any separate fee from policyholders which it serves under the terms of agreement with the insurance company. Failure to furnish any document/statement/ return and so on to the IRDA by any person would be construed as non-compliance of the Insurance Act.

Protection of Policyholders Interest Regulations

These regulations are in addition to any other regulations made by the IRDA which may, inter alia, provide for protection of the interest of the policy-holders. They apply to all insurers, insurance agents, insurance intermediaries and policy-holders. Their main elements are: **(1)** point of sale, **(2)** proposal for insurance, **(3)** grievance redressal procedure, **(4)** matters to be stated in life insurance policy, **(5)** matters to be stated in general insurance policy; **(6)** claims procedures in respect of life insurance policy, **(7)** claims procedures in respect of general insurance policy, **(8)** policy-holders' servicing and **(9)** general.

Point of Sale A prospectus (i.e. a document issued by an insurer or in its behalf to the prospective buyer of insurance containing such particulars as are mentioned in Rule 11 of Insurance Rules and includes a brochure/leaflet. It should also specify the type and character of riders on the main product indicating the nature of benefits following thereupon) of an insurance product should clearly state the scope of benefits, the extent of insurance cover (i.e. an insurance contract whether in the form of a policy/cover note/certificate of insurance/any other form prevalent in the industry to evidence the existence of an insurance cover) and in an explicit manner explain the warranties/exceptions/conditions of the insurance cover and, in case of life insurance, whether the product is participating (with benefits) or non-participating (without benefits). The allowable rider(s) on the product should clearly spell out with regard to their scope of benefits and, in no case, the premium relatable to health-related or critical illness riders in case of term/ group products should exceed 100 per cent of premium under the basic product. All other riders put together should be subject to a ceiling of 30 per cent of the premium of the basic product. Any benefit arising under each of the riders should not exceed the sum assured under the basic product. However, the benefit amount should be subject to Section 2 (11) of the Insurance Act.

An insurer/its agent/other intermediary should provide all material information in respect of a proposed cover to the prospect to enable him to decide on the best cover that would be in his/ her interest. Where the prospect depends upon their advice, they must advice him dispassionately. If, for some reason, the proposal and other connected papers are not filled by the prospect, a certificate may be incorporated at the end of the proposal form [i.e. a form to be filled in by the proposer for insurance for furnishing all material information (that is, all important, essential and relevant information in the context of underwriting the risk covered by the insurer) required by the insurer in respect of a risk in order to enable the insurer to decide whether to accept or decline to undertake the risk and in the event of acceptance of the risk, determine the rates/ terms/ conditions of a cover to be granted] from the prospect that the contents of the form and documents have been fully explained to him and that he has fully understood the significance of the proposed contract.

In the process of sale, the insurer/its agent/any other intermediary should act according to the code of conduct prescribed by **(i)** the IRDA, **(ii)** Councils established under Section 64-C of the Insurance Act and **(iii)** the recognised professional bodies/association of which they are members.

Proposal for Insurance Except in cases of marine insurance cover, where current market practice do not insist on a written proposal form, in all cases, a proposal for grant of a cover, either for life business or for general business, must be evidenced by a written document. An insurer should furnish a copy of the proposal form to the insured free of charge, within 30 days of the acceptance of a proposal. The forms and documents used in the grant of cover may, depending upon the circumstances of each case, be made available in languages recognised under the Constitution of India. In filing the form of proposal, the prospect is to be guided by the provisions of Section 45 of the Insurance Act. Any proposal form seeking information for grant of life cover may prominently state the requirements of Section 45 of the Insurance Act. Where a proposal form is not used, the insurer should record the information obtained orally or in writing, and confirm it within 15 days with the proposer and incorporate the information in its cover note or policy. The onus of proof would rest with the insurer in respect of any information not so recorded, where the insurer claims that the proposer suppressed any material information or provided misleading or false information on any matter material to the grant of a cover.

Wherever the benefit of nomination is available to the proposer, in terms of the Insurance Act or the conditions of policy, the issuer should draw the attention of the proposer to it and encourage the prospect to avail the facility. The proposals should be processed by the insurer with speed and efficiency and all decisions should be communicated by it in writing within a reasonable period not exceeding 15 days from receipt of proposals by the insurer.

Grievance Redressal Procedure Every insurer should have in place proper procedures and effective mechanism to address complaints and grievances of policyholders efficiently and with speed and the same along with the information in respect of Insurance Ombudsman should be communicated to the policyholder(s) along with the policy document and as may be found necessary.

Matters to be Stated in Life Insurance Policy A life insurance policy should clearly state:

- **(a)** The name of the plan governing the policy, its terms and conditions;
- **(b)** Whether it is participating in profits or not;
- **(c)** The basis of participation in profits such as cash bonus, deferred bonus, simple or compound reversionary bonus;
- **(d)** The benefits payable and the contingencies upon which these are payable and the other terms and conditions of the insurance contract;
- **(e)** The details of the riders attaching to the main policy;
- **(f)** The date of commencement of risk and the date of maturity or date(s) on which the benefits are payable;
- **(g)** The premium payable, periodicity of payment, grace period allowed for payment of the premium, the date of the last instalment of premium, the implication of discontinuing the payment of an instalment(s) of premium and also the provisions of a guaranteed surrender value;
- **(h)** The age at entry and whether the same has been admitted;
- **(i)** The policy requirements for **(a)** conversion of the policy into paid-up policy, **(b)** surrender, **(c)** nonforfeiture and **(d)** revival of lapsed policies;
- **(j)** Contingencies excluded from the scope of the cover, both in respect of the main policy and the riders;
- **(k)** The provision for nomination, assignments and loans on security of the policy and a statement that the rate of interest payable on such loan amount would be as prescribed by the insurer at the time of taking the loan;
- **(1)** Any special clauses or conditions, such as, first pregnancy clause, suicide clause and so on;
- **(m)** The address of the insurer to which all communications in respect of the policy should be sent;

(n) The document that are normally required to be submitted by a claimant in support of a claim under the policy.

While forwarding the policy to the insured, the insurer should inform him that he has a period of 15 days from the date of receipt of the policy document to review the terms and conditions of the policy, and where he disagrees to any of those terms or conditions, he has the option to return the policy stating the reasons for his objection, when he would be entitled to a refund of the premium paid, subject only to a deduction of a proportionate risk premium for the period on cover and the expenses incurred by the insurer on medical examination of the proposer and stamp duty changes. In respect of a unit linked policy, in addition to the above deductions, the insurer would also be entitled to repurchase the unit at the price of the units on the date of cancellation. In respect of cover, where premium charged is dependent on age, the insurer should ensure that the age is admitted as far as possible before issuance of the policy document. In case, where age has not been admitted by the time the policy is issued, the insurer should make efforts to obtain proof of age and admit the same as soon as possible.

Matters to be Stated in General Insurance Policy A general insurance policy should clearly state

(a) The name(s) and address(s) of the insured and of any bank(s) or any other person having financial interest in the subject matter of insurance;

(b) Full description of the property or interest insured;

(c) The location(s) of the property or interest insured under the policy and, where appropriate, with respective insured values;

(d) Period of insurance;

(e) Sums insured;

(f) Perils covered and not covered;

(g) Any franchise or deductible applicable;

(h) Premium payable and where the premium is provisional subject to adjustment, the basis of adjustment of premium be stated;

(i) Policy terms, conditions and warranties;

(j) Action to be taken by the insured upon occurrence of a contingency likely to give rise to a claim under the policy;

(k) The obligations of the insured in relation to the subject matter of insurance upon occurrence of an event giving rise to a claim and the rights of the insurer in the circumstances;

(1) Any special conditions attaching to the policy;

(m) Provision for cancellation of the policy on grounds of misrepresentation, fraud, non-disclosure of material facts or non-cooperation of the insured;

(n) The address of the insurer to which all communications in respect of the insurance contract should be sent;

(o) The details of the riders attaching to the main policy; and

(p) Proforma of any communication the insurer may seek from the policyholders to service the policy.

Every insurer should inform and keep informed periodically the insured on the requirements to be fulfilled by him regarding lodging of a claim arising in terms of the policy and the procedures to be followed by him to enable the insurer to settle a claim early.

Claims Procedure of a Life Insurance Policy A life insurance policy should state the primary documents which are normally required to be submitted by a claimant in support of a claim.

Upon receiving a claim, it should process the claim without delay. Any queries or requirement of additional documents, to the extent possible, should be raised all at once, within a period of 15 days of the receipt of the claim. A claim should be paid or disputed giving all the relevant reasons, within 30 days from the date of receipt of all relevant papers and clarifications required. Where, in the opinion of the insurance company, the circumstances of a claim warrant an investigation, it should initiate and complete such investigation at the earliest, and in any case not later than 6 months from the time of lodging the claim.

Subject to the provisions of Section 47 of the Insurance Act, where a claim is ready for payment but the payment cannot be made due to any reasons of a proper identification of the payee, the life insurer should hold the amount for the benefit of the payee and such an amount would earn interest at the rate applicable to a savings bank account with a scheduled bank (effective from 30 days following the submission of all papers and information). Where there is a delay on the part of the insurer in processing a claim for a reason other than the one covered above, it should pay interest on the claim amount at a rate which is 2 per cent above the bank rate prevalent at the beginning of the financial year in which the claim is reviewed by it.

Claim Procedure in Respect of a General Insurance Policy An insured or the claimant should give notice to the insurer of any loss arising under contract of insurance at the earliest or within such extended time as may be allowed by the insurer. On receipt of such a communication, a general insurer should respond immediately and give clear indication to the insured on the procedures that he should follow. In cases where a surveyor has to be appointed for assessing a loss/claim, it should be done within 72 hours of the receipt of intimation from the insured. Where the insured is unable to furnish all the particulars required by the surveyor or where the surveyor does not receive the full cooperation of the insured, the insurer/surveyor should inform in writing the insured about the delay that may result in the assessment of the claim. The surveyor would be subjected to the code of conduct laid down by the IRDA while assessing the loss, and should communicate his findings to the insurer within 30 days of his appointment with a copy of the report being furnished to the insured, if he so desires. Where, in special circumstances of the case, either due to its special and complicated nature, the surveyor should under intimation to the insured, seek an extension from the insurer for submission of his report. In no case should a surveyor take more than six months from the date of his appointment to furnish his report.

If an insurer, on the receipt of a survey report, finds that it is incomplete in any respect, he should require the surveyor under intimation to the insured, to furnish an additional report on certain specific issues as may be required by the insurer. Such a request may be made by the insurer within 15 days of the receipt of the original survey report. However, the facility of calling for an additional report by the insurer cannot be resorted to more than once in the case of a claim. The surveyor on receipt of this communication should furnish an additional report within three weeks of the date of receipt of communication from the insurer. On receipt of the survey/additional survey report, an insurer should, within a period of 30 days, offer a settlement of the claim to the insured. If the insurer, for any reasons to be recorded in writing and communicated to the insured, decides to reject a claim under the policy, it should do so within a period of 30 days from the receipt of the survey/additional survey report. Upon acceptance of an offer of settlement by the insured, the payment of the amount due should be made within 7 days from the date of acceptance of the offer by the insured. In case of delay in payment, the insurer would be liable to pay interest at a rate 2 per cent above the bank rate prevalent at the beginning of financial year in which the claim is reviewed by it.

Policyholder's Servicing An insurer carrying on life or general business, should at all times, respond within 10 days of the receipt of any communication from its policyholders in all matters, such as:

- **(a)** Recording change of address;
- **(b)** Noting of new nomination or change of nomination under a policy;
- **(c)** Noting an assignment on the policy;
- **(d)** Providing information on the current status of a policy indicating matters, such as, accrued bonus, surrender value and entitlement to a loan;
- **(e)** Processing papers and disbursal of a loan on security of policy;
- **(f)** Issuance of duplicate policy;
- **(g)** Issuance of an endorsement under the policy; noting a charge of interest or sum assured or perils insured, financial interest of a bank and other interests; and
- **(h)** Guidance on the procedure for registering a claim and early settlement thereof.

General The requirements of disclosure of 'material information' regarding a proposal or policy apply, under these regulations, both to the insurer and the insured. The policyholder should assist the insurer, if the latter so requires, in the prosecution of a proceeding or in the matter of recovery of claims which the insurer has against third parties. He should furnish all information sought by the insurer and also any other information which the insurer considers as having a bearing on the risk to enable the latter to assess properly the risk sought to be covered by a policy. Any breach of obligation cast on an insurer or insurance agent or insurance intermediary in terms of these regulations may enable the IRDA to initiate action against each or all of them, jointly or severally, under the Insurance Act and/or the IRDA Act.

Registration of Corporate Agents Regulation 2015

A **corporate agent** means a company, limited liability partnership, cooperative society, bank, corresponding ban, regional rural bank, NGOs/micro-lending financial institutions, any other person recognised by IRDA) for soliciting, procuring and servicing of insurance business of life, general and health insurer during the validity of certificate of registration. A **corporate agent (life)** may have arrangements with a maximum of three life insurers to solicit, procure and service their insurance products. A **corporate agent (general)** may have arrangements with a maximum of three general insurers to solicit, procure and service their insurance products. Further, he should solicit, procure and service retail lines of general insurance products and commercial lines of such insurers having a total sum insured not exceeding rupees five cores per risk for all insurances combined. A **corporate agent (health)** may have arrangements with a maximum of three health insurers to solicit, procure and service their insurance products. In case of **corporate agent (composite)**, the conditions as specified in clause **(a)** to **(c)** would apply. Any change in their arrangement with the insurance companies would be done only with the prior approval of the IRDA and with suitable arrangements for servicing existing policyholders. While **corporate agents (life, general and health)** solicit/service insurance business for life, general and health insurers respectively, a **composite corporate agent** solicit/services all the three or a combination of any two insurance business. The main elements of these regulations are discussed below.

Registration An applicant desiring to obtain a CoR to act as a corporate agent is either an entity whose principal business is **(i)** other than distribution of insurance products and insurance distribution is a subsidiary activity, **(ii)** to exclusively carry on insurance intermediation. The application should be made in the prescribed form accompanied by the requisite non-refundable application fee of ₹10,000 and registration fee of ₹25,000 plus applicable taxes. The fee for renewal of registration would be ₹25,000 plus applicable taxes. An application, not complete in all respects and not conforming to the specified instructions and these regulations, would be rejected. The IRDA may require an applicant to furnish any further information or clarification for the purpose of disposal of the application, and, thereafter, in regard to any other matter as may be deemed necessary. The applicant/its **principal officer** (i.e. director/partner/any designated officer/employee and approved by the IRDA exclusively appointed to supervise the activity of corporate agent and who possesses the requisite qualifications/practical training and has passed the required examination) should, if so required, appear before the IRDA for a personal representation in connection with its application.

Consideration of Application The IRDA, while considering an application for grant of registration, would take into account all matters relevant for carrying out the activities of a corporate agent. Without prejudice to the above, in particular, it would take into account whether applicant **(a)** **(i)** is not suffering from any of the specified disqualifications under the Insurance Act, **(ii)** has the necessary infrastructure, such as, adequate office space, equipment and trained manpower on its rolls to effectively discharge its activities; **(b)** any person, directly or indirectly connected (i.e. an associate/subsidiary/interconnected undertaking/group company) with the applicant, has been refused in the past the grant of licence/registration by the IRDA; **(c)** principal officer of the applicant is a graduate and has received at least 50 hours of theoretical and practical training from an **approved institution** (i.e. any IRDA-approved institution engaged in education/training particularly in the area of insurance sales/marketing including the **Insurance Institute of India**) according to a syllabus approved by the IRDA, and has passed an examination, at the end of the period of training, conducted by the examination body. Where the principal officer of the applicant is an associate/fellow of the Insurance Institute of India/CIL, London/Institute of Actuaries of India/ holds any post-graduate qualification of the Institute of Insurance and Risk Management, Hyderabad, the theoretical and practical training would be 25 hours; **(d)** principal officer, directors and other employees of the applicant have not violated the specified code of conduct during the last three years; **(e)** applicant, in case the principal business of the applicant is other than insurance, maintains an arms-length relationship in financial matter between its activities as corporate agent and other activities; **(g)** principal officer/director(s)/partner(s)/specified persons is/are fit and proper based on the specified statement; and **(h)** IRDA is of the opinion that the grant of registration will be in the interest of policyholders.

The **specified persons** (i.e. an employee of a corporate agent responsible for soliciting/procuring insurance business on its behalf fulfilling the specified requirements of qualification/training/examination) of the applicant should fulfil the following requirements: **(a)** have **(i)** passed minimum of 12th class or equivalent examination from a recognised board/institution, **(ii)** undergone at least 50 hours of training, for the specified category of life, general, health for which registration is sought for and have passed the examination conducted by the examination body, **(iii)** corporate agent (composite) should have undergone at least 75 hours of training from an approved institution and have passed the examination conducted by the examination body; **(b)** have valid certificate issued by the IRDA. The certificate should be valid for three years from the date of issue subject to the valid registration of the corporate agent; **(c)** a specified person of a corporate agent wishes to switch over to any other corporate agent, should applying to the IRDA through the new corporate agent along with a **no objection certificate** issued by the present corporate agent.

Capital Requirement An applicant exclusively doing insurance distribution should have a minimum equity share capital or contribution and net worth of rupees ₹50,00,000. In case of applicant exclusively doing insurance distribution, the aggregate holdings of equity shares or contribution by a foreign investor, including portfolio investors, would be as prescribed by the Central Government.

Procedure for Registration The IRDA, on being satisfied that the applicant fulfils all the specified conditions, would grant a registration subject to the applicant adhering to the conditions and the specified code of conduct. A corporate agent registered for a specified category may also apply for the grant of registration by the IRDA for any other category by fulfilling the prescribed requirements. However, such application should be made only after completion of one year from the grant of a registration in the first instance. A registration would be valid for three years from the date of it issue. A corporate agent may, within thirty days before the expiry of the registration, make an application in the prescribed form along with requisite fee for renewal of registration. A corporate agent is permitted to submit the application for renewal of registration 90 days prior to the expiry of the registration. The principal officer and specified persons before seeking a renewal of registration should have completed at least 25 hours of theoretical and practical training imparted by an approved institution. On being satisfied that the applicant fulfils all the specified conditions, the IRDA would renew the registration for three years. Where an application for grant of a registration does not satisfy the specified conditions, the IRDA may refuse to grant or renew the CoR.The refusal should be communicated within thirty days stating the grounds on which the application has been rejected. Any applicant aggrieved by the decision of the IRDA may make an appeal to Securities Appellate Tribunal, within 45 days from the date on which a copy of the order is received by it. On and from the date of the receipt of the communication cease to act as a corporate agent.

Conditions of Grant of Registration The registration/renewal would, *inter alia*, be subject to the following conditions. The corporate agent should/would **(i)** be permitted to solicit and service specified insurance business only; **(ii)** comply with the provisions of the Insurance Act, IRDA Act/regulations/circulars/guidelines and any other instructions; **(iii)** forthwith inform the IRDA in writing, if any information or particulars previously submitted to the IRDA by them are found to be false or misleading in respect of any material particular or if there is any material change in the information already submitted; **(iv)** take adequate steps for redressal of grievances of its client within 14 days of its receipt such complaint and keep the IRDA informed about the number, nature and other particulars of the complaints received in the prescribed format and manner; **(v)** solicit and procure reasonable number of insurance policies commensurate with their resources and the number of specified persons they employ; **(vi)** maintain records in the specified format which would capture policy-wise and specified person-wise details specified person except for those products which are simple, sold over-the-counter and specifically approved by the IRDA; **(vii)** under no circumstances undertake multi-level marketing for solicitation of insurance products; **(viii)** ensure compliance of code of conduct applicable to its directors, principal officer and specified persons; **(ix)** maintain separate specified books of account for their corporate agency business. In the event of a certificate of registration being lost or destroyed or mutilated, a corporate agent should submit to the IRDA an application with a declaration giving full details along with a fee of ₹1000 plus applicable taxes for issue of a duplicate certificate. Notwithstanding and without prejudice to initiation of any criminal proceedings against any person, who acts as a corporate agent without holding a valid registration, the IRDA may invoke penal action under the IRDA Act or any other law for the time being in force. Without prejudice to any other proceedings which may be taken by the IRDA against the company or firm or body corporate, every director, manager, secretary, other/every partner who is knowingly a party to such contravention would also be liable to be proceeded against.

Requirement of Professional Indemnity Insurance Policy Every corporate agent, where the revenues from their insurance intermediation activities is more than 50 per cent of total revenue from all the activities, should take out and maintain at all times a professional indemnity insurance cover throughout the validity of the period of its registration. The limit of indemnity would be 2 times the total annual remuneration of the corporate agent derived from their insurance intermediation activities in a year subject to a minimum of ₹15,00,000 and a maximum of ₹10 crore.

Board Approved Policy for Open Architecture Every corporate agent should file, at the time of seeking registration, with the IRDA, a Board or its equivalent approved policy on the manner of soliciting and servicing insurance products. It should address the manner of adopting the philosophy of open architecture and going forward in implementing the same. It should, *inter alia*, include the approach to be followed in having single/multiple tie-ups, partners, the business mix, type of product sold, grievance redressal mechanism and reporting requirements. The corporate agents should furnish half-yearly returns to the IRDA insurer-wise business placed separately in respect of life, general and health insurance, in the specified format, before October 31 and April 30 every year.

Conflict of Interest While soliciting/procuring business, the corporate agents should disclose to the prospective customer(s) the list of insurers, with whom they have arrangements to distribute their products and provide them with the details such as scope of coverage, term of policy, premium payable, premium terms and any other information which the customer seeks on all products available with them. The scale of commission should also be disclosed. Where the insurance is sold as an ancillary product along with a principal business product, the corporate agent or its shareholder or its associates should not compel the buyer of the principal business product to necessarily buy the insurance product through it. The principal officer and CFO (or its equivalent) of the corporate agent should file with the IRDA a certificate in the specified format on half-yearly basis, certifying that there is no forced selling of an insurance product to any prospect. No insurer should require the corporate agent to insure every client with it.

Disclosures An applicant-corporate agent should disclose to the IRDA at the time of filing application all material facts relevant for consideration of application on its own. In case of any change in the information, subsequent to filing/during the processing of application, the changes should be disclosed voluntarily by the applicant for consideration of the IRDA. Similarly, a corporate agent who holds a valid registration should disclose to the IRDA voluntarily any change in material facts, based on which a registration was made to them, within 30 days of the change. The IRDA may seek any clarification/issue directions as it deem fit. A corporate agent should also disclose to the IRDA proceedings initiated against them by other regulatory/ Government bodies within 30 days from the initiation of the proceedings. Any action/direction issued by them should also be disclosed within the 30-day time limit. The IRDA may require, from time to time, the corporate agent to furnish information/return as deemed appropriate. The corporate agent should disclose to the IRDA the details of its offices in which they propose to distribute insurance products and details of the specified persons along with their certificate number issued by the IRDA. Further, any opening or closure of an office by a corporate agent should be informed to the IRDA. Failure to adhere to the above conditions would attract regulatory actions such as suspension/cancellation of registration, imposition of monetary penalty/any other action deemed fit.

Arrangements with Insurers for Distribution of Products Corporate agents should enter into arrangements for minimum one year with insurers for distribution of their products which should be disclosed to the IRDA within 30 days. No corporate agent should promise nor any insurer should compel it to distribute the products of a particular insurer. The arrangements should have provisions to include duties and responsibilities of corporate agents towards the policyholders, duties and responsibilities of insurers and corporate agents, terms and conditions for termination of arrangements. No arrangement should be made against the interest of policyholder. To terminate arrangement with any insurer, the corporate agent should inform the insurer and the IRDA the reasons for termination of arrangement. They should ensure that the policies solicited and placed with the insurer are serviced till the expiry of policies, or six months, whichever is earlier within which time they should make suitable arrangements with the concerned insurer. An insurer can terminate the arrangement with any corporate agent after informing it and the IRDA the reasons for termination of arrangement. The concerned insurer should take the responsibility of servicing the policies procured by it and inform the policyholder concerned of the changes made in servicing arrangements. No insurer should pay and no corporate agent should receive any signing fee or any other charges, except those permitted by the IRDA for becoming its corporate agent. The insurers should not directly pay incentives (cash or non-cash) to the principal officer, specified persons and other employees of the corporate agent. The IRDA may direct any insurer/corporate agent to terminate the distribution arrangement by recording the reasons therefor.

Servicing of Policyholders A corporate agent would have the duty to service its policyholders during the entire period of contract. Servicing includes assisting in payment of premium, providing necessary assistance and guidance in the event of a claim, providing all other services and guidance on issues which arise during the course of an insurance contract.

Sale of Insurance by Tele-marketing Mode and Distance Marketing Activities of a Corporate Agent A corporate agent who intends to engage the services of a **telemarketer** (i.e. an entity registered with **TRAI** to conduct business of sending commercial communication and holding a certificate from the IRDA) or engage in distance marketing activities for the purpose of distribution of insurance products should follow the specified instructions. Without prejudice to above, it should comply with the following additional conditions. The telemarketer should comply with various circulars and/or guidelines or any other direction issued by the TRAI in the matter. A corporate agent intends to undertake telemarketing activities for insurance intermediation should seek prior approval of the IRDA. He should file with the IRDA the names of authorised verifiers engaged/proposed to be engaged by the telemarketer in the specified form. In case an authorised verifier intends to switch to another telemarketer who is also dealing with insurance intermediation, they should obtain a **No Objection Certificate** from the erstwhile telemarketer and submit the same to the IRDA for issuing a fresh certificate. The application for removal/addition of authorised verifier should be made by the corporate agent concerned through the principal officer. In case the corporate agent registers as telemarketer with TRAI, he should act as telemarketer for only those insurers with whom he was arrangements. No corporate agent/telemarketer should make outbound calls to any person unless he or she has shown interest in buying an insurance policy by making enquiries to that effect. They should maintain their database and the enquiry made for verification and checking by the IRDA or any person authorised by it. The telemarketer should disclose to the prospective customer the following information: **(a)** name of the corporate agent they represent, **(b)** registration number of the corporate agent, **(c)** contact number of the telemarketer and/or corporate agent in case the customer desires to call back or verify the telesales information, **(d)** name and identification number of the person (authorised verifier) making the tele-call. A corporate agent should enter into an agreement with the telemarketer providing the details such as source of the database, duties and responsibilities, payment details, period of agreement, actions to be taken in case of violation of the Insurance Act/regulations/guidelines/circulars/directions/code of conduct of authorised verifiers. It should be made available to the IRDA or any person authorised by it for verification. Every telemarketer and the authorised verifier should abide by the code of conduct applicable to corporate agents. The IRDA would have the power to inspect the premise of the telemarketer of any other promises, which it feels necessary for the verification of records/documents and seek any document/record, record statements of any employee of the telemarketer or make copies of any documents/records at its discretion. The telemarketer would have to comply with any other terms and conditions prescribed by the IRDA from time to time in the matter. A telemarketer should not be engaged with more than three insurers/insurance-related entities.

Code of Conduct for Corporate Agents Every corporate agent should abide by the specified code of conduct. He would be responsible for all the acts and omissions of its principal officer, specified persons and other employees including violation of specified code of conduct and liable to a penalty which may extend to one crore rupees.

Inspection of Corporate Agent The IRDA has the power to inspect the records of a corporate agent and performance of its activities any time and in case of any deficiency observed, it may take appropriate disciplinary action.

Suspension/Cancellation/Surrender of Registration The procedure for suspension, cancellation or surrender of registration would be as stipulated in the IRDA regulations.

Change in Ownership and/or Shareholding In case of a corporate agent, which is incorporated exclusively for the purpose of insurance intermediation, no change in ownership and/or shareholding exceeding 25 per cent, would be carried out without the prior approval of the IRDA.

Maintenance of Records A corporate agent should maintain the following records including in electronic for and make them available as and when required by the IRDA: **(i) Know Your Client** (KYC) records of the client, **(ii)** Copy of the proposal form duly signed by the client and submitted to the insurer with ACR signed by the specified person of corporate agent, **(iii)** A register containing **(a)** list of clients, details of policy such as type of policy, premium amount, date of issue of the policy, charge or fees received, **(b)** details of complaints received which include name of the complainant, nature of complaint, details of policy issued/solicited and action taken, **(c)** name, address, telephone number, photograph, date of commencement of employment, date of leaving the service monthly remuneration paid to the specified person, **(iv)** copies of correspondence with the IRDA ad **(v)** any other specified record.

Maintenance of Books of Accounts, Records A corporate agent incorporated exclusively for insurance intermediation should prepare the following books of account for every financial year: **(i)**balance sheet/statement of affairs as at the end of each accounting period, **(ii)** profit and loss account for that period, **(iii)** statement of cash/fund flow, **(iv)** additional statements required by the IRDA from time to time. The financial year would be of 12 months and the accounts should be maintained on accrual basis. There should be a schedule to their financial statements providing the details of all the incomes received from insurers and insurer's group companies, insurer-wise, by the corporate agent, and also the details of payments received by the group companies and/or associates from any insurer and its details. A copy of the audited financial statements along with the auditor's report should be submitted to the IRDA before September 30 every year along with the remarks/observations of the auditors. Within 90 days from the date of the Auditor's report, necessary steps to rectify any deficiencies should be made and informed to the IRDA. All the books of account, statements, documents should be maintained at the head office of the corporate agent or other designated branch office and notified to the IRDA, and be available on all working days to such officers of the IRDA, and authorised in this behalf for inspection. They should be retained for minimum ten years from the end of the year to which they relate. However, the documents pertaining to the case where claims are reported and the settlement is pending for a decision from court, the documents are required to be maintained till the disposal of the cases by the court.

Corporate agents whose principal business is other than insurance intermediation, should maintain segment-wise reporting capturing the revenues received for insurance intermediation and other income from insurers.

Every insurer who is engaging the services of a corporate agent should file with the IRDA a certificate in the prescribed format to be signed by the CEO and CFO. A similar certificate from the principal officer and CFO (or it equivalent) of the corporate agent specifying the commission/remuneration received from the insurer should be filed with the IRDA.

Distribution of Surplus Regulations

A life insurer should maintain separately **(a)** a life fund for participating policyholders (i.e. the holders of L 'par policies' and policies with deferred participation in profits) and **(b)** a life fund for non-participating policyholders who hold non-par policies as defined in IRDA Actuarial Report and Abstract Regulations. Failure to comply with this requirement would mean that the life fund maintained by the insurer would be for the benefit of the first category of policyholders only.

Procedure for Distribution On the advice of the appointed actuary, a life insurer may reserve a part of actuarial valuation surplus arising out of a valuation of assets and liabilities made for a financial year according to the Actuarial Report and Abstract Regulation to its shareholder. It should be **(a)** 100 per cent in case of a life fund maintained for non-participating policyholders and **(b)** one-ninth of the surplus allocated to the policyholders in case of life fund maintained for participating policyholders. An insurer would have to obtain prior approval of the IRDA when the allocation is not one-ninth of the surplus. However, an insurer cannot allocate/reserve in excess of 10 per cent of the actuarial surplus to its shareholders.

Life Insurance–Reinsurance

Procedure Every life insurer should draw up a programme of reinsurance in respect of lives covered by him. The profile of the programme, duly certified by the Appointed Actuary, which should include the name(s) of the reinsurer(s) with whom the insurer proposes to place business, should be filed by the insurer with the IRDA at least 45 days before the commencement of each financial year. The IRDA may also elicit additional information, if necessary. It would scrutinise the programme and may suggest changes which must be incorporated forthwith in the programme.

An insurer should retain the maximum premium earned (i.e. the amount of risk which he assumes for his own account) in India commensurate with his financial strength and volume of business. The reinsurer should have a credit rating of a minimum BBB (Triple-B) of Standard and Poor or equivalent rating of an international rating agency. The placement of business by the insurer with any other reinsurer would require prior approval of the IRDA. Similarly, any programme of reinsurance on original premium basis would also require IDRA's approval. A life insurer can have reinsurance treaty arrangement with its promoter/ associate/group company only on commercially competitive terms in the market with the prior approval of the IRDA. He should submit to the IRDA statistics relating to reinsurance transactions in the prescribed form together with its annual accounts.

Inward Reinsurance Business An insurer who wants to write inward reinsurance business should adopt a well-defined underwriting policy and ensure that decision on acceptance of reinsurance business are made by persons who have adequate knowledge and experience preferably in consultation with the Appointed Actuary. He should file with the IRDA at least 45 days before the commencement of each financial year a note on its underwriting policy indicating the class(es) of business, geographical scope, underwriting limits and profit objective. He should also file any change in the note as and when a change in underwriting policy is made.

Insurance Brokers

The IRDA regulations relating to insurance brokers are discussed below.

Functions/Categories An **insurance broker** means a person (i.e. a company, a cooperative society, a limited liability partnership or any other person recognised by the IRDA) licensed by the IRDA who for remuneration arranges insurance contracts with insurance/reinsurance" companies on behalf of his clients. There are five categories of insurance brokers: **(i)** direct (life), **(ii)** direct (general), **(iii)** direct (life and general) **(iv)** rein-insurance and **(v)** composite. Their functions are outlined below.

Direct Broker A direct broker is an insurance broker who carries out the functions specified below in the field of general/life insurance or both:

(a) Obtaining detailed information of the client's business and risk management philosophy;
(b) Familiarising himself with the client's business and underwriting information so that this can be explained to an insurer and others;
(c) Rendering advice on appropriate insurance cover and terms;
(d) Maintaining detailed knowledge of available insurance markets, as may be applicable;
(e) Submitting quotation received from insurer(s) for consideration of a client;

(f) Providing requisite underwriting information as required by an insurer in assessing the risk to decide pricing terms and conditions for cover;
(g) Acting promptly on instructions from a client and providing him written acknowledgements and progress reports;
(h) Assisting clients in paying premium under Section 64 (VB) of Insurance Act, 1938;
(i) Providing services related to insurance consultancy and risk management;
(j) Assisting in the negotiation of the claims; and
(k) Maintaining proper records of claims.

Reinsurance Broker A reinsurance broker is an insurance broker who arranges reinsurance for direct insurers with insurance/reinsurance companies. His functions include the following:
(a) Familiarising himself with the client's business and risk retention philosophy;
(b) Maintaining clear records of the insurer's business to assist the reinsurer(s) or others;
(c) Rendering advice based on technical data on the reinsurance covers available in the international insurance and the reinsurance markets;
(d) Maintaining a database of available reinsurance markets, including solvency ratings of individual reinsurers;
(e) Rendering consultancy and risk management services for reinsurance;
(f) Selecting and recommending a reinsurer or a group of reinsurers;
(g) Negotiating with a reinsurer on the client's behalf;
(h) Assisting in case of commutation of reinsurance contracts placed with them;
(i) Acting promptly on instructions from a client and providing it written acknowledgements and progress reports; and
(j) Collecting and remitting premiums and claims within such time as agreed upon;
(k) Assisting in the negotiation and settlement of claims;
(1) Maintaining proper records of claims; and
(m) Exercising due care and diligence at the time of selection of reinsurers and international insurance brokers having regard to their respective security rating and establishing respective responsibilities at the time of engaging their services.
(n) Creation of market capacity/facility for new/stressed/emerging/existing business/asset class for/from both direct insurers/reinsurers;
(o) Render preliminary loss advice (PLA) within reasonable time;
(p) Given the nature of business, separate norms need to be followed for inward/outward business: **(a)** Inward business **(i)** broker to have adequate specific knowledge of the country whose business is being offered like political stability, economic position, local regulations, tax laws and so on, **(iii)** Introduce new business/products depending on the reinsurers business plan and risk appetite, **(b)** Outward business: rating and market credibility of the insurer.
(q) To ensure prompt collection and remittance of funds, follow-up for funds to be initiated sufficiently before due dates for settlement from cedant to reinsurer and from reinsurer to cedant as relevant.

Composite Broker A **composite broker** means an insurance broker who arranges insurance for clients with insurance companies and/or reinsurance for his client(s). He performs the functions of both the direct broker as well as the reinsurance broker.

Grant of License An insurance broker should obtain a license from the IRDA. The application should be made in the prescribed form together with the specified non-refundable fee: **(i)** For direct broker, ₹20,000; **(ii)** For reinsurance broker, ₹25,000 and **(iii)** For composite broker, ₹40,000. The IRDA may require **(i)** the applicant to furnish further information and/or clarification and/or may direct the applicant to comply with certain requirements in regard to any matter or **(ii)** the applicant or its principal officer (i.e. proprietor/partner/director/chief executive officerappointed exclusively to carry out the functions of an insurance broker) for personal representation before it. The applicant may bring to the notice of the IRDA on its own further information/clarification having a bearing on consideration of application.

While considering the application for grant of license, the IRDA would take into account all relevant matters. In particular, it would take into account the following:

(A) The applicant does not suffer from any of the disqualifications specified under Section 42-D(5) of the Insurance Act (discussed in an earlier Section);

(B) The applicant has the necessary infrastructure, such as, adequate office space, equipment, trained manpower, to effectively discharge his activities. There should be atleast one such person in each branch and one each in life and general insurance.

(C) The applicant has in his employment a minimum of two persons who have the necessary qualifications specified in clause (F) below and experience to conduct the business of insurance broker;

(D) Any person, directly or indirectly connected (i.e. relative/associate, subsidiary, interconnected company, group company of the applicant) with the applicant, has been refused in the past the grant of a license by the IRDA.

(E) The applicant fulfills the capital, networth and deposit requirements specified below:

- **(i)** Capital Requirement: For direct broker, ₹50 lakh; For reinsurance broker, ₹200 lakh; and For composite broker, ₹250 lakh. While the capital of a cooperative society/company should be in the form of equity shares, it should be brought in cash in case of other applicants. A broker should provide information regarding its capital structure and details of shareholding annually on/before June 30 every year. Any change should also be reported within 30 days. Upto 26 per cent of the capital can be held by a non-Indian interest. The shares of the broken cannot be pledged and should always be unencumbered.
- **(ii)** Networth requirement: Not below 100 per cent of the minimum capital.
- **(iii)** Deposit Requirement: A sum equivalent to 20 per cent of the initial capital in fixed deposit with a bank to be released only with the prior permission of the IRDA. The IRDA may impose a separate limit of deposit upto ₹100 lakh for a person recognised to act as insurance broker.

(F) The principal officer of the applicant **(i)** possess the minimum qualification of:

- **(a)** Bachelors degree in arts, science, or social sciences or commerce or engineering, or law, or MBA or its equivalent from any institution/University recognised by any State Government or the Central Government; or
- **(b)** Associate/Fellow of the Insurance Institute of India, Mumbai; or
- **(c)** Associate/Fellow of the Institute of Risk Management, Mumbai; or
- **(d)** Any post-graduate qualification of the Institute of Insurance and Risk Management, Hyderabad; or

(e) Associate/Fellow of the Institute of Chartered Accountant of India, New Delhi; or
(f) Associate/Fellow of the Institute of Costs and Works Accountants of India, Kolkatta; or
(g) Associate/Fellow of the Institute of Company Secretaries of India, New Delhi; or
(h) Associate/Fellow of the Actuarial Society of India; or
(i) Certified Associateship of the Indian Institute of Bankers, Mumbai; or
(j) Any other qualification specified from time to time by the IRDA under these regulations; and

(ii) has completed at least 50 hours of theoretical and practical training from an institution recognised by the IRDA from time to time. However, where the principal officer of the applicant: **(a)** has been carrying on reinsurance related activity or insurance consultancy for a continuous period of 7 years, preceding the year in which such an application is made; or **(b)** has for a period of, not less than 7 years prior to the application has been made, a principal underwriter or has held the position of a manager in any one of the nationalised insurance companies in India; or **(c)** is an Associate/Fellow of the Insurance Institute of India, Mumbai; or Associate/Fellow of the Institute of Risk Management, Mumbai; or Associate/Fellow of the Actuarial Society of India; or has a post-graduate qualification of the Institute of Insurance and Risk Management, Hyderabad, the theoretical and practical training from an institution recognised by the IRDA from time to time according to a syllabus approved by it would be 25 hours.

(iii) has passed an examination, at the end of the period of training mentioned above, conducted by the National Insurance Academy, Pune or any other examining body recognised by the IRDA.

(G) In the opinion of the IRDA, the principal officer is suitable to be appointed keeping in view his experience, preferably in the insurance sector.

(H) The principal officer/director(s)/promoter(s)/shareholder(s)/partner(s)/key management personnel are fit and proper person and comply with the IRDA guidelines.

(I) The principal officer has not violated the code of conduct as specified by the IRDA (discussed subsequently).

(J) The applicant is not engaged in any other business other than the main objects of the applicant; and

(K) The IRDA is of the opinion that the grant of license would be in the interest of policyholders.

The promotor(s) shareholder(s) partner(s) are of sound financial position.

Any employee responsible for soliciting and procuring insurance business on behalf of an insurance broker would also have to fulfil the requirements mentioned above and a list of such employees need to be provided to the IRDA and acknowledged by it.

On being satisfied that the applicant fulfils all the conditions, the IRDA would grant the licence which would be valid for 3 years. Within 30 days before its expiry, the applicant should apply for its renewal on payment of the specified licence fee of ₹1,000. Every broker would pay annual license fee, namely, 0.50 per cent of the remuneration earned in the preceding financial year subject to a minimum and maximum of ₹25,000 and ₹10,00,000 for direct broker; ₹75,000 and ₹30,00,000 for re-insurance broker; and ₹1,25,000 and ₹50,00,000 for composite broker.

In addition, an insurance broker should complete at least 25 hours of theoretical and practical training imparted by an institution recognised by the IRDA.

Remuneration For life and general insurance, the remuneration of a broker including royalty/license fee/administration charges/in any other form cannot exceed the limit as specified/notified by the IRDA. No brokerage can be paid where agency commission is payable and *vice versa*.

For reinsurance business, the remuneration should be paid as per market practices. The brokerage charged may be disclosed on request to the insurer before building cover. Payments of all nature in respect of the particular account such as risk inspection/management fee/administration charges should be aggregated.

The settlement of accounts by insurers in respect of brokers remuneration should be done on a monthly basis and there should be no cross settlement of outstanding balances.

Sale of Insurance Online Insurance brokers may enter into an agreement with insurers for sale of insurance products online by linking to their web portals subject to the following conditions:

(1) The website developed by the insurance broker should carry the name of the insurance broker as licensed by the IRDA and usage of any other name or linkage to any other website is prohibited.

(2) The insurance brokers should prominently display on their website the information relating to their licence number, date of licence and its validity, the category of licence, name of the principal officer and its contact details, composition of the board, and other relevant information.

(3) The website should be used exclusively for web aggregation and comparison and of insurance products and online sale of insurance products of the concerned insurers.

(4) The insurance broker should not publish, advertise, or provide for display or sale, any other products of any nature or type, other than the insurance products by the concerned insurer.

(5) The website should provide a link to the website of the concerned insurer and the insurer and the online sale by the insurance broker should be executed only through the website of the insurer.

(6) The insurance broker should ensure that the customer has the choice of viewing products of at least five insurers who are offering similar products for online sale, and selecting the insurer and products of his choice. He is permitted only to offer the following ranges of products online or any other products range as approved from time to time by the IRDA: **(i)** Life: **(a)** whole life policies, **(b)** term insurance products, **(c)** endowment products, **(d)** health insurance products, **(e)** retirement-immediate annuities, **(f)** retirement-deferred annuities, and **(g)** children's products; **(ii)** Non-Life: **(a)** home insurance, **(b)** motor insurance, **(c)** health insurance, **(d)** travel insurance, **(e)** personal accident insurance, and **(f)** rural insurance.

(7) The insurance broker should display only those features of the products which are approved under File and use Guidelines of the IRDA. Any information which is detrimental to the interests of the policyholder or is misleading and is not approved by the IRDA should not be displayed on their websites and while displaying the product features of various insurers should not favour any one insurer.

(8) The templates which are displayed on the insurance broker's website should be mutually agreed to, between him and the insurers whose products are compared.

(9) Product comparisons that are displayed should be up to date and reflect a true picture of the products.

(10) The insurance brokers should **(a)** display product information purely on the basis of the information obtained from insurers, **(b)** and not **(i)** display any information pertaining to products or services of other financial institutions/FMCG or any product or service on the website, **(ii)** display advertising of any sort, either pertaining to any product or service including insurance product or service, other financial products or service/or any other product or service on the website, and **(iii)** operate multiple websites or tie-up with other approved/unapproved/unlicensed entities/websites for lead generation/comparison of product and so on *subject to the following exceptions*, namely, using multiple domain names or same domain names with suffixes such as **.com** or **.in** or **.co.in** for the primary website of the insurance broker used for display of insurance products is allowed provided **(a)** the domain names of primary or secondary product category specific websites or mobile sites are owned and registered in the name of the insurance brokers. **(b)** he informs the IRDA in writing about the date of registration/launching of domain names of such websites or mobile sites in the application for grant of licence and thereafter within 15 days from the date of domain name registration and launching respectively in case of any change in the name(s) of the existing websites or new websites.

(11) The insurance broker should **(i)** not charge any additional fees from insurers for displaying their products on their websites, **(ii)** may enter into an agreement with the insurer for extending services to his customer/clients and the agreement should be available with both the insurer and the insurance broker for inspection by the IRDA.

(12) The broker who has entered into an agreement with the insurer may be allowed to collect renewal premiums online through the websites of the insurers for the policies procured and serviced by him only.

(13) The manner of payment of premiums for online sale should be by way of credit/debit card/net banking or any other mode as permitted by the RBI through a payment gateway normally used by the insurer for online sale of insurance policies. The premium has to be directly credited to the insurers premium collection account of a designated bank and not routed through the bank account of the insurance broker in any manner. The insurance brokers should not accept any cash payments towards premiums for this purpose.

(14) On completion of online transaction, for payment of premium and sale of the policy, the insured should be able to generate and save/print the premium receipt and preferably policy document also immediately. Alternatively, the policy document may be delivered by email/or in hard copy as opted by the insured.

(15) The agreement entered into with the insurers for integrating their web portals for sale of products or receipt of premium online should not be in any way detrimental to the interests of the policyholders. The insurance brokers should not make any promise or commitment to insures for sale of their products.

(16) The insurance broker should ensure that the directions issued by the IRDA or any other authority for compliance of anti-money laundering matters are adhered to. The insurer should incorporate the necessary rules and applicable clauses in the agreement to be signed with the insurance broker to this effect.

(17) The insurers as well as the insurance broker should be jointly and severally liable for any breach of provisions of the agreement entered into for this purpose.

(18) They should abide by the provisions of the Insurance Act, the IRDA Act, and/or any other act and regulations/guidelines/circulars/directions issued by the IRDA while selling the insurance products online.

Sale of Insurance by Tele-marketing Mode An insurance broker who intends to engage the services of telemarketer for distribution of insurance products of various companies should abide by the IRDA Guidelines on Distance Marketing of Insurance Products. He should also comply with the following additional conditions:

- The telemarketer should **(i)** comply with various circulated guidelines/directions issued by the Telecom Regulatory Authority of India (TRAI) and **(ii)** not engage with any other insurer/insurance related entity;
- An insurance broker registered with the TRAI should do telemarketing for its own entity only and not for any other entity;
- Authorised verifiers employed by the telemarketer/broker would have to undergo statutory training and pass examination as required for insurance broker (**discussed in an earlier Section of this Chapter**);
- A copy of the agreement between the broker and the telemarketer should be filed with the IRDA together with the specified undertakings in the prescribed form copies of which should be in the possession of the broker for inspection by the IRDA/other regulatory bodies;
- The IRDA would have power to inspect the premises of telemarketer/other premises necessary for verification of records/documents and seek any document/record, record statement of any employee of the telemarketer and make copies of documents /records at its direction;
- The telemarketer would have to comply with any other terms/conditions prescribed by the IRDA.

Ceiling on Business from a Single Client An insurance broker should carry out its business in such a manner that 50 per cent of the premium (i.e. quantum/receipt) in a financial year onwards does not emanate from any single client (including an associate, subsidiary, a group concern under the same management). The 50 per cent ceiling would not include reinsurance premium as well as premium emanating from government/public sector undertaking. For group insurance companies, not more than 2.5 per cent of the insurance handled by the insurance broker in any financial year should be placed with the promoter group separately for life and general business.

Code of Conduct Every insurance broker should abide by the code of conduct specified below. The composite/reinsurance broker should abide by the additional code of conduct.

1. Professional Conduct Every insurance broker should follow recognised standards of professional conduct and discharge his functions in the interest of the policyholders.

2. Conduct of Matters Relating to Clients Relationship Every insurance broker should:

(a) Conduct its dealings with clients with utmost good faith and integrity at all times;
(b) Act with care and diligence;
(c) Ensure that the client understands his relationship with the broker and on whose behalf the broker is acting;
(d) Treat all information supplied by the prospective clients as completely confidential to themselves and to the insurers) to which the business is being offered;

(e) Take appropriate steps to maintain the security of confidential documents in their possession;
(f) Hold specific authority of client to develop terms;
(g) Understand the type of client it is dealing with and the extent of the client's awareness of risk and insurance;
(h) Obtain written mandate from client to represent the client to the insurer and communicate the grant of a cover to the client after effecting insurance;
(i) Obtain written mandate from client to represent the client to the insurer/reinsurer; and confirm cover to the insurer after effecting reinsurance, and submit relevant reinsurance acceptance and placement slips;
(j) Avoid conflict of interest;
(k) Obtain necessary documents required under KYC norms.

3. Conduct of Matters Relating to Sales Practices Every insurance broker should:
(a) Confirm that it is a member of the Insurance Broker Association of India or such a body of brokers as approved by the IRDA which has a memorandum of understanding with it.
(b) Confirm that he does not employ agents or canvassers to bring in business;
(c) Identify itself and explain as soon as possible the degree of choice in the products that are on offer;
(d) Ensure that the client understands the type of service it can offer;
(e) Ensure that the policy proposed is suitable to the needs of the prospective client;
(f) Give advice only on those matters in which it is knowledgeable and seek or recommend other specialist for advice when necessary;
(g) Not make inaccurate or unfair criticisms of any insurer or any member of the Insurance Broker Association of India or member of such body of brokers as approved by the IRDA;
(h) Explain why a policy or policies are proposed and provide comparisons in terms of price, cover or service where there is a choice of products;
(i) State the period of cover for which the quotation remains valid if the proposed cover is noteffected immediately;
(j) Explain when and how the premium is payable and how such premium is to be collected, where another party is financing all or part of the premium, full details should be given to the client including any obligations that the client may owe to the party; and
(k) Explain the procedures to follow in the event of a loss;
(l) Not indulge in any sort of money laundering activities;
(m) Not indulge in sourcing of business by themselves/through call centres by way of misleading/spurious calls.

4. Conduct of Relation to Furnishing of Information Every issuance broker should:
(a) Ensure that the consequences of non-disclosure and inaccuracies are pointed out to the prospective client;
(b) Avoid influencing the prospective client and make it clear that all the answers or statements given are the latter's own responsibility. Ask the client to carefully check details of information given in the documents and request the client to make true, fair and complete disclosure where it believes that the client has not done so and in case further disclosure is not forthcoming it should consider declining to act further;

(c) Explain to the client the importance of disclosing all subsequent changes that might affect the insurance throughout the duration of the policy; and

(d) Disclose on behalf of its clients all material facts within its knowledge and give a fair presentation of the risk.

5. Conduct in Relation to Explanation of Insurance Contract Every insurance broker, should:

(a) Provide the list of insurer(s) participating under the insurance contract and advice any subsequent changes thereafter;

(b) Explain all the essential provisions of the cover afforded by the policy recommended by him so that, as far as possible, the prospective client understands what is being purchased;

(c) Quote terms exactly as provided by the insurer;

(d) Draw attention to any warranty imposed under policy, major or unusual restrictions, exclusions under the policy and explain how the contract may be cancelled;

(e) Provide the client with prompt written confirmation that insurance has been effected. If the final policy wording is not included with this confirmation, the same should be forwarded as soon as possible;

(f) Notify changes to the terms and conditions of any insurance contract and give reasonable notice before any changes take effect;

(g) Advise its clients of any insurance proposed on their behalf which would be effected with an insurer outside India, where permitted, and, if appropriate, of the possible risks involved.

6. Conduct in Relation to Renewal of Policies Every insurance broker should:

(a) Ensure that its clients is aware of the expiry date of the insurance even if it chooses not to offer further cover to the client;

(b) Ensure that renewal notices contain a warning about the duty of disclosure including the necessity to advise changes affecting the policy, which have occurred since the policy inception or the last renewal date;

(c) Ensure that renewal notices contain a requirement for keeping a record (including copies of letters) of all information supplied to the insurer for the purpose of renewal of the contract;

(d) Ensure that the client receives the insurer's renewal invitation well in time before the expiry date.

7. Conduct in Relation to Claim by Client Every insurance broker should:

(a) Explain to its clients their obligation to notify claims promptly and to disclose all material facts and advise subsequent developments as soon as possible;

(b) Request the client to make true, fair and complete disclosure where it believes that the client has not done so. If further disclosure is not forthcoming, it should consider declining to act further for the client;

(c) Give prompt advice to the client of any requirements concerning the claim;

(d) Forward any information received from the client regarding a claim or an incident that may give rise to a claim without delay, and in any event within three working days;

(e) Advice the client without delay of the insurer's decision or otherwise of a claim; and give all reasonable assistance to the client in pursuing his claim. However, the insurance broker should **(i)** not take up recovery assignment on a policy contract **(ii)** not work as a claims consultant for a policy which has not been serviced through him.

8. Conduct in Relation to Receipt of Complaints Every insurance broker should:

(a) Ensure that letters of instruction, policies and renewal documents contain details of complaints handling procedures;
(b) Accept complaints either by phone or in writing;
(c) Acknowledge a complaint within 14 days from the receipt of correspondence, advise the member staff who would be dealing with the complaint and the time-table for dealing with it;
(d) Ensure that response letters are sent and inform the complainant of what he may do if he is unhappy with the response;
(e) Ensure that complaints are dealt with at a suitably senior level;
(f) Have in place a system for recording and monitoring complaints.

9. Conduct in Relation to Documentation Every insurance broker should:

(a) Ensure that any documents issued comply with all statutory or regulatory requirements from time to time in force;
(b) Send policy documentation without avoidable delay;
(c) Make available, with policy documentation, advice that the documentation should be read carefully and retained by the client;
(d) Not withhold documentation from its clients without their consent, unless adequate and justifiable reasons are disclosed in writing and without delay to the client. Where documentation is withheld, the client must still receive full details of the insurance contract;
(e) Acknowledge receipt of all monies received in connection with an insurance policy;
(f) Ensure that the reply is sent promptly or use its best endeavours to obtain a prompt reply to all correspondence;
(g) Ensure that all written terms and conditions are fair in substance and set out, clearly and in plain language, client's rights and responsibilities; and
(h) Subject to the payment of any monies owned to it, make available to any new insurance broker instructed by the client all documentation to which the client is entitled and which is necessary for the new insurance broker to act on behalf of the client.

10. Conduct in Matters Relating to Advertising Every insurance broker should conform to the relevant provisions of the IRDA (Insurance Advertisements and Disclosure) Regulations, 2000, and:

(a) Ensure that statements made are not misleading or extravagant;
(b) Where appropriate, distinguish between contractual benefits which the insurance policy is bound to provide and non-contractual benefits which may be provided;
(c) Ensure that advertisements would be restricted to the policies of one insurer, except where the reasons for such restrictions are fully explained with the prior approval of that insurer;
(d) Ensure the advertisements contain nothing which is in breach of the law nor omit anything which the law requires;
(e) Ensure that advertisement does not encourage or condone defiance or breach of the law;
(f) Ensure that advertisements contain nothing which is likely, in the light of generally prevailing standards of decency and propriety, to cause grave or widespread offence or to cause disharmony;
(g) Ensure that advertisements are not so framed as to abuse the trust of clients or exploit their lack of experience or knowledge;

(h) Ensure that all descriptions, claims and comparisons, which relate to matters of objectively ascertainable fact shall be capable of substantiation.

11. Conduct in Matters Relating to Receipt of Remuneration Every insurance broker should:

(a) Disclose whether in addition to the remuneration prescribed under these regulations, he proposes to charge the client, and if so in what manner;

(b) Advise the client in writing of the insurance premium and any fees or charges separately and the purpose of any related services;

(c) If requested by a client, disclose the amount of remuneration or other remuneration it receives as a result of effecting insurance for that client. This would include any payment received as a result of securing on behalf of the client any service additional to the arrangement of the contract of insurance; and

(d) Advise its clients, prior to effecting the insurance, of their intention to make any deductions from the amount of claim collected for a client, where this is a recognised practice for the type of insurance concerned.

12. Conduct in Relation to Matters Relating to Training Every insurance broker should:

(a) Ensure that its staff are aware of, and adhere to, the standards expected of them by this code;

(b) Ensure that staff are competent, suitable and have been given adequate training;

(c) Ensure that there is a system in place to monitor the quality of advice given by its staff;

(d) Ensure that members of staff are aware of legal requirements including the law of agency affecting their activities; and only handle classes of business in which they are competent;

(e) Draw the attention of the client to Section 41 of the Insurance Act, which prohibits rebating and sharing of commission.

13. Information and Education Common to Direct and Reinsurance Brokers The insurance broker should **(a)** support industry education initiatives aimed at explaining insurance to consumers/community, **(b)** make readily available to client **(i)** upto-date information on insurance, **(ii)** information to assist insured to determine the level of insurance cover they may require, and **(iii)** information about insurance products and services and **This Code**.

14. Every insurance broker should display, in every office where it is carrying on business and to which the public have access, a notice to the effect that a copy of the code of conduct is available upon request and that if a member of the public wishes to make a complaint or requires the assistance of the IRDA in resolving a dispute, he may write to it.

15. An insurance broker should not act as an insurance agent of any insurer under Section 42 of the Insurance Act.

16. Every insurance broker should abide by the provisions of the Insurance Act, IRDA Act, rules and regulations made thereunder which may be applicable and relevant to the activities carried on by them as insurance brokers.

Additional Code of Conduct for Reinsurance Broker and Composite Broker

1. General (Applicable to all Contracts of Reinsurance) **(a)** A composite insurance/reinsurance broker should **(i)** not enter the reinsurance markets either to develop terms for reinsurance cover or to place reinsurance on any risk without the specific written authorisation of the insurer insuring the risk or insurer/reinsurer who has been asked to quote terms for the risk, **(ii)** not block reinsurance capacity in anticipation of securing an order to place reinsurance, **(iii)** provide to the insurer/reinsurer, a true and complete copy of the reinsurance placement slip to be used, before entering the market and incorporate any modifications or corrections proposed by the insurer/reinsurer in the placement slips, **(iv)** put up to the insurer/reinsurer, all the terms (including the reinsurance commission and brokerage allowed) obtained by it from various reinsurers and indicate the share the lead reinsurer is willing to write at those terms and the expectation of the insurance broker about placement of the required reinsurance at the terms quoted with acceptable reinsurance security, **(v)** furnish to the insurer/reinsurer, a true copy of the placement slip signed by the lead reinsurer quoting terms, indicating the signed line of the reinsurer.

(b) Where reinsurance on a risk is proposed to be placed with different reinsurers at different terms, the fact that terms for all reinsurers are not uniform, should be disclosed to reinsurers suitably.

(c) Once the insurer/reinsurer has accepted the quoted reinsurance terms, he should place the required reinsurance cover and keep the insurer/reinsurer informed about the progress of placement from time to time. In selecting the reinsurers to whom the risk is offered, the insurance broke should be mindful of the need to use only such reinsurers who are rated **BBB** or higher by a recognised credit rating agency. Where the reinsurance is over placed, the signing down should be done in consultation with the insurer/reinsurer in a manner consistent with good market practice.

(d) Immediately after completion of placement of reinsurance, the insurance broker may issue a broker's cover note giving the terms of cover and the names of reinsurers and the shares placed with each of them. It may contain a listing of all important clauses and conditions applicable to the reinsurance and where the wordings of clauses are not market standard, they should be attached to the insurance broker's cover note.

(e) The insurance broker should **(i)** follow up the cover note by a formal signed reinsurance policy document or other acceptable evidence of the reinsurance contract signed by the reinsurers concerned, within one month of receipt of reinsurance premium, **(ii)** have a security screening procedure in-house or follow credit ratings given by recognised credit rating agencies and answer without any delay, any questions raised by the insurer about the credit rating of one or more reinsurers. Where the insurer/reinsurer declines to accept a particular reinsurer for whatever reason and asks the insurance broker to replace the security before commencement of risk, he should do so promptly and advise the insurer/reinsurer of the new reinsurer brought on the cover.

2. Placement of Proportional/Non-proportional Treaty

(a) A composite insurance or reinsurance broker invited to place a proportional treaty should prepare the treaty offer slip and supporting information with the cooperation of the insurer and secure his concurrence to the slip and information before entering the market.

(b) Where a reinsurance treaty is placed at different terms with different reinsurers, the fact that such is the practice should be made known to all the reinsurers suitably.

(c) Where a reinsurer accepts a share in a treaty subject to any condition, the conditions should be made known to the ceding insurer and its agreement obtained before binding the placement.

(d) The insurance broker should advise the progress of placement of the treaty from time to time. Immediately after completion of placement, he should issue a cover note setting out the treaty terms and conditions and list of reinsurers with their shares. Where a treaty is overplaced, the insurance broker should sign down the shares in consultation with the insurer in a manner consistent with good market practice.

(e) The insurance broker should **(i)** secure signature of formal treaty wordings or other formal reinsurance contract documentation within three months of completion of placement, **(ii)** have a security screening procedure in-house or follow credit ratings given by recognised credit rating agencies and answer without any delay, any question raised by the credit insurer about the credit rating of one or more reinsurer. Where the insurer declines to accept a particular reinsurer for whatever reason and ask the insurance broker to replace the security before commencement of the reinsurance period, the insurance broker should do so promptly and advise the insurer of the new reinsurer brought on the cover.

3. Placement of Foreign Inward Reinsurance

(a) The reinsurance broker should **(i)** ensure that Indian reinsurer(s) receive the reinsurance premium from the overseas insurer as per the premium payment condition stipulated in the reinsurance contract, **(ii)** not enter the Indian reinsurance markets either to develop terms for reinsurance cover or to place reinsurance on any risk without the specific written authorisation of the overseas insurer insuring the risk or insurer who has been asked to quote terms for the risk, **(iii)** provide to the reinsurer in India, a true and complete copy of the placement slip to be used, before committing any terms to the overseas client. He should incorporate any modifications or corrections proposed by the reinsurer in the placement slip, **(iv)** put up the overseas insurer, all the terms (including the reinsurance commission and brokerage allowed) obtained by it from various Indian reinsurers and indicate the share the reinsurer(s) is willing to write at those terms and the expectation of the insurance broker about placement of the required reinsurance at the term quoted, with acceptable reinsurance security, **(v)** furnish to the overseas insurer, a true copy of the placement slip signed by the Indian reinsurer quoting terms, indicating thereon, the signed line of the reinsurer.

(b) Where reinsurance on a risk is proposed to be placed with different reinsurers at different terms, the fact that terms for all reinsurers are not uniform, should be disclosed to reinsurers suitably.

(c) The insurance broker should provide complete information as desired by the Indian reinsurer(s) to process the claim arising out of any inwards business.

4. Reinsurance Business Placed with Overseas Reinsurers **(a)** The reinsurance broker should ensure **(i)** that business is placed with only those overseas reinsurers which are registered with the IRDA, **(ii)** the compliance of any taxation, foreign exchange, anti-money laundering or any other applicable statutory laws at the time of placing the reinsurance business.

5. Responding to Catastrophes and Disasters **(a)** The reinsurance broker should respond to catastrophes and disasters, such as floods, earthquakes, cyclones, severe storms and hail which result in a large number of claims, in a timely, professional and practical way and in a compassionate manner.

6. Conduct in Relation to Explanation of Reinsurance Contract Every reinsurance broker should:

(a) provide the list of reinsurer(s) participating under the reinsurance contract and advise any subsequent changes;

(b) explain all the essential provisions of the cover afforded by the policy recommended by him so that, as far as possible, the prospective client understands what is being purchased;

(c) quote terms exactly as provided by reinsurer;
(d) draw attention to any warrant imposed under the policy, major or unusual restrictions, exclusions under the policy and explain how the contract may be challenged;
(e) provide the insurer/reinsurer with prompt written confirmation that reinsurance has been affected. If the final policy wording is not included with the confirmation, the same should be forwarded as soon as possible;
(f) notify changes to the terms and conditions of any reinsurance contract and give reasonable notice before any changes take effect.

Segregation of Insurance Money The provisions of Section 64-VB of the Act would continue to determine the question of assumption of risk by an insurer. In the case of reinsurance of contracts, it may be agreed between the parties specifically or as a part of international market practices that the licensed reinsurance/composite broker can collect the premium and remit to the insurer and/or collect the claims due from the reinsurer to be passed on to the insured. In these circumstances, the money collected by the licensed insurance broker should be dealt with in the following manner:

(a) Should act as the trustee of the insurance money that he is required to handle in order to discharge his functions as a reinsurance broker and it would be deemed that a payment made to the reinsurance broker would be considered as payment made to the reinsurer;
(b) Ensure that "insurance money" is held in an "Insurance Bank Account" with one or more of the scheduled banks or with such other institutions as may be approved by the IRDA.
(c) Give written notice to, and receive written confirmation from, a bank, or other institution that he is not entitled to combine the account with any other account, or to exercise any right of set-off, charge or lien against money in that account.
(d) Ensure that all monies received from or on behalf of an insured is paid into the "Insurance Bank Account" to remain in deposit until it is transferred on to the reinsurer or to the direct insurer;
(e) Ensure that any refund of premium which may become due to a direct insurer on account of the cancellation of a policy or alteration in its terms and conditions or otherwise would be paid by the insurer directly to the direct insurer;
(f) Interest on recovery/payment received should be for the benefit of the direct insurer or reinsurer;
(g) Only remove from the "Insurance Bank Account" charges, fees or commission earned and interest received from any funds comprising the account;
(h) Ensure that no payment is made from Insurance Bank Accounts for purposes other than those specified by the IRDA regulations.
(i) Money held in the Insurance Bank Account should not be held in fixed deposits/inverted elsewhere by the insurance broker.
(j) Take immediate steps to restore the required position if at any time he becomes aware of any deficiency in the required "segregated amount".

Professional Indemnity Insurance Every insurance broker should take out and maintain at all times a professional indemnity insurance cover throughout the validity of the period of the licence granted to him by the IRDA. However, in appropriate cases, it may allow a newly licensed insurance broker to produce such a guarantee within 12 months from the date of issue of the original licence. The insurance cover must indemnify an insurance broker against:

(a) Any error or omission or negligence on his part or on the part of his employee and directors;
(b) Any loss of money or other property for which the broker is legally liable in consequence of any financial or fraudulent act or omission;
(c) Any loss of documents and costs and expenses incurred in replacing or restoring such documents;
(d) Dishonest or fraudulent acts or omissions by brokers' employees or former employees.

The indemnity cover should **(a)** be on a yearly basis for the entire period of licence; **(b)** not contain any terms to the effect that payments of claims depend upon the insurance broker having first met the liability; **(c)** indemnify in respect of all claims made during the period of the insurance regardless of the time at which the event giving rise to the claim may have occurred. However, an indemnity insurance cover not fully conforming to the above requirements would be permitted by the IRDA in special cases for reasons to be recorded by it in writing.

The limit of indemnity for any one claim and in the aggregate for the year in the case of insurance brokers would be as follows: three times remuneration received at the end of every financial year subject to a minimum of ₹50 lakh for direct broker, ₹2 crore for reinsurance broker and ₹5 crore for a composite broker.

The uninsured excess in respect of each claim should not exceed 5 per cent of the capital employed by the broker in business.

The insurance policy should be obtained from any registered insurer in India who has agreed to:

(a) Provide the insurance broker with an annual certificate containing the name and address, including the licence number of the insurance broker, the policy number, the limit of indemnity, the excess and the name of the insurer as evidence that the cover meets the requirements of the IRDA.
(b) Send a duplicate certificate to the IRDA at the time the certificate is issued to the insurance broker; and
(c) Inform the insurer immediately of any case of voidance, non-renewal or cancellation of cover midterm.

Every insurance broker should:

(a) Inform immediately the IRDA, should any cover be cancelled or voided or if any policy is not renewed;
(b) Inform immediately the insurer in writing of any claim made by or against it;
(c) Advice immediately the insurer of all circumstances or occurrences that may give rise to a claim under the policy; and
(d) Advise the IRDA as soon as an insurer has notified that it intends to decline indemnity in respect of 2 claim under the policy.

Maintenance of Books of Accounts/Records Every insurance broker should prepare on accrual basis for very financial year (April 1 – March 31) a **(i)** balance sheet/statement of affairs at the end of each accounting year, **(ii)** profit/loss account for the period, **(iii)** statement of cash/fund flow, and **(iv)** additional statements on insurance broking business required by the IRDA. A copy of the audited financial statements along with the auditor's report/observations and suitable explanation on such observations should be submitted to the IRDA before September 30 every year. Within 90 days from the auditor's report, the insurance brokers should take steps to rectify the deficiencies and inform the IRDA. All maintained books of accounts/statements/documents should be available on all working days to the authorised officers of the IRDA for inspection and should be retained for at least 10 years. The documents required for cases pending with the courts should be maintained till the final disposal of the case.

A certificate confirming the compliance of various regulations should be part of the auditor's report. The details of the statutory auditors engaged by the broker along with the audited accounts should also be submitted to the IRDA.

Submission of Half-yearly Results Every insurance broker should, before October 31, and April 30 each year, furnish to the IRDA a half-yearly unaudited financial statements containing details of performance, financial position along with the following certificate(s) to the effect that **(i)** he is maintaining required capital/networth/deposit, maintaining a separate insurance bank account and incomes are used only for specific purposes and is not engaged in any other business, **(ii)** a preferential indemnity policy is in force, and **(iii)** confirming the receipt of his remuneration.

Claims Consultancy Limited claims consultancy by broker is permitted by the IRDA: **(i)** for claims which do not emanate from a policy, upto ₹1 crore, **(ii)** a written mandate from the client to the represent him with the concerned insurer, **(iii)** a mutually-agreed fee may be charged for such services but it cannot be expressed as a percentage of the claim, **(iv)** their code of conduct will apply in all dealings.

Disclosures An insurance broker should disclose to the IRDA on its own any material change which has a bearing on its license within 30 days of the change. He should disclose to the IRDA as and when required within 30 days of the requisition the following information: **(i)** responsibilities with regard to the placement of insurance contract, **(ii)** any change in information/particulars previously furnished which have a bearing on the grant of license, **(iii)** names of clients whose portfolio they manage/have managed, and **(iv)** any other specified requirement/information. In any case, he should have to take the prior approval of the IRDA for the following: change of/in **(i)** principal officer, **(ii)** director(s)/partner(s), **(iii)** name of the company, **(iv)** place of corporate/registered office, and **(v)** principal place of business.

He should furnish the following information as and when there is a change/addition to the information furnished previously: **(i)** opening/closing of the branch offices, **(ii)** list of broker qualified persons, **(iii)** in respect of a claim under the professional indemnity policy, and **(iv)** acquiring of immovable property.

The IRDA may from time to time require the insurance broker to furnish information/data/documents in the specified manner. Failure to comply will lead to action.

A broker should also furnish the following: **(i)** audit arrangements, **(ii)** information about registered/branch offices, **(iii)** standing arrangements with other brokers/service providers, **(iv)** spread of business during the year, **(v)** bank accounts, **(vi)** professional indemnity insurance in force **(vii)** claims data, **(viii)** reinsurance balances outstanding, **(ix)** security screening proceedings for reinsurance broking, **(x)** Board of Directors/partners/management, **(xi)** financial data of brokers, **(xii)** business particulars of brokers, **(xiii)** organisation structures and **(xiv)** reinsurance business details.

Inspection The IRDA has the right to appoint its officers as an inspecting authority to inspect the premises of the insurance broker to ascertain and see how the business is carried on and also to inspect the books of accounts, records and documents to: **(i)** ensure that they are being maintained in the prescribed manner, **(ii)** ensure that the provisions of the Insurance Act, rules, regulations are being complied with, **(iii)** investigate the complaints from any insured/insurer/insurance broker/any other person on any matter having a bearing on his activities and **(iv)**

investigate his affairs **suo motu** in the interest of the proper development of the insurance business or in policy-holders' interests.

The IRDA may also appoint a Chartered Accountant or an Actuary or any qualified and experienced individual in the insurance field to investigate the books of accounts or the affairs of the insurance broker.

The inspecting authority/investigator should have full access to the premises of the insurance broker and be extended all facilities for examining books/records/ documents to examine his records statements of any principal officer/employee and have power to seize/make copies of documents/records. Such persons would be duty bound to give all assistance in connection with the inspection which the broker may reasonably be expected to give. The expenses and costs of the investigation would be recovered from the concerned broker.

Suspension of Licence with Notice The licence of an insurance broker may be cancelled or suspended after due notice and after giving him a reasonable opportunity of being heard if he:

(a) Violates the provisions of the Insurance Act, IRDA Act, or rules or regulations, made thereunder;
(b) Fails to **(i)** furnish any information relating to his activities as an insurance broker as required by the IRDA, **(ii)** comply with any IRDA directions;
(c) Furnishes wrong or false information, or conceals or fails to disclose material facts in the application submitted for obtaining a licence;
(d) Does not submit periodical returns as required by the IRDA;
(e) Does not cooperate with any inspection or enquiry conducted by the IRDA;
(f) Fails to resolve the complaints of the policy-holders or fails to give a satisfactory reply to the IRDA in this behalf;
(g) indulges in rebates or inducements in cash or kind to a client or any of the client's directors or other employees or any person acting as an introducer;
(h) Is found guilty if misconduct or his conduct is not in accordance with the code of conduct;
(i) Fails to maintain the capital requirements;
(j) Fails to pay the fees or the reimbursement of expenses under these regulations;
(k) Violates the conditions of licence;
(1) Does not carry out his obligations as specified in the regulations;
(m) If the principal officer does not acquire practical training and pass the examination within the stipulated period.
(n) The IRDA feels that the establishment of an insurance broker is only to divert funds within a group of companies or their associates.

Cancellation or Suspension of Licence without Notice The licence of an insurance broker may be cancelled or suspended without notice, if he:

(a) Violates any one or more of the requirements under the code of conduct;
(b) Is found guilty of fraud, or is convicted of a criminal offence;
(c) Commits such defaults, which require immediate action in the opinion of the IRDA, provided that it has communicated the reasons for the cancellation in writing;
(d) Has not commenced the business within six months of being granted a licence.

Insurance Surveyors and Loss Assessors

The IRDA regulations relating to licensing, professional requirements and code of conduct of insurance surveyors and loss assessors are briefly discussed below.

Licensing Procedure Individual Surveyors and Loss Assessors Every person who is a student member of the Indian Institute of Insurance Surveyors and Loss Assessors (IIISLA) and intending to act as surveyor and loss assessor in respect of general insurance business should obtain a licence from the IRDA. While granting licence, the IRDA would take into account all matters relating to his duties/responsibilities/functions and satisfy itself that the applicant is a fit and proper person for licence. In particular, it would satisfy that the applicant satisfies all the applicable requirements of Section 64-UM and Section 42-D of the Insurance Act (**discussed earlier**) and Rule 56-A of the Insurance Rules and fulfils the eligibility criteria (**discussed later**), pays the fee of ₹1,000 for all membership levels, encloses the required documents, makes the applicable disclosures and would furnish such additional information as may be required by the IRDA from time to time.

On being satisfied about the applicant's eligibility, the IRDA would grant licence mentioning the level of membership granted by the IIISLA, particular class/department or subject of general insurance business, that is, fire, marine cargo, marine hull, engineering, motor, miscellaneous crop insurance and loss of profit allotted based on their technical/professional/insurance and other qualifications. The licence would be valid for 5 years.

Eligibility Criteria **(a)** ***Qualifications*****: (i)** Under Section 64-UM/42-d of the Insurance Act, **(ii)** Additional technical qualifications under Rule 56-A of the Insurance Rule, **(iii)** Post-Graduate Diploma in General Insurance from IIRM, **(iv)** B.Sc. (Agricultural Sciences), **(v)** Additional as specified by the IRDA from time to time, **(vi)** A student member of the **IIISLA**.

(b) ***Training*****: (i)** 12-month specified training (**discussed later in this Section**) and **(ii)** other specified by the IRDA from time to time;

(c) ***Examination*****:** Passing of relevant paper(s) of surveyors examination conducted by the Insurance Institute of India/any other authorised by the IRDA. The allotment of department/area of work to act as surveyor and loss assessor would be specified by the IRDA from time to time. A surveyor/loss assessor would be subject to level of membership in the **IIISLA** (**discussed later in this Section**).

Registration of License An application can the rejected if, **(i)** it does not conform the application fails to comply with, the provisions of the Insurance Act/IRDA regulations, or **(ii)** the IRDA is of the opinion that the grant of license is not in the interest of policyholders.

Corporate Surveyors and Loss Assessors Corporate surveyor means a company/firm/limited liability partnership licensed to act as surveyor and loss assessor. The IRDA would satisfy itself that the application is complete in all respects, al the applicable requirements of Sections 64-UM/42-D and Rule 56-A and the eligibility criteria applicable to individual surveyors/loss assessors *mutatis mutandis* are satisfied.

At least two directors/partners should be members of the **IIISLA** and licensed to act as surveyors/loss assessors. The department/level of membership of the director/partner under his individual license would be applicable to the company/firm and he can undertake job/issue reports only in his capacity as a director/partner of the applicant-company/firm. Employee-licensed surveyors would undertake jobs only of the concerned organisation and only in these departments and level of membership allotted to the individual license.

A director/partner of a corporate surveyor is barred from directorship/partnership in another corporate surveyor. To reflect the main object, the name of the company/firm should include .... "**Insurance Surveyors and Loss Assessors**".

The aggregate holding of equity share held by a foreign company (not exceeding 49 per cent) should be disclosed while applying for license. It should be ensured that a promoter-subscriber of the applicant has only one license.

The license fee, documents to be enclosed, declarations to be submitted applicable to individual surveyors would apply *mutatis mutandis* to corporate surveyors.

Removal of License Application should reach the IRDA 30 days before the expiry of the validity period along with a fee of ₹100 only. To avoid undue hardship, the IRDA may accept application within six months of expiry on payment of penalty of ₹752. The licence of a surveyor can be renewed for 5 years if the IRDA is satisfied that the applicant has complied with all the specified requirements.

The IRDA may refuse to grant/renew licence or suspend/cancel a licence if he/it: **(i)** makes a statement which is false in material particulars with regard to eligibility for licence or **(ii)** suffers from any of the disqualifications under Sections 42(4), and 64-UM (1)(D) of the Insurance Act.

Constitution and Functions of Surveyors and Loss Assessors Committee The IRDA would constitute a Committee to be called "Surveyors and Loss Assessors Committee" ("Committee"), for assisting it on the matters and affairs relating to insurance surveyors and loss assessors consisting of the following persons: **(i)** an Officer of the IRDA; **(ii)** two representatives of the surveyors and loss assessors; **(iii)** a representative of insurer each from public and private sector, and **(iv)** a representative of the policyholders. The Committee would be for a period of three years and presided over by the officer of the IRDA.

Functions of the Committees The Committee would perform the following functions:

(i) Recommending the syllabus for examination and practical training requirements for persons to qualify as surveyors and loss assessors.

(ii) Recommending to the IRDA for its consideration to recognise foreign qualifications and training for the purposes of grant of licence to act as surveyors and loss assessors;

(iii) Improving and developing the status and standard of the profession of surveyors and loss assessors;

(iv) Coordinating with educational or other institutions, having as their objects, wholly or partly, similar to those of the profession of surveyors and loss assessors, in such manner as may be conducive for the attainment of common objectives;

(v) Looking into the matters of professional misconduct, indiscipline, non-adherence to code of conduct by surveyors and loss assessors; and dealing with complaints of insured/insurer in respect of survey work done by them;

(vi) Discharging any other function, which may be entrusted by the IRDA, from time to time.

Appointment of Surveyors and Loss Assessors To act as a surveyor/loss assessor, a person/firm/company must obtain a license from the IRDA. An insurer/insured can appoint him to assess loss in respect of general insurance business above ₹20,000 within 72 hours from the time the occurrence of loss is known to the insured. Notice of the appointment in writing to be sent to the insurer/insured would form part of the claim settlement process. A surveyor/loss assessor would assess losses only of departments specified in the license. In case of dispute/dissatisfaction in the assessment of loss by surveyor appointed by the insurer, the insured would be entitled to appoint on payment of fee an appropriate assessor. Any dispute between them about the quantum of assessed loss may be referred to arbitration.

Duties and Responsibilities of a Surveyor and Loss Assessor A **surveyor and loss assessor** should, for a major part of the working time, investigate, manage, quantify, validate and deal with losses (whether insured or not) arising from any contingency, and report thereon, and carry out the work with competence, objectivity and professional integrity by strictly adhering to the code of conduct expected of him. The following would, inter alia, be the duties and responsibilities of a surveyor and loss assessor:

(i) Declaring whether he has any interest in the subject-matter in question or whether it pertains to any of his relatives, business partners or through material shareholding;
(ii) Maintaining confidentiality and neutrality without jeopardising the liability of the insurer and claim of the insured;
(iii) Conducting inspection and reinspection of the property in question suffering a loss;
(iv) Examining, inquiring, investigating, verifying and checking upon the causes and the circumstances of the loss in question including extent of loss, nature of ownership and insurable interest;
(v) Conducting spot and final surveys, as and when necessary, and comment upon franchise, excess/ under insurance and any other related matter;
(vi) Estimating, measuring and determining the quantum and description of the subject under loss;
(vii) Advising the insurer and the insured about loss minimisation, loss control, security and safety measures, wherever appropriate, to avoid further losses;
(viii) Commenting on the admissibility of the loss as also observance of warranty conditions under the policy contract;
(ix) Surveying and assessing the loss on behalf of insurer or insured;
(x) Assessing liability under the contract of insurance;
(xi) Pointing out discrepancy, if any, in the policy wordings;
(xii) Satisfying queries of the insured/insurer and of persons connected thereto in respect of the claim/loss;
(xiii) Recommending applicability of depreciation and the percentage and quantum of description;
(xiv) Giving reasons for repudiation of claim, in case the claim is not covered by policy terms and conditions;
(xv) Taking expert opinion, wherever required; and
(xvi) Commenting on salvage and its disposal wherever necessary.

A surveyor or loss assessor should submit his report to the insurer as expeditiously as possible, but not later than 30 days of his appointment with a copy of the report to the insured. The period can be extended to six months with the consent of the insured and the insurer in exceptional cases due to its special and complicated nature. Within 15 days of the receipt of the report, the insurer may require the surveyor under intimation to insured to furnish an additional report on any incomplete issues within three weeks of the date of communication from the insurer in this regard.

Categorisation of Surveyors A surveyor/loss assessor would be categorised on the basis of level of membership by the **IIISLA**. The three levels of membership are: **(i)** Licentiate, **(ii)** Associate and **(iii)** Fellow. Each will carry on work accordingly. The **IILSLA** would grant appropriate membership to eligible person(s) within 15 days from the date of receipt of application for membership based on the under-mentioned criteria.

Licentiate Member Is any person holding a valid license and fulfils the IRDA stipulations relating to training, examination, seminars and workshops conducted by the **IIISLA**. In addition to the practical training (**discussed later in this Section**), every member should undergo training for 100 hours and five seminars/workshops.

Associate Member Is a licentiate member holding valid license continuously for at least 5 years and undergoes training for 50 hours and attends at least 8 seminars/workshops.

Fellow Member Is a associate member holding valid license continuously for not less than 8 years and undergoes 25 hours training and at least 10 seminars/workshops.

Code of Conduct Every surveyor and loss assessor should:

(1) Behave ethically and with integrity in the professional pursuits. Integrity implies not merely honesty but fair dealings and truthfulness;
(2) Strive for objectivity in professional and business judgement;
(3) Act impartially, when acting on instructions from an insurer, in relation to a policyholder's under a policy issued by that insurer;
(4) Conduct himself with courtesy and consideration to all people with whom he comes into contact during the course of his work;
(5) Not accept or perform surveys works in areas for which he does not hold a licence;
(6) Not accept or perform work which he is not competent to undertake, unless he obtains some advice and assistance, as would enable him to carry out the work competently;
(7) Carry out his professional work with due diligence, care and skill and with proper regard to technical and professional standards expected of him;
(8) Keep himself updated with all developments relevant to his professional practice;
(9) At all times maintain proper record for work done by him and comply with all relevant laws;
(10) Assist and encourage his colleagues to obtain professional qualifications, and, in this behalf, provide free articleship and/or practical training for a period of twelve months;
(11) Maintain a register of survey work, containing the relevant information, such as details of insured/insurer/policy number/date of allocation of survey work/date of submission of survey report, amount of claims assessed, fee details and should keep important records of the survey reports, photographs and other important documents for a period of 3 years and furnish the same and such other specified returns, as and when called by the IRDA or by any investigating authority or the insurer. However, in case of litigation, the records should be maintained till the conclusion of the litigation.
(12) Disclose to all parties concerned his appointment, where the acceptance or continuance of such an engagement may materially prejudice, or could be seen to material affect the interests of any interested party. As soon as a conflict of interest is foreseen, every surveyor and loss assessor should notify all interested parties immediately and seek instructions for his continuance;
(13) Not disclose any information, pertaining to a client or employer or policy-holder acquired in the course of his professional work, to any third party, except, where the consent has been obtained from the interested party, or where there is a legal right to duty enjoined upon him to disclose;
(14) Neither use nor appear to use, any confidential information acquired or received by him in the course of his professional work, to his personal advantage or for the advantage of a third party;
(15) Comply with all the provisions of the Insurance/IRDA Act(s)/rules and regulations and orders/directions/guidelines issued by the IRDA;
(16) Undertake survey jobs in a company/firm only as an employee/director/partner;
(17) Neither act as a consultant of the insured nor involve in any settlement of loss particularly those being assessed by him; and
(18) Comply with the provisions of AOA/regulations and code of ethics from the **IIISLA**.

Training Applicants A student member of the **IIISLA** seeking license to act as a surveyor/loss assessor should enrol with the IRDA and undergo a practical training for at least 12 months with a licensed surveyor/loss assessor, who should be associate/fellow member of the **IIISLA**. The requirement of training would not be applicable to student-members having over 15 years of experience in areas relating to risk management/settlement of claims in relevant field in general insurance. The license to him would be in that particular area only. A practical training of not less than six months would be acquired for a licensed surveyor seeking a license for acting as a surveyor in another category. During the period of training, he should comply with the code of conduct/ethics prescribed by the **IIISLA** and duly approved by the IRDA including the following: **(i)** Behave ethically and with integrity implying not merely honesty but fair dealings and truthfulness, **(ii)** Not accept/perform/undertake any survey work and issue any report without holding a valid license, **(iii)** Maintain at all times duly certified proper record of training details, **(iv)** Disclose all information relating to any proceedings initiated/investigation pending/carried out against him by any agency, **(v)** File within 15 days any changes in information already submitted, and **(vi)** Any other information specified by the **IIISLA**.

The trainee should maintain a certified quarterly record of training and attach the certificate to the application seeking license from the **IIISLA**. The IRDA may also prescribe the passing by an applicant of an examination conducted by **IIISLA** or by an IRDA-authorised institution on the successful completion of the training.

Miscellaneous The other requirements of IRDA regulations are discussed below.

Register of Licensed Insurance Surveyors and Loss Assessors The **IIISLA** would maintain a register of all licensed insurance surveyors and loss assessors containing the following particulars: **(i)** full name, date of birth, domicile, residential and professional address; **(ii)** the date on which name is entered in the Register; **(iii)** licence number and period of validity; **(iv)** professional and other qualifications; **(v)** areas of survey work licensed to be undertaken; **(vi)** level of membership in the **IIISLA** of the surveyor and loss assessor; and **(vii)** any other particulars as may be prescribed by the IRDA from time to time. However, in the case of corporate surveyors, the particulars to be entered in the register, would be with reference to every director or partner. The IRDA may publish the appropriate relevant particulars in the register at intervals and in a manner deemed fit.

Submission of Returns Every licensed surveyor and loss assessor should: **(a)** furnish such of the document, statement, account, return on report, as and when required by the IRDA, and comply with such directions, as may be issued by the IRDA in this behalf, from time to time; and **(b)** submit an annual statement in the prescribed form. Every insurer should submit to the IRDA the following: **(i)** quarterly report on misconduct of licensed surveyors including any action taken on the employee surveyors **(ii)** a copy of the annual policy on the methodology followed for appointment/utilisation of surveyors and allotment of survey jobs to them, and **(iii)** any changes in the annual policy within 15 days of the change with reasons.

Inspection The IRDA, may appoint one or more persons as inspecting authority to undertake inspection of survey work, books, records and documents, or to investigate any bona fide complaint received against a surveyor and loss assessor. A surveyor should provide the information demanded by the inspection authority and extend all possible cooperation to facilitate the conduct of its work. After consideration of the inspection report, the IRDA would communicate the findings to the surveyor and loss assessor, and give him a reasonable opportunity of being heard before any action is taken by it on the findings of the inspection report.

Action in Default ***Suspension of License*** The IRDA would suspend for a specified period license of an individual/corporate surveyor/loss assessor if he/it: **(i)** Fails to discharge duties/responsibilities in a satisfactory/professional manner, **(ii)** Violates code of conduct, **(iii)** Makes a statement which is false in material particulars regarding eligibility for obtaining/renewal of license or in any size of the activities transacted or connected matters or has after the issue/renewal of license acquired a disqualification under Section 42(4) of the Insurance Act, **(iv)** Has contravened any provision of the Insurance/IRDA Act/Rules/regulations/directions, **(v)** Has been negligent in the discharge of obligations, and **(vi)** Has been sentenced to punishment by a court. A license may also be suspended if the IRDA is of the opinion that its continuation would be prejudicial to the policyholders interest. For an act committed by a director/partner, the license of the corporate surveyor may also be suspended.

Cancellation of License The license of a surveyor/loss assessor may be cancelled by the IRDA if found **(a)** suffering from a disqualification under Section 42(d) read with Section 42(4) of the Insurance Act, **(b)** knowingly contravening any provision of Insurance/IRDA Act/Rules/regulations/directions/instructions. The IRDA may also cancel a license if in its opinion its continuation would be prejudicial to the policyholders interest. Similarly, license may be cancelled if representation is not made to the IRDA within 45 days of the order of suspension of license.

Micro-Insurance

A **micro-insurance** product includes life as well as general micro-insurance products. A life/general insurance may offer life as well general micro-insurance products in terms of the IRDA's Micro-Insurance Regulations, 2005. **General micro-insurance product** means a health insurance contract/any contract covering the belongings, such as a hut, live stock, tools, instruments/any personal accident contract, of a personal or group (i.e., at least 20 persons), as per the terms specified below:

Type of cover (1)	*Minimum amount of cover* (2)	*Maximum amount of cover* (3)	*Minimum term of cover* (4)	*Maximum term of cover* (5)	*Minimum age at entry* (6)	*Maximum age at entry* (7)
1. Dwelling and contents or livestock or tool or implements or other assets/crop insurance against all perils	₹5,000 per asset/cover	₹30,000 per asset/cover	1 year	1 year	NA	NA
2. Health insurance contract (individual)	₹5,000	₹30,000	1 year	1 year	Insurer's discretion	
3. Health insurance contract (family**) [Option to avail limit for individual/ float of family]	₹10,000	₹30,000	1 year	1 year	Insurer's discretion	
4. Personal accident (per life/earning member of family)	₹10,000	₹50,000	1 year	1 year	5 years	70 years

**means a unit comprising of husband, wife, dependent parents and a maximum of 3 children.

Life micro-insurance product means any term insurance contract, with/without return of premium/any endowment insurance contract/health insurance contract with/without an accident benefit rider, either on individual or group basis, as per the terms stated below. The group insurance contracts may be renewable on an yearly basis.

Type of cover (1)	*Minimum amount of cover* (2)	*Maximum amount of cover* (3)	*Minimum term of cover* (4)	*Maximum term of cover* (5)	*Minimum age at entry* (6)	*Maximum age at entry* (7)
1. Term insurance with/without return of premium	₹5,000	₹50,000	5 years	15 years	18 years	60 years
2. Endowment insurance	₹5,000	₹30,000	5	15	18	60
3. Health insurance (individuals)	₹50,000	₹30,000	1	7	Insurer's discretion	
4. Health insurance (family)	₹10,000	₹30,000	1	7	Insurer's discretion	
5. Accident benefit as rider	₹10,000	₹50,000	5	15	18	60

The main elements of IRDA's regulations, namely: tie-ups, distribution, appointment and code of conduct are discussed in this Section.

Tie-up The insurer should tie-up with a general insurer for the purpose and subject to the provisions of Section 64-VB of the Insurance Act (discussed in an earlier Section), collect the attributable premium from the prospect (proposer) and make it over to the general insurer. He would forward any claim in regard to the general micro-insurance product to the general insurer and offer all assistance for its expeditious disposal. A general insurer can similarly tie-up with a life insurer to offer life micro-insurance products.

Distribution of Micro-insurance Products In addition to the individual/corporate insurance agents and insurance brokers, insurers may distribute micro-insurance products through micro-insurance agents who would not distribute any other insurance products.

A **micro-insurance agent** means **(i)** a Non-Government Organisation (NGO), **(ii)** a Self-Help Group (SHG) and **(3)** a Micro-Finance Institution (MFI). The **NGO/SHG** means a non-profit organisations registered as a society/an informal group, consisting of 10-20 persons, which has been working for at least 3 years with marginalised groups, with proven track record, clearly stated terms and objectives/transparency and accountability as outlined in its memorandum/ rules/bylaws/ regulations and which demonstrates involvement of committed people. An **MFI** means any institution/entity/association registered as a society/cooperative society including all non-profit organisations registered with non-profit objective under the appropriate laws including companies for, inter-alia, sanctioning loans/finance to members.

Appointment A micro-insurance agent (MIA) can work for only one life insurer and one general insurer. The insurer would enter into a deed of agreement duly approved by its head office, with the MIA, clearly specifying the terms and conditions of the appointment, including their mutual duties and responsibilities. The deed should specifically authorise, the MIA to perform the following additional functions: **(i)** Collection of proposal forms/self-declaration forms from the proposer, of his being in good health and remittance of premium; **(ii)** Distribution of policy documents; **(iii)** Maintenance of a register of all the insured and their dependents, together with details of name/sex/age/address/nominees/ thumb impression/signature of the policy holders; **(iv)** Assistance in settlement of claims; **(v)** Ensuring nominations to be made by the insured; and **(vi)** Any policy administrative service. The agreement can be terminated by either party by giving a three months notice. But in case of termination on account of misconduct/indiscipline/ fraud by the MIA, no notice would be necessary. The MIA, with the prior approval of the insurer, can employ specified persons to discharge his functions. Corporate agents/insurance brokers procuring micro-insurance business would, however, be governed by the respective IRDA regulations applicable to them (discussed earlier).

Code of Conduct The MIAs and the specified persons employed by him should abide by the code of conduct prescribed by the IRDA's Licensing of Insurance Agents and the Insurance Advertisement and Disclosure Regulations (discussed in earlier Sections). The insurer would have to ensure compliance with these by the MIA. Any violation of the code would result in the termination of his appointment, in addition to penal consequences for breach.

Every insurer would be subject to the 'file and use' procedure with respect to the filing of micro-insurance products with the IRDA, which should prominently carry the caption 'Micro-Insurance Product' (MIP).

The insurance contracts with individual micro-insurance policyholders should be in a simple and easily understandable vernacular language. A detailed write-up about the policy details in the vernacular language should be issued if it is not possible to issue the policy contracts in the vernacular language. The insurer should issue insurance contracts to the group micro-insurance policyholders, in an unalterable form, along with a schedule showing the details of individuals covered under the group and also issue a separate certificate to each individual evidencing proof of insurance, containing details of validity of period of cover, nominee, and addresses of the underwriting/servicing office. He should not authorise any MIA/any outsider to underwrite any insurance proposal for granting insurance cover. He should impart a minimum of 25 hours of training at its expense and through its designated officer(s) in the local vernacular language, to all the MIAs/their specified person in the areas of insurance selling, policyholder servicing and claims administration.

The remuneration of an MIA, including the commission payable by an insurer, would be subject to the following limits: **(a)** For life business, single premium policies–10 per cent and for non-single premium policies–20 per cent of the premium for all the years, **(b)** For non-life business 15 per cent of the premium. For group insurance products, the insurer may decide the commission subject to the overall limit.

The issuer must ensure that all transactions relating to the micro-insurance business are in accordance with the provisions of the Insurance Act/IRDA Act/rules and regulations and furnish the required information to the IRDA.

All micro-insurance policies may be reckoned for fulfillment of social obligations by an insurer and a policy issued in a rural area may be reckoned for both–rural and social obligations, pursuant to the provisions of the Insurance Act/regulations.

Complaints/grievances against MIAs should be handled by the insurer with speed and promptitude and a quarterly report should be sent to the IRDA regarding the handling of such complaints/grievances. The IRDA may cause an inspection of the office/records of any MIA at any time, if deemed necessary.

CORPORATE GOVERNANCE GUIDELINES FOR INSURANCE COMPANIES

These are available on the accompanying website. The address is **http://www.mhhe.com/khanifs10e.**

Issuance of Capital by Life Insurance Companies Regulation

The main elements of these regulations are: **(i)** prior written approval of IRDA, **(ii)** criteria for consideration of approval, and **(iii)** conditions for approval.

Prior Approval Prior specific written approval of the IRDA would be necessary for insurance companies before approaching the SEBI for **(i)** public issue of capital and **(ii)** divestment of equity by promoter(s) through a public offer for sale under the SEBI ICDR regulations (**discussed in Chapter 14**). However, insurance companies can issue/allot only fully paid-up shares.

An applicant-insurance company can raise share capital only on completion of 10 years/ period prescribed by Government from the date of commencement of business. The approval would be valid for one year. The IRDA's approval should not be deemed to, or serve as a, validation of the representations by the issuer and this fact should be disclosed in the offer document. It may not accord approval if, in its opinion, **(i)** the applicant-issuer is not compliant with the regulatory framework, **(ii)** it may be detrimental to the policyholders interests and **(iii)** it may not be in the interest of insurance business in India.

Criteria for Consideration of Approval The IRDA would generally consider the applicant-company's overall financial position/regulatory record/proposal for issue/offer of capital/ capital structure post-issue/offer of capital and the purposes to which the capital raised would be applied. In particular, the IRDA would, *inter-alia*, consider the following parameters: **(i)** period for which in life insurance business, **(ii)** history of compliances with the regulatory requirements, **(iii)** maintenance of the prescribed regulatory margin at the end of the preceding six quarters, **(iv)** compliance with the disclosure requirements and corporate governance guidelines, **(v)** record of policyholders protection, and **(vi)** the embedded value. The embedded value report should be prepared in the manner prescribed by the Actuarial Practice Standard issued by the Institute of Actuaries in India by an independent actuarial expert and peer review by another independent actuary. The value should be twice the paid-up equity capital including share premium.

Conditions for Approval While approving the proposal, the IRDA may prescribed the following condition: **(a)** extent to which the promoters should dilute their respective shareholdings, **(b)** maximum subscription which could be allotted to foreign investors, **(c)** minimum lock-in period for promoters (without prejudice to the SEBI ICDR regulations) and **(d)** disclosures in the offer document/prospectus in addition to those prescribed by the SEBI.

The IRDA would process/grant approved as expeditiously as possible and the issuer-applicant should ensure prompt response to queries/requests for information from the IRDA for processing the application.

Health Insurance Regulations 2016

The main elements of these regulations, namely, **(i)** registration/scope, **(ii)** health insurance products, **(iii)** general provisions, **(iv)** administration and submission of returns are discussed below.

Registration and Scope of Health Insurance Business Health insurance products may be offered only by entities with a valid registration to carry on life/general/health insurance business under the IRDA Registration of Indian Insurance Companies Regulations 2016 (**discussed earlier in this Chapter**). Life insurers may offer long term individual health insurance products for term of 5 years or more, but the premium should remain unchanged for at least every block of three years. The may not offer indemnity based individual/group products. No single premium health insurance product should be offered under the unit-linked platform. General and health insurers may offer individual health products with a minimum tenure of one year and a maximum tenure of three years, provided that the premium remains unchanged for the tenure. Group health policies may be offered for a term of one year except credit linked products where the term can be extended upto the loan period not exceeding five years. Group personal accident policies may be offered by general and health insurers with term less than one year also to provide coverage to specific events. Other insurance products offering travel cover and individual personal accident cover may also be offered for a period less than one year. Overseas/domestic travel insurance policies may only be offered by general/health insurers as a standalone product/as an add-on cover to a health/personal accident policy.

Provisions Relating to Health Insurance Products pertain to **(i)** filing procedure, **(ii)** review of products, **(iii)** group insurance, **(iv)** underwriting, **(v)** proposal form and **(vi)** pricing.

Product Filing Procedure for Health Insurance Products The insurance products of a life/general/ health insurer under health insurance business should be marketed/offered if filed as per the product filing guidelines and duly disposed of by the IRDA. The health insurance products of life insurers would also be subject to the provisions specifically provided for health products in the IRDA **(1)** Linked-Insurance **(2)** Non-linked Insurance Product Regulations **(discussed in another Section of this Chapter)**.

Review of Health Insurance Products All particulars of any health insurance product should, after introduction, revision or modification be reviewed by the appointed actuary at least once a year. If the product is found to be financially unviable, or is deficient, it may be revised appropriately.

Group Insurance A group health insurance policy should not be issued by an insurer where the group is formed with the main purpose of availing itself of insurance. There should be a IRDA-specified clearly evident relationship between the members of the group and the group policyholder. The group should have minimum size of 7, to be eligible for issuance of a group insurance policy. The insurers should follow the IRDA-specified guidelines on group insurance.

Underwriting All insurers should evolve a health insurance underwriting policy approved by the Board of the company. They should also put in place measures for periodical review of the underwriting policy in tune with the changes affecting the medical field and health insurance business. The underwriting policy should also cover the approach and aspects relating to offering health insurance coverage not only to standard lives but also to sub-standard lives. It should have in place various objectives underwriting parameters to differentiate the various classes of risks being accepted in accordance with the respective risk categorisation. Any proposal for health insurance may be accepted/modified/denied wholly based on the Board-approved underwriting policy. General and health insurers may devise and disclose upfront in the prospectus/policy document mechanism/incentives to reward policyholders for early entry, continued renewals, favourable claims experience, preventive and wellness habits.

Proposal Form The insurers should devise a proposal form to be submitted by a proposer seeking a health insurance policy capturing all the information necessary to underwrite a proposal.

Information collected from the proposal form during the course of solicitation/issuance of an insurance policy should not be parted with to any third party, except with the statutory authorities or for underwriting the policy of the same individual or claim settlement. All the applicable provisions of the law/other regulations/guidelines specified by the IRDA while designing the proposal forms.

Principles of Pricing of Health Insurance Products Offered Insurers should ensure that the premium for a health insurance policy is based on **(i)** age for individual/group policies, **(ii)** other applicable relevant risk factors. For cover under family floater, the impact of the multiple incidence of rates of all family members should be considered. The premiums filed should ordinarily be not changed for three years after a product has been cleared. The premium rates may be revised depending on the experience. However, the revised rates should not be changed for at least one year from the date of the revision.

The policy premium rate should be unchanged for all **(i)** group products for the term of the policy,**(ii)** individuals and family floater products, other than travel insurance products, for at least one year in case of one-year renewable policies and 1 – 3 years in the case of the rest, **(iii)** in case of individual health products, every block of three years. Changes in rates will be applicable from the date of approval by the IRDA and applied only prospectively for new policies and from the date of renewal for the existing policies. All IRDA-specified guidelines should be complied with while pricing the products.

General Provisions Relating to Health Insurance pertains to designing, entry/exit age, renewal, free look period, cost of pre-insurance health-check-up, cumulative bonuses, migration of policy, Ayush coverage, wellness/preventive aspects, optional coverage, special provisions for senior citizens, multiple policies and loading on renewal.

Designing of Health Insurance Policies The health insurance products may be designed to offer various covers for **(i)** specific age/gender groups, **(ii)** different age groups, **(iii)** treatment in all hospitals throughout the country, **(iv)** treatment in specific hospitals/geographies only. These specifications should be disclosed clearly upfront in the product prospectus, documents and during sale process. In order to facilitate offering of innovative covers by insurers, **Pilot products** may be designed and filed for approval of the of the IRDA. They can be offered only by general and health insurers for policy tenure of one year. Every pilot product may be offered up to 5 years after which it needs to get converted into a regular product or withdrawn subject to the insured being given an option to migrate to another product subject to portability conditions. The insurers should not compel the insured to migrate to other health insurance products. In case of migration from a withdrawn product, they should offer an alternative available product. They should ensure adequate dissemination of product information on all their health insurance products on their websites, including a description of the product, copies of the prospectus, proposal form, policy document wordings and premium rates inclusive and excusive of service tax. **Pilot product** means a close-ended product with a one-year policy term which can be offered upto 5 years with a view to giving scope to innovation for covering risk that have not been offered hitherto or stand excluded in the extant products.

Entry and Exit Age All health insurance policies should ordinarily provide for an entry age of at least upto 65 years. Except travel insurance/personal accident and pilot products, once a proposal is accepted and a periodically renewable without break policy is issued, further renewal should not be denied on grounds of the age of the insured.

Renewal of Health Policies Unless withdrawn, a health insurance policy should ordinarily be renewable except on grounds of fraud/moral hazard/misrepresentations/non-cooperation by the insured. An insurer should not deny the renewal of a health insurance policy on the ground that the insured had made a claim(s) in the preceding policy years, except for benefit based policies where the policy terminates following payment of the benefit covered under the policy like critical illness policy. He should provide for a mechanism to condone a delay in renewal upto 30 days from the date of renewal without deeming such condonation as a break in policy. The promotion material and the policy document should explicitly state the conditions under which a policy terminates, such as on the payment of the benefit in case of critical illness benefits policies.

Free Look Period All new individual health insurance policies, except those with tenure of less than a year, should have a free look period. It would be applicable at the inception of the policy and the insured will be allowed at least 15 days from the date of receipt of the policy to review its terms and conditions and to return it if not applicable. If the insured has not made any claim during the free look period, the insured would be entitled to **(a)** a refund of the premium paid less expenses incurred by the insurer on medical examination of the insured persons and the stamp duty charges or; **(b)** where the risk has already commenced and the option of return of the policy is exercised by the policyholder, a deduction towards the proportionate risk premium for period on cover or; **(c)** where only a part of the insurance coverage has commenced, proportionate premium commensurate with the insurance coverage; **(d)** in respect of unit-linked policy, in addition to the above deductions, the insurer would also be entitled to repurchase the unit at the price as on the date of the return of the policy.

Manner of Treating Cost of Pre-insurance Health Check-up The cost of any pre-insurance medical examination should generally form part of the expenses allowed in arriving at the premium. However, in case of products with term upto one year, not less than 50 per cent of the cost should be borne by the insurer once the proposal is accepted, except in travel insurance policies. The insurers should maintain a list of medical examiners/institutions where pre-insurance medical examination may be conducted whose reports will be accepted by them. The details of fee payable should be made available to the prospective policyholder at the time of pre-insurance medical examination on demand.

Cumulative Bonus The cumulative bonuses offered under policies should be stated explicitly in the prospectus and the policy document. If a claim is made in any particular year, the cumulative bonus accrued may be reduced at the same rate at which it has accrued.

Migration of Health Insurance Insurers offering health covers specific to age groups such as maternity covers, children under family floater policies, students and so on should offer an option to migrate to a suitable alternative available health insurance policy at the end of the specific exit age or at the time of withdrawal of the policy at the option exercised by them by allowing suitable credits for all the previous policy years, provided the policy has been maintained without a break. All health insurance policies should allow the portability of any policy. **Portability** means the right accorded to an individual insurance policyholder (including family cover) to transfer the credit gained from pre-existing conditions and time-bound exclusions from one insurer/plan to another.

AYUSH Coverage The insurers may endeavour to provide coverage for one or more systems covered under 'AYUSH treatment' provided the treatment has been undergone in a Government hospital or in any institute recognised by Government and/or accredited by Quality Council of India or National Accreditation Board on Health. **Ayush treatment** refers to medical/hospitalisation treatment given under Ayurveda, Yoga and Naturopathy, Unani, Siddha and Homeopathy systems.

Wellness and Preventive Aspects While wellness and preventive elements as part of product design is encouraged, no policy of insurance should promote or offer the products and services of third parties who are not network providers in terms of TPA-Health Services Regulations 2016 **(discussed in another Section of this Chapter)**. Insurers should not offer discounts to the policyholders, on the products of the third parties either as part of policy contract or otherwise. However, they may endeavour promoting wellness amongst policyholders by offering the following health specific services offered by network providers: **(1)** outpatient consultations/treatments, **(2)** pharmaceuticals, **(3)** health check-ups including discounts on all the above at specific network providers. They may also endeavour to put in place procedures for offering discounts on premiums on renewals based on the fitness and wellness criteria stipulated and disclosed. The costs towards these services should be factored into the pricing of the underlying health insurance product.

Optional Coverage for Certain Items The list of generally excluded items that may be optionally covered by the insurers may be specified by the IRDA **(a)** in respect of hospitalisation indemnity policies that exclude certain standard items. Insurers should ensure that these are mentioned in the product filing, **(b)** product-wise specific list of excluded items should be disclosed in the website of insurers and a reference should be made in the prospectus and policy wordings of the respective products about them and the availability of the details on the website along with the address of website, **(c)** insurers should supply the policyholders on demand a copy of the excluded list of the concerned product if it is not incorporated in the policy document. They may offer cover for these items and mention it clearly in the policy.

Special Provision for Senior Citizens The premium charged for health insurance products offered by insurers to **senior citizens** (i.e. any person of atleast 60 years of age on the date of commencement/renewal of policy) should be fair, justified, transparent and duly disclosed upfront. They should be informed in writing of any underwriting loading charges as filed and approved over and above the premium and specific consent of the policyholder for such loadings should be obtained before issuance of a policy. All insurers and TPAs should establish a separate channel to address the health insurance-related claims as grievances of senior citizens.

Multiple Policies In case of multiple policies which provide fixed benefits, on the occurrence of the insured event in accordance with the terms and conditions of the policies, each insurer should make the claim payments independent of payments received under other similar policies. If two or more policies are taken by an insured during a period from one or more insurers to indemnify treatment costs, the policyholder should have the right to require a settlement of his/her claim in terms of any of his/her policies: **(1)** in all such cases, the insurer would be obliged to settle the claim within the limits, and according to the terms, of the chosen policy, **(2)** claims under other policy(ies) may be made after exhaustion of the sum insured in the earlier chosen policy(ies), **(3)** if the amount claimed exceeds the sum insured under a single policy after considering the deductibles or co-pay, the policyholder would have the right to choose insurers from whom he/she wants to claim the balance amount, **(4)** where an insured has policies from more than one insurer to cover the same risk on indemnity basis, he should only be indemnified the hospitalisation costs in accordance with the terms and conditions of the chosen policy.

Loadings of Renewals For individual products, the loadings on renewal should be in terms of increase or decrease in premium offered for the entire portfolio and not be based on an individual policy claim experience. The discounts and loadings offered should be **(1)** not at the discretion of the insurer, **(2)** based on an objective criteria, **(3)** disclosed upfront in the prospectus and policy document along with the objective criteria. No insurer should resort to fresh underwriting by calling for medical examination, fresh proposal form and so on, at renewal stage where there is no change in the sum insured offered. Where, however, there is an improvement in the risk profile, the insurer may endeavour to recognise that for removal of loadings at the point of renewal.

Administration of Health Insurance Policies Every insurer should ensure the following: **(i)** protection of policyholders interest, **(ii)** settlement/rejection of claims, **(iii)** minimum disclosure, **(iv)** other disclosures, **(v)** administration, **(vi)** health service agreements, **(vii)** payment to network providers, **(viii)** engagement of TPAs, **(ix)** change of TPAs and **(x)** data and related issues.

Protection of Policyholders' Interest Every insurer should be provided with a IRDA-specified customer information sheet. He should establish necessary systems, procedures, offices and infrastructure to enable efficient issuance of pre-authorisations on a 24-hour basis and for prompt settlement of claims and grievances.

Settlement/Rejection of Claim by Insurer An insurer should settle/reject a claim, within 30 days of the receipt of the last **necessary** document. Except in cases where a fraud is suspected, ordinarily no document not listed in the policy terms and conditions would be deemed **necessary**. The insurer should ensure that all the documents required for claims processing are called for at one time and that they are not called for in a piece-meal manner. The information that the insurer has captured in the proposal form, the terms and conditions offered under the policy, the medical history as revealed by earlier claims and the prior claims experience should all be maintained by him as an electronic record and not be called for again from the policyholder/ insured at the time of subsequent claim settlements. The insurer may stipulate a period within which all necessary claim documents should be furnished by them to make a claim. However, claims filed even beyond such period should be considered if there are valid reasons for any delay. Every insurance claim should be disposed of in accordance with the terms and conditions of the policy contract and the extant regulations governing their settlement. No claim should be closed in the books of the insurers.

Minimum Disclosures in Policy Document In addition to the requirements stipulated in IRDA Protection of Policyholders' Interest Regulation **(discussed earlier in this Chapter)**, the policy document should contain: **(i)** list of disclosures required as per health insurance regulations, **(ii)** procedures for claims submission, time lines and possible course of action, if times lines for claim submission are not adhered to along with all the claims documents required for claim processing, **(iii)** sub-limits applicable on any of the covers offered in the health insurance product and their impact on other covers provided in the product should be clearly spelt out, **(iv)** penal interest provision should invariably be incorporated in the policy document, **(v)** the TPAs details along with the complete address and contact number should be attached to the policy document. It should also be mentioned that the updated list of the TPAs will be available on the website of the insurers.

Other Disclosures Every insurer should disclose product-wise/location or geography-wise particulars of the TPAs that are engaged for rendering health services in their respective website.

The product-wise **cashless services** offered should be clearly explained in their respective website. In case of pilot products, in addition to all extant disclosures norms applicable to insurance advertisements, all the sales and publicity material pertaining to them should disclose the following: **(1)** the product offered is a pilot product and that it is a close-ended one. **(2)** it may be discontinued form the specified date or may be continued as a regular product, **(3)** in the event of its discontinuation, the insured would be provided the option of migration, **(4)** the product should carry a tag line of **Pilot Project**. The insurer should keep the insured informed of the list of network providers and display the same on their website. It should be displayed geography-wise and updated as and when there is any change in the network providers.

Administration of Health Policies Subject to the terms of a policy, the insurers should extend to all policyholders a **cashless facility** for treatment at specific establishments or the reimbursement of the costs of medical and health treatments or services availed at any medical establishment. **Cashless service/facility** means a facility extended by the insurer/TPA whereby the payments for the costs of treatment undergone by the insured are directly made to the network provider by the insurer to the extent pre-authorisation is approved. It should be offered only at establishments which have entered into an agreement with the insurer to extend such services. Such establishments will be termed as network providers. Reimbursement should be allowed at any medical establishment. All such establishment must be licensed or registered as may be required by any local/state/national law. The administration of all **health plus life-combi products** (i.e. products which offer the combination of life insurance cover and health insurance cover) should be in accordance with the specified provisions. Except in emergencies a cashless facility may require a pre-authorisation to be issued by the insurer or an appointed TPA to the network provider where the treatment is to be undergone. To avail the benefit of cashless facility, insurers should issue an identification card to the insured within 15 days from the date of issuance of a policy, either through a TPA or directly. Where there is no mention of the expiry date on the card, the insurer may provide a permanent card which is valid as long as the policy is renewed with the company. The identification card should at the minimum, carry details of the policyholder and the logo of the insurer. The insurers should endeavour to issue smart cards with features such as cards with quick response code, magnetic reader to enable the TPAs and network providers offer health service seamlessly. Where a policyholder has been issued a pre-authorisation for the conduct of a given procedure in a given hospital or if he is already undergoing such treatment at a hospital, and the hospital is proposed to be removed from the list of network provider before the final settlement of the claim, insurers should provide the benefits of cashless facility to the policyholders as if the hospital continues to be on the network provider list. An insurance company may enter into an arrangement with other insurance companies for sharing of network providers, transfer of claim and transactional data arising in areas beyond their service.

Health Services Agreement Insurance companies may offer policies providing cashless services to the policyholders provided they are offered through network providers who have been enlisted to provide medical services under a direct written agreement with the insurer where there is a direct arrangement or by a tripartite agreement amongst health services provider, the TPA and the insurer where it is through a TPA. Where an insurer wishes to utilise the services of TPA, it should ensure that the written agreement is entered into for defined services with a TPA holding a valid CoR in accordance with the IRDA TPA Regulation, 2016 **(discussed in another Section of this Chapter)**. The agreements which should be entered into between/amongst insurers, network providers or TPAs should, *inter-alia*, cover: **(i)** the tariff applicable with respect to various kinds of healthcare services being provided by the network provider, **(ii)** a clause empowering the insurer to cancel/modify the agreement in case of any fraud, misrepresentation, inadequacy of service or other non-compliance or default on the part of TPA or network provider, **(iii)** a standard clause providing for continuance of services by a network provider to the insurance company if the TPA is changed or the agreement with TPA is terminated, **(iv)** a clause providing for opting out of network provider from a given TPA or disempanelment of a network provider by a TPA subject to IRDA-specified guidelines for reasons of inadequacy of service rendered by the TPA to the network provider, **(v)** a clause specifically fixing the onus on the insurer to deny or repudiate a claim, **(vi)** a clause enabling insurer to inspect the premises of the network provider at any time without prior intimation.

Insurers and TPAs should comply with the IRDA-specified standard clauses to be incorporated in all such agreements. The insurance company should endeavour to enter into agreements with adequate number of both public and private sector network providers across the geographical spread. The copy of the agreement should be maintained by him for a period of at least five years from the date of the expiry/termination of the agreement. The IRDA may specify certain standards, benchmarks and protocols for network provider from time to time. The insurers and TPAs should ensure that only those providers who meet with such standards, benchmarks and protocols are enrolled into the network.

Payments to Network Providers and Settlement of Claims of Policyholders The insurer should make direct payments to the network provider and to the policyholders by integrating their banking system platform with network provider or the policyholder. If a claimant opts for payment through a cheque or demand draft, the insurer should not deny such request.

Engagement of Services of TPAs by Insurers in Relation to Health Insurance Policy Every insurer should provide detailed product-wise guidelines to TPAs for handling of claims, that is, claim admission and assessments. They should articulate the payments/benefits allowed/disallowed under various products that are being serviced by the TPAs. They should also prescribe the capacity requirements, internal control procedures to be put in place by the TPA under the agreement for rendering the services under each product. Moreover, detailed product specific claim guidelines should be issued to the TPAs. They should ensure that the TPAs are not carrying out the following activities as part of the agreement: **(i)** claim rejections/repudiations with respect to the health insurance policies; **(ii)** payments to the policyholders, claimants or the network providers; **(iii)** any services directly to the policyholder/insured/any other person unless it is in accordance with the terms and conditions of the agreement entered into with the insurer and complies with the IRDA regulations. The insurers and/or TPAs, should endeavour to collect documents for processing claims for disposal electronically. Claims that are being settled should be done through e-payments by them. Where claims are directly handled by the insurers, the specified provisions should be complied in the correspondence to the policyholder with respect to settlement of the claims. The insurer would be responsible for proper and prompt service to the policyholders at all times. Where a claim is denied/repudiated, the communication should be made only by the insurer by specifically stating the reasons for the denial or repudiation, while necessarily referring to the corresponding policy conditions. He should also furnish the grievance redressal procedures available with the insurance company and with the insurance ombudsman along with the detailed address of the respective offices. More than one TPA may be engaged by an insurance company.

Change of TPAs Where there is a change in TPA, insurers should communicate to the policyholders 30 days before giving effect to the change. The contact details like helpline numbers, addresses, etc. of the new TPA should be immediately made available to all the policyholders. The insurer should take over all the data in respect of the policies serviced by the earlier TPA within thirty days from the cessation of his services and make sure that the same is transferred seamlessly to the newly assigned TPA. No inconvenience/hardship should be caused to the policyholders as a result of the change. The following aspects should receive special attention: status of cases where **(a)** pre-authorisation has already been issued by the existing TPA, **(b)** claim documents have been submitted to the existing TPA for processing, **(c)** claims where processing has been completed by the TPA and payment is pending with the insurer.

Data and Related Issues The TPA and the insurer should establish a seamless electronic flow of data transfer for all the claims. The respective claim settlement files should be handed over to the insurer within 15 days. The IRDA may require insurers, TPAs and network providers, to comply with specified data related matters that may be issued separately.

Systems to be in Place to Mitigate Frauds Insurers and TPAs should put in place systems and procedures to identify monitor and mitigate frauds and also follow the IRDA guidelines.

Submission of Returns All insurance companies carrying on health insurance business should furnish the specified returns to the IRDA.

CONCLUDING OBSERVATIONS

- Until 1999, the insurance organisation in India was comprised of two state-owned monolithic institutions: LIC and GIC and its four subsidiaries. With the entry of private players, the organisation has undergone a notable transformation. The elements of the present framework are the (i) Insurance Act, (ii) IRDA Act and (iii) Regulations framed by the IRDA.
- The Insurance Act provides the broad framework for the insurance sector in the country. Some of the important aspects of the framework contained in the Act are: eligibility, registration, accounts and balance sheet, actuarial report and abstract; investment of assets; insurance business in rural/social sector; investigation; power to issue directions; registration of principal/chief/special agent(s); issue of license to intermediary/insurance penalties; power to call for information; power of Government to make rules; powers of IRDA to make regulations.
- Any class of insurance business can be carried out only by a public company, a cooperative society, an insurance cooperative society, or a body corporate other than a private company. After the enactment of the IRDA Act, only Indian insurance companies are eligible to carry out any class of insurance business (i.e., life/general/fire/marine and miscellaneous), Indian companies are defined as those in which the aggregate holding of equity by a foreign company does not exceed 26 per cent of the paid-up equity capital.
- To carry on their business, insurance companies should be registered with the IRDA. It would register an applicant on being satisfied that its financial condition and the general character of its management are sound, the volume of its business, capital structure and earnings prospects would be adequate, the interest of the public would be served, and it has complied with all the other requirements. The minimum paid up capital of an insurance company should be ₹100 crore (for life/general business) and ₹250 crore (for reinsurance business). The registration would be renewed annually. Promoters cannot hold more than 26 per cent of the paid-up capital of an insurance company. Every insurer should also keep a specified deposit with the RBI which would be deemed to be a part of its assets.

- The assets of insurers should be invested in the following manner: 25 per cent in Government securities (including deposits with the RBI); at least 25 per cent in Government/other approved securities; and the balance in approved and other investments. Upto 15 per cent of the controlled fund of the insurers can be invested in other investments. Upto 25 per cent of the assets of general insurance companies can be invested in other investments. No funds of policyholders can be invested outside India.
- The IRDA may conduct an investigation in to the affairs of an insurer. It may issue directions in public interest/to prevent the affairs of an insurer being conducted in a manner detrimental to the interest of its policyholders or generally to secure the proper management of any insurer, which would be binding on the insurer. The CEO of an insurer may be removed from office on similar grounds.
- Penalties can be imposed for the following offences under the Insurance Act: **(a)** default in compliance with/act in contravention of the act, **(b)** carrying on business in contravention of requirement of registration and deposits, **(c)** false statements in documents, **(d)** wrongly obtaining/withholding property, **(e)** offences by companies, and **(f)** failure to comply with the rural/social sector obligations.
- The Government may make rules to carry out the purposes of the Act and the IRDA may make regulations to carry out its provisions.
- The duty of the IRDA is to regulate, promote and ensure the orderly growth of the insurance and reinsurance business. Its powers and functions include: Issue/renewal/ cancellation/suspension of registration of insurance companies; protection of policyholder's interests; specifying the requisite qualifications/practical training for intermediaries/agents; specifying the code of conduct for surveyors/loss assessors; promoting efficiency in the conduct of insurance business; promoting/regulating professional organisations; calling for information, undertaking inspection, conducting inquiries/investigations of insurers/intermediaries/other organisations; regulating investments of funds/maintenance of margin of solvency and so on. The IRDA would be bound by the directions of the Government on questions of policy.
- The powers of the Government in relation to the undermentioned activities/operations of insurance companies have been delegated to the IRDA: **(i)** investment of assets, **(ii)** maintenance of assets, **(iii)** limit on expenditure, **(iv)** provision regarding directors, **(v)** acquisition of surrender values by policyholders and so on.
- To carry out its powers/functions, the IRDA has issued a number of regulations as ground rules for the conduct of insurance business. The major regulations covered here relate to the following: Rural/social sector obligations; Insurance advertisements/disclosures; Licensing of insurance agents; General insurance - reinsurance; Appointment of an actuary; Registration of Indian insurance companies; Investment norms; Preparation of financial statements and auditor's report; Third party administrators - health services; Protection of policyholders interest's; Licensing of corporate/composite corporate agents; Distribution of surpluses; Life insurance - reinsurance; Insurance brokers; Insurance surveyors and loss assessors; Micro-insurance; and Corporate governance guidelines for insurance companies.
- All new life insurers have to undertake the following obligation pertaining to the rural sector: of the total policies written in that year the percent share of the rural sector is as follows: first year–7 per cent; second year–9 per cent; third year–12 per cent; fourth year–14 per cent; fifth year–16 per cent; and sixth year–18 per cent. The obligations for general insurers are: in the first two years the share should be 2 and 3 per cent and it should be 5 per cent thereafter. All categories of insurers are obliged to issue 5, 7, 10, 15, 20 and 25 thousand lives in the first six years respectively. The norms would be reviewed by the IRDA every five years.

- An insurance advertisement means/includes any communication directly or indirectly related to an insurance policy and intended to result in an eventful sale/solicitation of a policy from the public. It includes all forms of printed/published materials or any material using the print and/or electronic medium for public communication.
- Insurance intermediaries include brokers, consultants, surveyors and loss assessors.
- Every insurer/intermediary/agent should **(1)** have a compliance officer to oversee advertisements, **(2)** establish and maintain a system of control over the content/form/ method of dissemination of all advertisements, **(3)** maintain a register to include a specimen of every advertisement for 3 years, **(4)** file a copy of each advertisement with the IRDA as soon as it is issued first and **(5)** file a certificate of compliance with the IRDA regulations and the advertisement code prescribed by the ASCI. The register would be open to inspection/review by the IRDA for content/context/ prominence/ position of the required disclosures /omission of the required information and so on.
- Any change in an advertisement would be considered a new advertisement. All advertisements by insurance agents must have prior written approval from the insurer, which must ensure that they comply with the IRDA regulations and are not deceptive/misleading. The identity of all advertisers should be stated.
- In case of a complaint, the IRDA can take action and issue directions to the advertisers. Failure to comply would entail necessary action, including levy of penalty.
- An Insurance/composite insurance agent means an individual appointed for soliciting/procuring insurance business including business relating to continuance/renewal/revival of insurance policies. A composite insurance agent is appointed by two/more insurers and he can act as an agent for one life/general/health insurance and one mono-line insurer. The application seeking appointment as an insurance agent should be made to the designated official appointed by the insurer to make the appointments. The main elements of the IRDA regulations relate to: (i) appointment of insurance agents, (ii) insurance agency examination, (iii) code of conduct, (iv) right to inspect, (v) suspension/cancellation of appointment, and (vi) general conditions of appointment.
- A life insurer cannot transact business without an appointed actuary, who should be a fellow member of the Acturial Society, of India. He should have access to all the information/ documents of the insurer, for a proper/effective performance of his duties/functions. The duties and obligations of an appointed actuary include: **(1)** advice to the insurer in the area of product design and pricing, insurance contract wording, investment and reinsurance, **(2)** ensure solvency of the insurer, **(3)** comply with the IRDA's directions, **(4)** certify the acturial report and abstract/other returns, and so on.
- The appointed actuary should enjoy absolute privilege to any written/oral statement, so as to perform his functions.
- An Indian insurance company is a company owned and controlled by resident Indian citizens/ Indian companies owned/controlled by the resident Indian citizens.
- Indian promoter means (i) a company which is not a subsidiary, (ii) banks(s) excluding foreign banks, (iii) core investment company, (iv) public financial institution, (v) LLP, and (vi) other person/entity allowed by the IRDA. Foreign investors mean all eligible non-resident entities/ persons resident outside India investing in and Indian insurance company through FDI/FPI windows.

- The main elements of the IRDA regulations relating to their registration are: (i) procedure for registration, (ii) application for registration, (iii) annual fee, and (iv) action in case of default.
- The investment norms for insurance companies relate to regulation of investment and exposures.
- The controlled fund of a life insurer should be invested as follows: In Government/approved securities at least–50 per cent; approved investments,–35 per cent; and infrastructure investments-15 per cent. In the case of a general insurer, investment in other investments can be upto 25 per cent.
- The share of Government/approved securities in the investment of assets of a pension and general annuity business should be 40 per cent and the balance (60 per cent) should be in approved and other investments. Not more than 25 per cent of the fund should be invested in an unapproved category in case of unit linked life insurance business.
- The assets of a reinsurance business should be invested in the same pattern as of a general insurance business.
- The different categories of investments should conform to the exposure norms specified below: **(a)** limit for investee company: not exceeding the lower of 10% of capital, free reserves, debentures/bonds of the investee company or 10% of the assets of the general insurer/controlled fund of the life insurer; **(b)** limit for the group: the same as in **(a)**; limit for the industry sector to which the investee company belongs: not exceeding 10% in the total investment exposure to the industrial sector as a whole.
- All insurance companies can deal in financial derivatives. Margin/unamortised premium paid by an insurer to the extent they are reflected as an asset position in the balance sheet as per the IRDA guidelines, would be treated as approved investments, only to the extent that the derivative position constitutes a hedge for the underlying investment/portfolios which itself is treated as approved investments.
- The TPAs provide health services for a fee/remuneration specified in an agreement with an insurance company. It prescribes the terms/conditions of health services which may be rendered to and/or received by parties to the agreement. A TPA registered with the IRDA should have a minimum capital of ₹1 crore, at least one of the directors should be a doctor registered with the MCI and not more than 26 per cent of its shares should be held by a foreign company.
- A TPA should act in the best possible professional manner and would be duty-bound to follow the prescribed code of conduct. He should maintain records of all transactions carried on behalf of the insurance company and follow strictly, the professional confidentiality between the concerned parties. To look into the proper and efficient performance of any TPA, the IRDA may constitute committees consisting of members representing the TPAs, insurers, IRDA and so on. All contracts of TPAs with the insurance companies would be open for inspection by the IRDA.
- The main elements of the regulations aimed at the protection of the policyholders, interest are: point of sale, proposal for insurance, redressal of grievances, matters included in policy, claims procedures and policyholders' servicing.
- A prospectus of an insurance product should clearly state the scope of benefits, the extent of insurance cover, explain the warranties/exceptions/conditions of the insurance cover and whether the product is participating or non-participating. The insurer should provide all material information in respect of a proposed cover to the prospect, to enable him to decide on the best cover that would his interest.

- A proposal for insurance cover must be in a written document. The insurer should encourage the prospect to avail of the nomination facility. The proposal should be processed with speed and efficiency and the decision communicated within 15 days.
- Every insurer should have in place a proper procedure and an effective mechanism to address complaints and grievances of policyholders efficiently and with speed.
- The insurance policies should clearly state the matters specified by the IRDA.
- The life insurance policy should state the primary documents normally required to be submitted by a claimant in support of a claim. The claim should be processed without delay and paid within 30 days, failing which interest rate of 2 per cent above the bank rate would have to be paid.
- A life insurer should respond within 10 days of the receipt of any communication from its policyholders in all matters such as change of address, nomination, assignment, current status of policy, loan on security, duplicate policy, endowment and so on.
- A corporate agent means a company/LLP/cooperative society/bank/corresponding bank/RRB/NGO/MFI/other person recognised by the IRDA for soliciting, procuring and servicing of life/general/health insurance business. A composite corporate agent solicits/services all the three or a combination of insurance business. The main elements after IRDA regulations are: **(i)** registration, **(ii)** requirement of indemnity insurance policy, **(iii)** Board approved policy for open architecture, **(iv)** conflict of interest, **(v)** servicing of policyholder, **(vi)** sale of insurance by telemarketing mode, **(vi)** code of conduct, **(vii)** inspection, **(viii)** suspension/cancellation of registration, **(ix)** change in ownership/shareholding, and **(x)** maintenance of records/books/accounts.
- The Insurance broker arranges, for a commission, insurance contracts with insurance/reinsurance companies on behalf of his clients. There are three categories of insurance brokers: direct, reinsurance and composite. While a direct broker functions in general/life insurance business, a reinsurance broker arranges reinsurance for direct insurers. A composite broker performs the functions of both the direct broker and the reinsurance broker. The framework of their operations includes the following: license, remuneration, ceiling on business from a single client, code of conduct, segregation of insurance money, professional indemnity insurance, books, disclosures, inspection, and cancellation/suspension of registration.
- An insurance broker should obtain a licence from the IRDA. The IRDA takes into account the following: **(i)** he does not suffer from any disqualification, **(ii)** he the has necessary infrastructure, **(iii)** he has two qualified persons in employment, **(iv)** fulfillment of capital and deposit requirements; **(v)** the principal officer possesses the minimum laid down qualification, has received the prescribed training, passed the required examination and has not violated the code of conduct.
- The main elements of the code of conduct of an insurance broker relate to: **(1)** standards of professional conduct and discharge of functions in the policyholder's interest; **(2)** matters relating to client relationships, **(3)** matters relating to sales practices, **(4)** matters relating to furnishing of information, **(5)** conduct in relation to insurance contract, **(6)** conduct in relation to renewal of policies, **(7)** conduct in relation to claim by clients, **(8)** receipt of complaints, **(9)** documentation, **(10)** advertising, **(11)** receipt of remuneration; **(12)** training and so on.
- Every insurance broker should have a professional indemnity insurance throughout the validity of the licence.

- The IRDA can conduct an inspection of insurance brokers. Their licenses can be suspended/cancelled by the IRDA, with/without notice.
- The main elements of the operations of surveyors and loss assessors are licensing procedure, constitution and functions of surveyors and loss assessors, categorisation, code of conduct, practical training, register, submission of returns and inspection.
- Both individual and corporate surveyors and loss assessors should have a licence from the IRDA. The IRDA has constituted a Surveyors and Loss Assessors Committee to assist it on matters relevant to surveyors and loss assessors. The functions of the Committee would be recommending the **(i)** syllabi for examination and practical training for surveyors and loss assessors, **(ii)** considerations while recognising foreign qualifications and training to grant licence; **(iii)** improving/developing their status; **(iv)** coordination with educational/other institutions; **(v)** looking into matters of professional misconduct, indiscipline, non-adherence to code of conduct and so on.
- The duties and responsibilities of surveyor loss assessors are: to investigate, manage, quantify, validate and deal with losses arising from any contingency and report thereon and to carry out the work with competence, objectivity and professional integrity by strictly adhering to the code of conduct. They should submit their report as expeditiously as possible, but not beyond 30 days.
- Based on their professional qualification, training experience and so on, surveyors and loss assessors are categorised into A, B and C categories. They are eligible to carry on their work as per the categorisation specified in the licence.
- Every surveyor/loss assessor should abide by the prescribed code of conduct. He should undergo practical training for at least 12 months with Category A or B surveyor/loss assessor. He may also be required by the IRDA to pass an examination on the successful completion of training. The IRDA should maintain a register of all licensed surveyors and loss assessors. It can inspect, survey the work/books/records/ documents or investigate any bona fide complaint against a surveyor/loss assessor and take the necessary action.
- Micro-insurance products are both general and life insurance products. A general micro-insurance product (GMIP) means a health insurance contract/any contract covering belongings, such as, hut, livestock, tools, instruments/any personal accident contract a on personal/group basis. Life micro-insurance product (LMIP) means any term insurance contract with/without return of premium/any endowment insurance contract/health insurance contract with/without an accident benefit rider, either on individual or group basis.
- In addition to the insurance agents/brokers, MIPs can also be distributed by MIAs, namely, SHFs, NGOs and MFIs.
- Corporate governance is a system of financial and other controls in a corporate entity and broadly defines the relationship between the Board of Directors, senior management and shareholders. The corporate governance framework should clearly define the roles/responsibilities/accountability within an organisation with in-built checks and balances. The main elements of the IRDA corporate governance guidelines for insurance companies are: **(i)** objectives, **(ii)** governance structure, **(iii)** Board of Directors, **(iv)** control functions, **(v)** senior management, **(vi)** disclosure requirements, **(vii)** outsourcing, **(viii)** relationship with stakeholders, **(ix)** interaction with supervisor, and **(x)** whistle blower policy.
- The objective is to ensure that the structure/responsibilities/functions of the Board of Directors/senior management of the company fully recognise the expectations of all stakeholders as well as those of the regulator. The structure should **(i)** take steps to adopt sound/prudent principles/practices in the governance of the company, and **(ii)** have the ability to quickly address issues of non-compliance/weak oversight and controls.

- The Board of Directors should ensure ongoing compliance with the statutory requirements relating to **(i)** 5-year lock-in for promoters, **(ii)** FDI ceiling of 26 per cent, **(iii)** prior approval of IRDA for registration/transfer of shares, **(iv)** conflict/potential conflict of interest of shareholders, policyholders, management, auditors/actuaries/directors/senior managers and so on.
- The elements of governance structure relate to varying structure and group/conglomerates.
- The insurance companies should familiarise with corporate governance structure/requirements appropriate to listed companies as outlined in Clause 49 of the listing agreement. Whatever structure of the Board of Directors is taken, the broader elements of good corporate governance should be present. The companies associated with a group/or financial/non-financial conglomerate should also maintain consistency in policies/practices to reinforce controls across the group.
- The elements relating to the Board of Directors are composition, role and responsibilities, fit and proper criteria and conduct of meetings.
- The Board should comprise competent/qualified directors. Its size/composition should ensure that they collectively provide knowledge, skills, experience and commitment along with independence. There should be a significant number of independent directors, ranging between one-third and half and in no case less than two.
- The Board should concentrate on the direction/control/governance and particularly articulate/commit to a corporate philosophy/governance that will shape the level of risk adoption, standard of business conduct and ethical behaviour of the company. Delegation would not absolve the directors from responsibilities. The interest of policyholders should receive special attention. There should be concurrent arrangements to review policies.
- The directors have to meet the **fit and proper** criteria in terms of integrity in personal behaviour and business conduct, soundness of judgement and financial soundness. They should not have been convicted/come under adverse notice of law involving moral turpitude. A nomination committee of the Board should handle appointments/reappointments of directors.
- The annual report of the company should disclose the number of meetings of the Board, details of their composition, numbers of meetings attended and remuneration to independent directors.
- The main elements of the control function are policy framework and delegation of functions.
- Given the risk associated with operations and its impact on business, the Board of the company should have a policy framework in terms of **(i)** robust/efficient mechanism for identification/assessment/control/mitigation/ monitoring of risk, **(ii)** appropriate **(a)** processes for compliance with policy/laws/regulations, **(b)** internal controls, **(iii)** internal audit function and **(iv)** independence of control function.
- With a view to providing adequate time for discharge of the significant responsibilities, the Board can delegate the overall monitoring responsibilities to various committees in terms of their constitution, objectives, responsibilities, frequency of meetings/quorum requirements. Typically, the committee that assists the Board are: **(a) mandatory**, namely, audit, investment, risk management, ALM committees, policyholders protection committee, and other **(b) non-mandatory** committees, such as remuneration/ethics committees.
- The elements relating to the senor management are CEO and other functionaries, appointed actuaries and external audit.
- The Board should carry out a due diligence to establish that the CEO is fit and proper. It should have succession planning for the senior functionaries through a process of identification/nurturing of individuals for taking over senior management positions.

- The Board should ensure that the requirements pertaining to the appointment/qualifications/powers/duties/obligations of the appointed actuaries are scrupulously complied with.
- The guidelines/directions relating to the external auditors include their qualifications and experience/rotation period of appointment and so on. The external/statutory auditors should have access to the audit committee/Board.
- The disclosure requirements include the following: **(i)** quantitative/qualitative information on the financial/operating ratios, **(ii)** solvency margins, **(iii)** policy lapse ratio, **(iv)** financial performance, **(v)** risk management structure, **(vi)** details of claims, **(vii)** all pecuniary relationships/transactions of the non-executive directors and so on.
- Insurers can outsource only functions permitted by the IRDA. All such arrangements should have the approval of the Board and should be reported to the IRDA.
- The stakeholders in an insurer are its shareholders, employees, policyholders, superiors and others, including creditors, service providers, rating agencies, equity analysts and so on. Their concerns must be duly addressed by the companies.
- The insurers should put in place a whistle blowing policy in terms of mechanism for employees to raise concerns internally about possible irregularities, governance weaknesses, financial reporting issues/other such matters. The appointed actuary and the statutory/internal auditors should also **whistle blow** to enable the IRDA to take prompt action to protect the policyholders' interest.
- The main elements of issue of capital by life insurance companies regulations are: **(i)** prior written approval of IRDA, **(ii)** criteria for consideration of approval, and **(iii)** conditions for approval.
- Prior specific written approval of the IRDA would be necessary for insurance companies before approaching the SEBI for **(i)** public issue of capital and **(ii)** divestment of equity by promoter(s) through a public offer for sale under the SEBI ICDR regulations. However, insurance companies can issue/allot only fully paid-up shares.
- In particular, the IRDA would, *inter-alia*, consider the following parameters: **(i)** period for which in life insurance business, **(ii)** history of compliances with the regulatory requirements, **(iii)** maintenance of the prescribed regulatory margin at the end of the preceding six quarters, **(iv)** compliance with the disclosure requirements and corporate governance guidelines, **(v)** record of policyholders protection, and **(vi)** the embedded value.
- While approving the proposal, the IRDA may prescribed the following condition: **(a)** extent to which the promoters should dilute their respective shareholdings, **(b)** maximum subscription which could be allotted to foreign investors, **(c)** minimum lock-in period for promoters (without prejudice to the SEBI ICDR regulations) and **(d)** disclosures in the offer document/prospectus in addition to those prescribed by the SEBI.
- Health insurance products may be offered only by entities with a valid registration to carry on life/general/health insurance business. The main elements of the IRDA health insurance regulations are: **(i)** registration/scope,**(ii)** products, **(iii)** general provisions, and **(iv)** administration and submission of returns.
- The health insurance products offered by the insurers are long-term products by life insurers, short-term (1-3 years) by health and general insurers, group health/personal accident policies, overseas/domestic travel insurance policies and so on.
- The provisions relating to health insurance products pertain to filing procedure, review of products, group insurance, underwriting, proposal form and pricing.

- The general provisions relating to health insurance pertain to designing of policies, entry/exit age renewal, free lock period, cost of pre-insurance health check-up, cumulative bonuses, migration of policy, Ayush coverage wellness/ preventive aspects, optional coverage, special provisions for senior citizens, multiple policies and loading on renewal.
- The administration of health insurance policies cover protection of policyholders interest, settlement/rejection of claims, minimum disclosures, other disclosures, administration, health service agreements, payment to network providers, engagement of TPAs, change of TPAs and data/related issues.

Part 4

Capital Market Instruments

The maturity and sophistication of financial system, indeed, depends upon the prevalence of a variety of securities/financial instruments/assets/products to suit the varied investment requirements of heterogeneous investors so as to enable it to mobilise savings from as wide a section of the investing public as possible. The Indian financial system has witnessed, particularly since the early nineties, tremendous growth in differentiated financial assets as financial product innovation by corporates as well as financial institutions. Part four of the book (Chapter 17) describes the main long-term financial/capital market assets that have emerged on the Indian financial scene.

CHAPTER 17

Capital Market Instruments

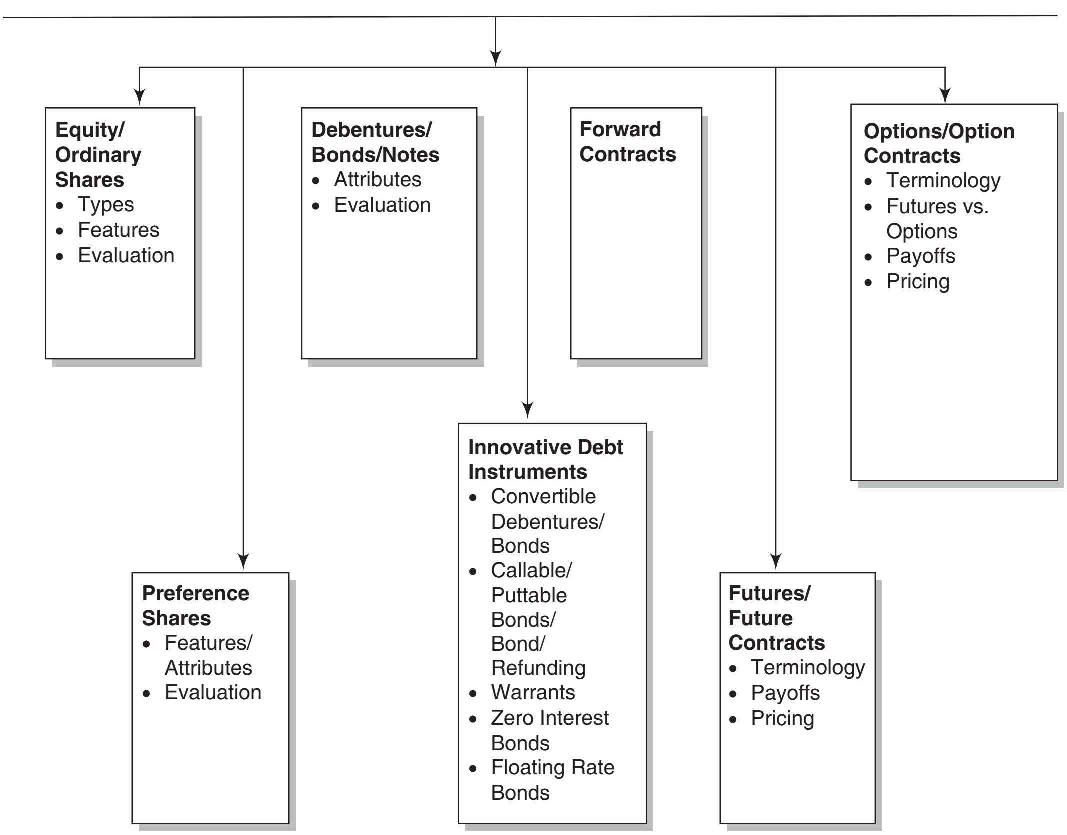
INTRODUCTION

This Chapter describes capital market instruments as long-term sources of finance. They fall into two broad groups: **(i)** direct and **(ii)** derivatives. Included in the first category are: **(a)** Equity/ordinary shares, **(b)** Preference shares, **(c)** Debentures/notes, and **(d)** Innovative debt instruments. While the equity and preference shares represent ownership instruments/securities, debentures/notes and innovative debt instruments are creditorship securities. **Sections 1–4** describe their features and evaluate them from the point of view of the investors as well as the company. Derivative instruments are defined by the Securities Contracts (Regulation) Act to include **(1)** a security derived from a debt instrument, share, secured/unsecured loan, risk instrument or contract for differences, or any other form of security and **(2)** a contract that derives its value from the prices/index of prices of underlying securities. Derivative contracts have several variants. The most common variants are forwards, futures and options. Three broad categories of participants—hedgers, speculators and arbitrageurs—trade in the derivatives market. Hedgers face risk associated with the price of an asset. They use futures or options markets to reduce/eliminate this risk. Speculators wish to bet on future movements in the price of an asset. Futures and options contracts can give them an extra leverage, that is, they can increase both the potential gains and potential losses in a speculative venture. Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock-in a profit.

The derivatives market performs a number of economic functions. First, prices in an organised derivatives market reflect the perception of the market participants about the future and lead the prices of underlying to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of the derivatives contract. Thus, derivatives help in the discovery of the future as well as current prices. Second, the derivatives market helps to transfer risks from those who have them but may not like them to those who have an appetite for them. Third, derivatives, due to their inherent nature, are linked to the underlying cash markets.

With the introduction of derivatives, the underlying market witnesses higher trading volumes because of participation by more players who would not otherwise participate for lack of an arrangement to transfer risk. Fourth, speculative trades shift to a more controlled environment of derivatives market. In the absence of an organised derivatives market, speculators trade in the underlying cash markets. Margining, monitoring and surveillance of the activities of various participants become extremely difficult in these kind of mixed markets. Fifth, an important incidental benefit that flows from derivatives trading is that it acts as a catalyst for new entrepreneurial activity. Derivatives have a history of attracting many bright, creative, well educated people with an entrepreneurial attitude. They often energise others to create new businesses, new products and new employment opportunities, the benefit of which are immense. Finally, derivatives markets help increase savings and investment in the long run. Transfer of risk enables market participants to expand their volume of activity. **Sections 5–7** dwell on the three most commonly used derivative contracts, namely, forwards, futures and options. **The main capital market instruments in India are portrayed in Exhibit 17.1.** Some concluding observations are given in the last Section.

Exhibit 17.1 Capital Market Instruments in India



EQUITY/ORDINARY SHARES

Equity shares/capital represents ownership capital and its owners—ordinary shareholders/equity holders—share the reward and risk associated with ownership of corporate enterprises. It is also called ordinary share/capital in contrast with preference shares, which carries certain preferences/prior rights with regard to income and redemption. This section discusses the types, features and evaluation of equity capital.

Types

The equity/ordinary share capital is of several types. Authorised equity/share capital represents the maximum amount that a company can raise from the ordinary shareholders. It can be changed in the prescribed manner. The portion of the authorised capital offered by the company to the investors is the issued capital. Subscribed share capital is that part of the issued capital which has been accepted/subscribed by the investors. The actual amount paid by the shareholders is the paid-up capital. The issued, subscribed and paid-up capitals are generally the same.

Ordinary shares typically have a par/face value in terms of the price of each share, the most popular denomination being ₹10. However, companies are permitted to issue such shares without a par/face value. The price at which the equity shares are issued is the issue price. The issue price for new companies is generally equal to the face value. It may be higher for existing companies, the difference/excess being the share premium. The book value of ordinary shares refers to the paid-up capital plus reserves and surplus (net worth) divided by the number of outstanding shares. The price at which equity shares are traded in the stock market is their market value. However, the market value of unlisted/thinly traded shares is not available.

Features

Ordinary shares have some special features in terms of the rights and claims of their holders: **(i)** residual claim to income/assets, **(ii)** right to control, **(iii)** pre-emptive rights and **(iv)** limited liability.

Residual Claim to Income The equity shareholders have a residual claim to the income of the company. They are entitled to the remaining income/profits of the company after all outside claims are met. The earnings/income available to the shareholders (EAS) equal profit after tax (PAT) minus preference dividend; the PAT is equal to operating profits (EBIT) less taxes. However, the residual claim is only a theoretical entitlement as the amount actually received by the shareholders in the form of dividend will depend on the decision of the Board of Directors. The directors have the right to decide what portion of the EAS will be distributed to the shareholders as cash dividend and what portion will be ploughed back as retained earnings, which the shareholders will receive later in the form of capital appreciation/bonus shares. In other words, the payment of dividends depends on the discretion of the management and the shareholders have no legal right to receive/the company has no legal obligation to distribute dividends out of EAS. This is in sharp contrast to the claims of debentureholders, which as a contractual obligation of the company must always be honoured irrespective of its financial position.

Residual Claim on Assets The ordinary shareholders' claim in the assets of the company is also residual in that their claim would rank after the claims of the creditors and preference shareholders in the event of liquidation. If the liquidation value of assets is insufficient, their claims may remain unpaid.

Right to Control As owners of the company, equity-holders have the right to control the operations of, participate in the management of, the company. Their control is, however, indirect. The major policies/decisions are approved by the Board of Directors and the board appointed management carries out the day-to-day operations. The shareholders have the legal right/power to elect the Board of Directors as well as vote on every resolution placed in various meetings of the company. Though, in theory, they have indirect right to control/participate in management, in actual practice, it is weak and ineffective partly because of the apathy and indifference of the majority of the shareholders who rarely bother to cast their votes and partly because scattered and, by and large unorganised equityholders are unable to exercise their collective power effectively.

Voting System The ordinary shareholders exercise their right to control through voting in the meetings of the company. According to the most commonly used system of voting in India, namely, Majority rule voting, each share carries one vote and each director is elected individually. Therefore, a shareholder can cast the total number of shares held by him, separately, for the election of each director. As a result, shareholders/groups holding more than 50 per cent of the outstanding equity shares would be able to elect all the directors of their choice. An alternative is the Proportionate rule voting under which the number of votes held by a shareholder/group equals the number of shares held by him multiplied by the number of directors to be elected. The total votes held may be cast/spread in any manner: all just for one candidate or spread over as many candidates as the shareholder wishes to vote for. The proportionate voting system may enable even minority shareholders some representation on the board, while all the members of the board may be elected by the holders of the majority of ordinary shares.

Pre-emptive Rights The ordinary shareholders of a company enjoy pre-emptive rights in the sense that they have a legal right to be offered, by the company, the first opportunity to purchase additional issues of equity capital in proportion to/pro rata basis their existing/current holdings/ownership. A shareholder owning 2 per cent of the existing issued capital is entitled/has a pre-emptive right to acquire 2 per cent of additional shares to be issued by the company. The option to the shareholders to purchase a specified number of equity shares at a stated price during a given period is called rights. The shareholders can **(i)** exercise, **(ii)** sell in the market and **(iii)** renounce/forfeit their pre-emptive right partially or completely. The shares available as a result of non-exercise of right would be allotted on a pro rata basis to shareholders exercising the right. Any balance of shares can be offered to the public for subscription. While the pre-emptive rights ensure that the management cannot issue additional shares to strengthen its control by selling them to persons/groups favourably inclined to it, on one hand, it protects the existing shareholders from dilution of their financial interest as a result of new equity issues, on the other.

Assume, Avon Industries Ltd (AIL) currently has 30,00,000 shares outstanding. The market price is ₹65 per share. The AIL plans to issue 10,00,000 additional shares at a subscription/issue price of ₹40 per share. The number of rights to buy a new share $\left(\frac{30,00,000}{10,00,000}\right)$ The market price of a share after the rights issue $\frac{(30,00,000 \times ₹65) + (10,00,000 \times ₹40)}{(30,00,000) + (10,00,000)} = ₹58.75$ A shareholder can buy one new share for ₹40 plus 3 rights. The total value of 3 rights = ₹58.75 – ₹40 = ₹18.75.

The value of each right = $\frac{₹18.75}{3}$ ₹625. Thus, the ex-right price of a share drops by ₹6.25 from the cum-right (rights-on) price of ₹65 to the ex-rights price of ₹58.75. The existing shareholders do not gain/lose from rights issue. What he receives in the form of value of a right, he loses in the form of a decline in the share price. His financial interest remains unaffected when he exercises his right or sells his rights. In case he does not exercise his right, there will be a dilution of his financial interest.

Assume further, Mr X owns 300 shares of the AIL. His total wealth/financial interest is ₹19,500 (300 × ₹65). After the exercise of his right, his holdings will be 400 shares. His total wealth would be ₹23,500 (400 × ₹58.75). But he has spent ₹4,000 (₹40 × 100) to acquire additional shares. So his net financial interest = ₹23,500 – ₹4,000 = ₹19,500, that is, equal to the interest before the rights issue. In case Mr X sells his right @ ₹6.25, his total financial position in the AIL would be, ₹19,500 [(₹58.75 × 300) + (₹6.25 × 300)], the same as before the right issue. If he does not exercise his right to buy/sell, his financial interest will suffer a dilution as his total wealth = ₹17,625 (₹58.75 × 300), that is, a dilution of ₹1,875 (₹19,500 – ₹17,625). In brief, an investor suffers dilution of financial interest when he does not exercise is pre-emptive rights.

Limited Liability Although the equity-holders share the ownership risk, their liability is limited to the extent of their investment in the share capital of the company.

Evaluation

As a significant capital market instrument, equity share/capital has merits as well as demerits from the viewpoint of the company as well as the shareholders.

Merits The advantages of equity capital to a company are: first, it is a permanent source of funds without any repayment liability; second, it does not involve obligatory dividend payment and, thirdly, it forms the basis of further long-term financing in the form of borrowing related to its creditworthiness. The advantage to the shareholders is that with limited liability they exercise control and share other ownership rights in the income/assets of the firm.

Demerits The disadvantages of equity capital, from the viewpoint of a company, are: **(i)** High cost of funds reflecting the high required rate of return of investors, as a compensation for higher risk, as also the fact that equity dividends are not tax deductible payments, they are paid out of post-tax profits: **(ii)** High flotation cost in terms of underwriting, brokerage and other issue expenses compared to other securities: **(iv)** Dilution of control of existing shareholders on sale of new shares to outsiders/public. The disadvantages associated with equity capital for the shareholders are: **(i)** Equity capital is in reality risk capital as it ranks the last as a claimant to income as well as the assets of the company; **(ii)** Scattered and unorganised shareholders are unable to exercise effective and real control over the company; **(iii)** Shareholders cannot claim dividend as a matter of right; **(iv)** There is wide fluctuation in share prices, with attendant risk for the investors.

In brief, equity share/capital is a high risk-high reward permanent capital market instrument/ source of long-term finance for corporate enterprises. Shareholders who desire to share the risk, return and control associated with ownership of companies would invest in corporate equity. As a source of long-term fund, it has high cost, low/nil risk, does not dilute control and puts no restraint on managerial freedom.

PREFERENCE SHARES

Preference share/capital is a unique type of long-term capital market instrument in that it combines some of the features of equity shares as well as some of debentures. As a hybrid security/form of financing/instrument, it is similar to debentures insofar as it: **(i)** carries a fixed/stated rate of dividend, **(ii)** ranks higher than equity as a claimant to the income/assets, **(iii)** normally does not have voting rights and **(iv)** does not have a share in residual earnings/assets. It also partakes some of the attributes of equity capital, namely, **(i)** dividend on preference capital is paid out of divisible/after tax profit, that is, it is not tax-deductible, **(ii)** payment of preference dividend depends on the discretion of the management, that is, it is not an obligatory payment and non-payment does not force insolvency/liquidation and **(iii)** irredeemable types of preference shares have no fixed maturity date. The main attributes of preference shares, as capital market instruments, and a brief evaluation of these instruments have been outlined in this section.

Features/Attributes

The main attributes of preference shares/capital are discussed below.

Prior Claim on Income/Assets Preference share/capital has a prior claim/preference over equity share/capital both on the income and assets of the company. In other words, preference dividend must be paid in full before payment of any dividend on the equity capital and, in the event of liquidation, the whole of preference share/capital must be paid before anything is paid to the equity share/capital. Thus, preference share/capital stands midway between debentures and equity as regards claims on the income and assets of the company. It is also referred to as a senior security. Stated in terms of risk perspective, the preference share is less risky than ordinary shares but more risky than debentures.

Cumulative Dividends The preference share is cumulative, in the sense that all unpaid dividends are carried forward and payable before any ordinary dividend is paid.

Redeemability The preference share has a limited life/specified/fixed maturity (typically 7 years) after which it must be retired. However, there are no serious penalties for breach of redemption stipulation.

Fixed Dividend Preference share dividends are fixed and expressed as a percentage of par value. Yet, it is not a legal obligation and failure to pay will not force bankruptcy. Preference shares are also called a fixed income security.

Convertibility Preference shares may sometimes be convertible partly/fully into equity shares/debentures at a certain ratio during a specified period. A variant in India is the cumulative convertible preference shares that combines the cumulative and convertibility features. It has, however, been a virtual non-starter so far.

Voting Rights A preference share ordinarily does not carry voting rights. It is, however, entitled to vote on every resolution if **(i)** the preference dividend is in arrear for two years with respect to cumulative preference shares or **(ii)** the preference dividend has not been paid for a period of two/more consecutive preceding years or for an aggregate period of three/more years in the preceding six years ending with the expiry of the immediately preceding financial year.

Participation Features The preference share may be participating or entitling participation in surplus profits, if any, that is, profits after payment of preference dividend and equity dividend, at a certain specified rate. Similarly, it may be entitled to participate in the residual assets after the payment of their normal claim, according to a specified formula, in the event of liquidation of the company.

Evaluation

Preference share, as a source of long-term financing/capital market instrument, has merits and demerits from the point of view of the investors/shareholders as well as the company.

Merits The advantages for the investors are: **(i)** the assurance of a stable dividend and **(ii)** the exemption to corporate investors on preference income to the extent of dividend paid out. The issuing companies enjoy several advantages, namely, **(i)** no legal obligation to pay preference dividend and skipping of dividend without facing legal action/bankruptcy, **(ii)** redemption can be delayed without significant penalties, **(iii)** as a part of net worth, it improves the creditworthiness/borrowing capacity and **(iv)** no dilution of control.

Demerits Preference shareholders suffer serious disadvantages such as **(a)** vulnerability to arbitrary managerial action, as they cannot enforce their right to dividend/right to payment in case of redemption and **(b)** modest dividend in the context of the associated risk. For the company, the preference capital is an expensive source of finance due to non-tax deductibility of preference dividend.

In brief, preference share/capital **(i)** involves high cost; **(ii)** does not dilute control, **(iii)** has negligible risk and **(iv)** puts no restraint on managerial freedom. The shareholders receive modest returns and are vulnerable to arbitrary managerial actions. It is, however, not a popular capital market instrument in India.

DEBENTURES/BONDS/NOTES

Akin to a promissory note, debentures/bonds represent creditorship securities and debentures-holders are long-term creditors of the company. As a secured instrument, it is a promise to pay interest and repay principal at stipulated times. In contrast to equity capital, which is a variable income (dividend) security, the debentures/notes are fixed income (interest) security. This section discusses their attributes and evaluates them as a capital market instrument.

Attributes

As a capital market instrument/long-term source of borrowing, debentures have some contrasting features compared to equity shares.

Trust Indenture/Deed When a debenture is sold to the investing public, a trustee is appointed through an indenture/trust deed. It is a legal agreement between the issuing company and the trustee, who is usually a financial institution/bank/insurance company/firm of attorneys. The trust deed provides the specific terms of agreement such as description of debentures, rights of debenture-holders, rights of the issuing company and responsibilities of the trustee. The trustee is responsible for ensuring that the borrower/company fulfils all its contractual obligations.

Interest Debentures carry a fixed (coupon) rate of interest, the payment of which is legally binding/enforceable. The debenture interest is tax deductible and is payable annually/semi-annually/quarterly. Some public sector undertakings/ financial institutions issue tax-free bonds, the income from which is tax exempted. A company is free to choose the coupon rate, which may be fixed or floated, determined in relation to some benchmark rate. It is also related to the credit rating of the debenture as an instrument.

Maturity It indicates the length of time for redemption of par value. A company can choose the maturity period, though the redemption period for non-convertible debentures is typically 7–10 years. The redemption of debentures can be accompanied by either **(i)** the debentures redemption reserve (sinking fund) or **(ii)** the call and put (buy-back) provision.

Debenture Redemption Reserve (DRR) A DRR has to be created for the redemption of all debentures with a maturity period exceeding 18 months, equivalent to at least 50 per cent of the amount of issue/redemption, before commencement of redemption.

Call and Put Provision The call/buy-back provision provides an option to the issuing company to redeem the debentures at a specified price before maturity. The call price may be more than the par/face value, usually by 5 per cent, the difference being the call premium. The put option is a right of the debenture-holder to seek redemption at the specified time, at predetermined prices.

Security Debentures are generally secured by a charge on the present and future immovable assets of the company by way of an equitable mortgage.

Convertibility Apart from pure non-convertible debentures (NCDs), debentures can also be converted into equity shares at the option of the debentureholders. The conversion ratio and the period during which conversion can be affected are specified at the time of the issue of the debenture itself. The convertible debentures may be fully convertible (FCDs) or partly convertible (PCDs). The FCDs carry interest rates lower than the normal rate on NCDs; they may even have a zero rate of interest. The PCDs have two parts: **(a)** convertible part and **(b)** non-convertible part. Typically, the convertible portion is converted into equity shares at a specified premium, after a specified date from the date of allotment, while the non-convertible portion is payable/ redeemable in specified equal instalments on the expiry of specified years from the date of allotment.

Credit Rating To ensure timely payment of interest and redemption of principal by a borrower, all debentures must be compulsorily rated by one or more of the four credit rating agencies, namely, CRISIL, ICRA, CARE and FITCH India.

Claim on Income and Assets The payment of interest and repayment of principal is a contractual obligation enforceable by law. Failure/default would lead to bankruptcy of the company. The claim of debenture-holders on income and assets ranks pari passu with other secured debt and higher than that of shareholders—preference as well as equity.

Evaluation

The merits and demerits of debentures, as capital market instruments, from the point of view of the company and investors/debentureholders are as follows:

Advantages The advantages for the company are: **(i)** lower cost due to lower risk and tax deductibility of interest payment, **(ii)** no dilution of control as debentures do not carry voting rights. For the investors, debentures offer stable returns, have a fixed maturity, are protected by the debenture trust deed and enjoy preferential claim on the assets in relation to shares.

Disadvantages The disadvantages for the company are the restrictive covenants in the trust deed, legally enforceable contractual obligations in respect of interest payments and repayments, increased financial risk and the associated high cost of equity. Debentures have no voting rights and debenture prices are vulnerable to change in interest rates.

To summarise, debentures, as long-term source of funds/capital market instrument have low cost, do not dilute control, involve high risk and put some restraint on managerial freedom.

INNOVATIVE DEBT INSTRUMENTS/SECURITIES

In order to improve the attractiveness of fixed income securities, namely, bonds and debentures, some new features have been added. As a result, a wide range of innovative debt securities have emerged in India, particularly, after the early nineties. This section describes some of the important ones among these instruments.

Convertible Debentures/Bonds

Features Convertible debentures give the holders the right (option) to convert them into equity shares on certain terms. They are entitled to a fixed income till the conversion option is exercised and would share the benefits associated with equity shares after the conversion. At present the operational features of convertible debentures in India are as follows.

All the details about conversion terms, namely, conversion ratio, conversion premium/price and conversion timing are specified in the offer document/prospectus. Companies can issue fully convertible debentures (FCDs) or partly convertible debentures (PCDs). The number of ordinary shares for each convertible debenture is the conversion ratio. The conversion price is the price paid for the ordinary shares at the time of conversion. Thus, conversion ratio equals par value of convertible debentures divided by the conversion price. The conversion time refers to the period from the date of allotment of convertible debentures after which the option to convert can be exercised. If the conversion is to take place between 18–36 months, the holder will have the option to exercise his rights in full or part. A conversion period exceeding 36 months is not permitted without put and call options. The call option give the issuer the right to redeem the debentures/bonds prematurely, on the stated terms. The investor has the right to prematurely sell them back to the issuer, on the specified terms. In addition, compulsory credit rating is necessary for fully convertible debentures.

Valuation Three types of convertible debentures are presently available in India: **(i)** compulsorily convertible with in 18 months, **(ii)** optionally convertible within 36 months and **(iii)** convertible after 36 months, with call and put features. However, only the first two types are popular.

Compulsorily Partly/Fully Convertible Debentures: *Value* The holders of PCDs receive interest at a specified rate, over the term of the debenture, plus equity share(s) on part conversion and repayment of the unconverted part of the principal. Symbolically,

$$V_0 = \sum_{t=1}^{n} \frac{I_t}{(1+k_d)^t} + \frac{aP_i}{(1+k_e)^t} + \sum_{j=m} \frac{F_j}{(1+k_d)^j} \qquad \textbf{(17.1)}$$

where V_0 = Value of the convertible debenture at the time of issue

I_t = Interest receivable at the end of period t

n = Term of debentures

a = Equity shares on part conversion at the end of period i

P_i = Expected pre-equity share price at the end of period i

F_j = Instalment of principal payment at the end of period j

k_d = Required rate of return on debt

k_c = Required rate of return on equity.

Example 17.1 In June, Year 1, the TISCO Ltd had offered ₹30 lakh worth of partly convertible debentures at ₹1,200 each, at par. The conversion terms were: **(i)** compulsory conversion of ₹600 par value into an equity share of ₹100 at a premium of ₹500 within six months of the date of allotment, that is, on February 1, Year 2, **(ii)** 12 per cent per annum interest payable half-yearly and **(iii)** redemption of the non-convertible portion of the debentures at the end of 8 years.

It had also simultaneously issued 32, 54, 167, 12 per cent of FCDs, of ₹600 each at par, on rights basis to the existing shareholders. Each debenture was fully convertible into one share of ₹600—that is, ₹100 par plus a premium of ₹500—within six months from the date of allotment of debentures.

Assuming 8 and 10 per cent as the half-yearly required rate of return on debt and equity respectively, find the value of a TISCO convertible debenture at the time of issue.

Solution

$$\text{Value of the PCD} = \left(\frac{₹72}{1.08}\right) + \sum_{t=12}^{16}\left(\frac{36}{(1.08)^t}\right) + \left(\frac{1 \times ₹1{,}200}{(1.10)^t}\right) + \left(\frac{₹600}{(1.08)^{16}}\right)$$

$$= ₹352.03 + ₹1{,}090.91 + ₹175.20 = ₹1{,}618.14$$

Cost The cost of partly convertible debenture (kc) is given by Equation 17.2.

$$S_0 = \sum_{t=1}^{N}\frac{I_t(1-T)}{(1+k_d)^t} + \frac{aP_jb}{(1+k_e)^I} + \sum_{j=m}^{n}\frac{F_j}{(1+k_d)^j} \qquad \textbf{(17.2)}$$

where S_0 = net subscription price of debentures at the time of issue

I_t = interest payable at the end of period t

T = tax rate

a = number of equity shares offered on the occurrence of conversion at the end of period i

P_i = per equity share price at the end of period i

b = proportion of net realisable proportion of Pi on equity share issues to the public

F_j = principal repayment instalment at the end of period j

k_c = cost of capital/discount rate

For the TISCO convertible issues as detailed in Example 17.1, assuming further issue expenses of ₹80, 35 per cent tax rate and 75 per cent as the realisable proportion of equity shares issued to the public, the cost of capital (convertible debenture), on a semi-annual basis, is the discount rate derived by solving the following equation:

$$1{,}120 = \frac{72(1-0.35)}{(1+k_c)} + \sum_{t=2}^{16} \frac{36(1-0.35)}{(1+k_c)^t} + \left(\frac{1 \times 1{,}200 \times 0.75}{(1+k_c)}\right) + \frac{600}{(1+k_c)^{16}}$$

k_c = 11.5 per cent

Optionally Convertible Debentures The value of a debenture depends upon three factors: **(i)** straight debenture value, **(ii)** conversion value and **(iii)** option value.

Straight Debenture Value (SDV) equals the discounted value of the receivable interest and principal repayment, if retained as a straight debt instrument. The discount factor would depend upon the credit rating of the debenture. Symbolically

$$\text{SDV} = \sum_{t=1}^{n} \frac{I}{(1+k_d)^t} + \frac{P}{(1+k_d)^t} + \sum_{t=1}^{n} \frac{12}{(1.16)^8} + \frac{100}{(1.10^8)} \qquad \textbf{(17.3)}$$

Where, Maturity period = 8 years, Discount = 0.16, Interest = 0.12 payable annually and Face value of debenture = ₹100.

Conversion Value (CV) If the holders opt for conversion, conversion value is equal to the share price multiplied by the conversion ratio, that is, the number of equity shares offered for each debenture. If the price of share is ₹50 and one debenture is convertible into 5 shares (conversion ratio = 5), the CV = ₹250 (₹50 × 5).

The value of a convertible debenture cannot be less than the SDV and CV, which, in a sense, represents its two floor values. In other words, the value of convertible debenture would be the higher of the SDV and CV.

Optional Value (OV) The investors have an option, that is, they may not exercise the right/exercise the right at a time of their choosing and select the most profitable alternative. Thus, the option has value in the sense that the value of the debenture will be higher than the floor values. Therefore, the value of the convertible debentures = Max [SDV,CV] + OV.

Evaluation Convertible debentures/bonds have emerged as fairly popular capital market instruments of long-term finance in India, in recent years, for three reasons. In the first place, they improve the cash flow matching of firms. With the invariably lower initial interest burden, a growing/expanding firm would be in a better position to service the debt/debenture. Subsequently, when it does well, it can afford to service the financial instrument, after conversion.

Secondly, they generate financial synergy. The assessment of risk characteristics of a new firm is costly and difficult. Convertible debentures provide a measure of protection against error of risk assessment. They have two components: straight debentures and call option. In case the firm turns out to be risky, the former will have a low value while the latter will have a high value and vice versa if the firm turns out to be relatively risk free. As a result, the required yield will not be very sensitive to default risk. In other words, firms with widely varying risks can issue convertible debentures on similar terms whereas the cost for straight debentures would be substantially different. Thus, convertible debentures offer a combination/financial synergy/risk synergy to companies to obtain capital on more favourable terms.

Finally, convertible debentures can mitigate agency problems associated with financing arising out of the conflicting demands of equity-holders and debenture- holders/lenders. The focus of the latter is on minimising default risk whereas the former would like the firm to undertake high risk projects. This conflict can be resolved by the issue of convertible debentures/bonds. Debentureholders would not impose highly restrictive covenants to protect the interest and firms can undertake profitable investment opportunities.

Callable/Puttable Bonds/Debentures/Bond Refunding

Beginning from 1992, when the Industrial Development Bank of India issued bonds with call features, several callable/puttable bonds have emerged in the country in the recent years. Call provisions provide flexibility to the company to redeem them prematurely. Generally, firms issue bonds at a presumably lower rate of interest when market conditions are favourable to redeem such bonds. In other words, the firm refunds its debt.

Evaluation The bond refunding decision can be analysed as a capital budgeting decision. If the present value of the stream of net cash savings exceeds the initial cash outlay, the debt should be refunded.

Example 17.2 The 22 per cent outstanding bonds of the Bharat Industries Ltd (BIL) amount to ₹50 crore, with a remaining maturity of 5 years. It can now issue fresh bonds of 5 year maturity at a coupon rate of 20 per cent. The existing bonds can be refunded at a premium (call premium) of 5 per cent. The unamortised portion of the issue expenses on existing bonds is ₹1.5 crore. They would be written off as soon as the existing bonds are called/refunded. If the BIL is in the 35 per cent tax bracket, would you advise it to call the bond?

Solution

	(₹ *crore)*
Annual net cash savings (Working note 2)	0.710
PVIFA (10,13) (Working note 3)	3.517
Present value of annual net cash savings	2.497
Less Initial outlay (Working note 1)	3.600
NPV (bond refunding)	(1.103)

It is not advisable to call the bond as the NPV is negative.

Working Notes

(1)	(a)	Cost of calling/refunding existing bonds		
		Face value		50.0
		Plus call premium (5 per cent)		2.5
				52.5
	(b)	Net proceeds of new bonds		
		Gross proceeds		50.0
		Less flotation cost		2.5
				47.5
	(c)	Tax savings on expenses		
		Call premium	2.5	
		Plus unamortised issue costs	1.5	4.0
			4.0 × (0.35 tax)	1.40
			3.60	
		Initial outlay [(1a) – (1b) – (1c)]		1.40

(*Contd.*)

(*Contd.*)

(2)	(a) Annual net cash outflow on existing bonds		
	Interest expenses	11.00	
	Less tax savings on interest expenses and amortisation of issue costs: 0.35 × [11.0 + 1.5/5)]	3.96	7.04
	(b) Annual net cash outflows on new bonds		
	Interest expenses	10.00	
	Less tax savings on interest expenses and amortisation of issue costs: 0.35 × [11.0 + (2.5/5)]	3.67	6.33
	Annual net cash savings [(2)(a) – (2)(b)]		0.71
(3)	Present value interest factor of 5 year annuity, using a 13 per cent after tax [0.20 (1 – 0.35)] cost of new bonds =		3.517

Warrants

A warrant entitles its holders to subscribe to the equity capital of a company during a specified period at a stated/particular/certain price. The holder acquires only the right (option) but he has no obligation to acquire the equity shares. Warrants are generally issued in conjunction with/tied to other instruments, for example, attached to **(i)** secured premium notes and **(ii)** debentures. They can be/are issued independently also.

Difference with Convertible Debentures Warrants are akin to convertible debentures to the extent that both give the holder the option/right to buy ordinary shares but there are differences between the two. While the debenture and conversion option are inseparable, a warrant can be detached. Similarly, the conversion option is tied to the debenture but warrants can be offered independently also. Warrants are typically exercisable for cash.

Features The important features of warrants are as follows:

Exercise Price It is the price at which the holder of a warrant is entitled to acquire the ordinary shares of the company. Generally, it is set higher than the market price of the shares at the time of the issue.

Exercise Ratio It reflects the number of shares that can be acquired per warrant. Typically, the ratio is 1:1, which implies that one equity share can be purchased for each warrant.

Expiry Date It means the date after which the option to buy shares expires, that is, the life of the warrant. Usually, the life of warrants is 5–10 years although theoretically perpetual warrants can also be issued.

Types Warrants can be **(i)** detachable, and **(ii)** non-detachable. A detachable warrant can be sold separately in the sense that the holder can continue to retain the instrument to which the warrant was tied and at the same time sell it to take advantage of price increase. Separate sale, independent of the instrument, is not possible in case of non-detachable warrants. Detachable warrants are listed independently for stock exchange trading but non-detachable warrants are not.

Theoretical Value A warrant is option (call option) to buy a number of ordinary shares (exercise ratio) at the exercise price. Therefore, the theoretical value of a warrant would depend upon the market price of the shares of the company, the exercise price and exercise ratio. Thus,

$$\text{Theoretical value} = (\text{Market share price} - \text{Exercise price}) \times \text{Exercise ratio} \qquad (17.4)$$

Assuming an exercise price of ₹75, the expected market price of shares of the company at the time of exercise for the option (expiry date) of ₹100 and exercise ratio of 2; the theoretical value of a warrant = (₹100 – ₹75) × 2 = ₹50. Alternatively, share price = ₹200 (₹100 × 2) + 2 warrants, that is, one warrant = ₹50. If the market value of shares is lower than the exercise price, the value of a warrant would be zero. The difference between the market value of shares and the theoretical value of the warrant is the premium. The premium divided by the theoretical value expresses premium in percentage terms. As an option, the value of a warrant can be computed using sophisticated option pricing models. However, they are beyond the scope of this book.

Zero Interest Bonds/Debentures (ZIBs/Ds)

Also known as zero coupon bonds/debentures, ZIBs do not carry any explicit/coupon rate of interest. They are sold at a discount from their maturity value. The difference between the face value of the bond and the acquisition cost is the gain/return to the investors. The implicit rate of return/interest on such bonds can be computed by Equation 17.5.

$$\text{Acquisition price} = \text{Maturity (face) value}/(1 + I)^n \tag{17.5}$$

where, i = rate of interest

n = maturity period (years)

Deep Discount Bonds (DDBs) A deep discount bond is a form of ZIB. It is issued at a deep/steep discount over its face value. It implies that the interest (coupon) rate is far less than the yield to maturity. The DDB appreciates to its face value over the maturity period.

DDBs are being issued by the public financial institutions in India, namely, IDBI, SIDBI and so on. For instance, in 1992 IDBI sold a DDB with a face value of ₹1 lakh at a deep discount price of ₹2,700, with a maturity period of 25 years. If the investor could hold the DDB for 25 years, the annualised rate of return would work out to 15.54 per cent. The investor had the option to withdraw (put option) at the end of every five years with a specified maturity/deemed face value ranging between ₹5,700 (after 5 years) and ₹50,000 (after 20 years), the implicit annual rate of interest being 16.12 and 15.71 per cent respectively. Investors could also sell the DDBs in the market. The IDBI had also the option to redeem them (call option) at the end of every 5 years, presumably to take advantage of prevailing interest rates. A second series of DDBs was issued by the IDBI in 1996 with a face value of ₹2 lakh and a maturity period of 25 years, the deep discount issue price being ₹5,300.

The merit of DDBs/ZIDs is that they enable the issuing companies to conserve cash during their maturity. They protect the investors against the reinvestment risk to the extent that the implicit interest on such bonds is automatically reinvested at a rate equal to its yield to maturity. However, they are exposed to high repayment risk as they entail a balloon payment on maturity.

Secured Premium Notes (SPNs) The SPN is a secured debenture, redeemable at a premium over the face value/purchase price. It resembles a ZIB. There is a lock-in period for SPN, during which no interest is paid. The holder has the option to sell the SPN back to the issuing company, at par, after the lock-in period. The redemption is made in instalments. The SPN is a tradeable instrument. A typical example is the SPN issued by TISCO, the salient features of which were:

- Each SPN had a face value of ₹300. No interest would accrue during the first year after allotment.
- During years 4–7, the principal was repayable in annual instalments of ₹75. In addition, ₹75 was payable each year as interest and redemption premium. The investor could choose

a mix of low interest/high premium or high interest/low premium from three options: **(i)** interest, ₹37.5, premium, ₹37.5; **(ii)** interest, ₹25 and premium, ₹50 and **(iii)** interest, ₹50 and premium, ₹25.

- A warrant was attached to the SPN, entitling the holder to acquire one equity share for a cash payment of ₹100. The option could be exercised between the first year and one and a half years after allotment, by which time the SPN will be fully paid-up.
- The holder was given an option to sell back the SPN at the par value of ₹300.

Although the SPN is taken to a ZIB to the extent it has no coupon rate of interest, the interest payment and principal repayment are spread over a period of 5 years, whereas in case of ZIBs the entire payment is made in lump sum on maturity.

The before tax rate of return on the SPN = 13.65 per cent, that is,

$$300 = \frac{0}{(1+r)} + \frac{0}{(1+r)^2} + \frac{0}{(1+r)^3} + \frac{150}{(1+r)^4} + \frac{150}{(1+r)^5} + \frac{150}{(1+r)^6}$$

Floating Rate Bonds (FRBs)

The interest on such bonds is not fixed. It is floating and is linked to a benchmark rate such as interest on treasury bills, bank rate, maximum rate on term deposits. It is typically a certain percentage point higher than the benchmark rate. The price of FRBs tend to be fairly stable and close to par value in comparison with fixed interest bonds. They provide protection against inflation risk to investors, particularly banks and financial institutions.

FORWARD CONTRACTS

A forward contract is an agreement to buy or sell an asset on a specified date for a specified price. One of the parties to the contract assumes a long position and agrees to buy the underlying asset on a certain specified future date, for a certain specified price. The other party assumes a short position and agrees to sell the asset on the same date for the same price. Other contract details like delivery date, price and quantity are negotiated bilaterally by the parties to the contract. Forward contracts are normally traded outside stock exchanges. They are popular on the Over the Counter (OTC) market. The salient features of forward contracts are as follows: **(i)** They are bilateral contracts and, hence, exposed to counterparty risk; **(ii)** Each contract is customer designed, and, hence, is unique in terms of contract size, expiration date and the asset type and quality; **(iii)** The contract price is generally not available in public domain; **(iv)** On the expiration date, the contract has to be settled by delivery of the asset and **(v)** If a party wishes to reverse the contract, it has to compulsorily go to the same counterparty, which often results in a high price being charged. However, forward contracts in certain markets have become very standardised, as in the case of foreign exchange, thereby reducing transaction costs and increasing transaction volume. This process of standardisation reaches its limit in the organised futures market.

Forward contracts are very useful in hedging and speculation. A classic hedging application would be that of an exporter who expects to receive payment in dollars, three months later. He is exposed to the risk of exchange rate fluctuations. By using the currency forward market to sell dollars forward, he can lock-on a rate today and reduce his certainty. Similarly, an importer who is required to make a payment in dollars two months hence can reduce his exposure to exchange rate fluctuations by buying dollars forward. If a speculator has information or analysis, which forecasts an upturn in a price, he can go along on the forward market instead of the cash market. The speculator would go long on the forward, wait for the price to rise and then take a reversing transaction to book profits. Speculators may well be required to deposit a margin upfront. However, this is generally a relatively small proportion of the value of the assets underlying the forward contract. The use of forward markets here supplies leverage to the speculator.

Limitations of Forward Contracts Forward markets are afflicted by several problems: **(i)** Lack of centralisation of trading, **(ii)** Liquidity and **(iii)** Counterparty risk. In the first two of these, the basic problem is that of too much flexibility and generality. The forward market is like a real estate market in that any two consenting adults can form contracts against each other. This often makes them design terms of the deal that are very convenient in that specific situation, but makes the contracts non-tradable. Counterparty risk arises from the possibility of default by any one party to the transaction. When one of the two sides to the transaction declares bankruptcy, the other suffers. Even when forward markets trade standarised contracts and, hence, avoid the problem of illiquidity, the counterparty risk remains a very serious issue.

FUTURES/FUTURE CONTRACTS

Futures markets are designed to solve the problems that exist in forward markets. A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future, at a certain price. But unlike forward contracts, futures contracts are standardised and stock exchange traded. To facilitate liquidity in the futures contracts, the exchange specifies certain standard features for the contract. It is a standardised contract with a standard underlying instrument, a standard quantity and quality of the underlying instrument that can be delivered, (or which can be used for reference purposes in settlement) and a standard timing of such settlement. A futures contract may be offset prior to maturity by entering into an equal and opposite transaction. The standardised items in a futures contract are: **(i)** Quantity of the underlying, **(ii)** Quality of the underlying, **(iii)** The date/month of delivery, **(iv)** The units of price quotation and minimum price change and **(v)** Location of settlement. The distinction between forward and future contracts are listed in **Table 17.1.**

Table 17.1 Distinction Between Futures and Forwards

Futures	*Forwards*
1. Traded on an organised stock exchange	1. Over the Counter (OTC) in nature
2. Standardised contract terms, hence, more liquid	2. Customised contract terms, hence, less liquid
3. Requires margin payments	3. No margin payment
4. Follows daily settlement	4. Settlement happens at the end of the period

Thus, future contracts are a significant improvement over forward contracts as they eliminate counterparty risk and offer more liquidity. This section illustrates future contracts with reference to **(i)** Futures terminology, **(ii)** Payoff for futures, **(iii)** Pricing futures, **(iv)** Issuing index futures and **(v)** Using futures on individual securities (stock futures).

Futures Terminology

Important terms associated with futures contracts are as follows:

Spot Price The price at which an instrument/asset trades in the spot market.

Future Price The price at which the futures contract trade in the future market.

Contract Cycle The period over which a contract trades. For instance, the index futures contracts typically have one month, two months and three months expiry cycles that expire on the last Thursday of the month. Thus, a January expiration contract expires on the last Thursday of January and a February expiration contract ceases trading on the last Thursday of February. On the Friday following the last Thursday, a new contract having three month expiry is introduced for trading.

Expiry Date It is the date specified in the futures contract. This is the last day on which the contract will be traded, at the end of which it will cease to exist.

Contract Size The amount of asset that has to be delivered under one contract. For instance, the contract size of the NSE future market is 200 Nifties.

Basis Basis is defined as the futures price minus the spot price. There will be a different basis for each delivery month for each contract. In a normal market, basis will be positive. This reflects that futures prices normally exceed spot prices.

Cost of Carry The relationship between futures prices and spot prices can be summarised in terms of the cost of carry. This measures the storage cost plus the interest that is paid to finance the asset, less the income earned on the asset.

Initial Margin The amount that must be deposited in the margin account at the time a futures contract is first entered into is the initial margin.

Marking to Market In the futures market, at the end of each trading day, the margin account is adjusted to reflect the investor's gain or loss depending upon the futures closing price. This is called marking to market.

Maintenance Margin This is somewhat lower than the initial margin. This is set to ensure that the balance in the margin account never becomes negative. If the balance in the margin account falls below the maintenance margin, the investor receives a margin call and is expected to top up the margin account to the initial margin level before trading commences on the next day.

Pay off for Futures

A pay off is the likely profit/loss that would accrue to a market participant with change in the price of the underlying asset. Futures contracts have linear payoffs. In simple words, it means that the losses as well as profits, for the buyer and the seller of futures contracts, are unlimited. The pay off for futures, that is, for buyers (long futures) and sellers (short futures) is discussed below.

Pay Off for Buyer of Futures: *Long Futures* The pay offs for a person who buys a futures contract is similar to the pay off for a person who holds an asset. He has a potentially unlimited upside as well as downside. Take the case of a speculator who buys a two month Nifty index futures contract when the Nifty stands at 1220. The underlying asset in this case is the Nifty portfolio.

When the index moves up, the long futures position starts making profits and when the index moves down it starts making losses.

Pay Off for Seller of Futures: *Short Futures* The pay off for a person who sells a futures contract is similar to the pay off for a person who shorts an asset. He has a potentially unlimited upside as well as downside. Take the case of a speculator who sells a two month Nifty index futures contact when the Nifty stands at 1220. The underlying asset in this case is the Nifty portfolio. When the index moves down, the short futures position starts making profits and when the index moves up, it starts making losses. The pay off for futures is illustrated in Examples 17.3 to 17.6.

Example 17.3 On January 15, X bought a January Nifty futures contract that cost him ₹5,38,000. For this he had to pay an initial margin of ₹43,040 to his broker. Each Nifty futures contract is for the delivery of 200 Nifties. On January 25, the index closed at 2,720. How much profit/loss did he make?

Solution

X bought one futures contract costing him ₹5,38,000. At a market lot of 200, this means he paid ₹2,690 per Nifty future. On the futures expiration day, the futures price converges to the spot price. If the index closed at 2,720 this must be the futures close price as well. Hence, he would have made of profit of (₹2,720 – ₹2,690) × 200 = ₹6,000.

Example 17.4 X sold a January Nifty futures contract for ₹5,38,000, on January 15. For this he had to pay an initial margin of ₹43,040 to his broker. Each Nifty futures contract is for the delivery of 200 Nifties. On January 25, the index closed at 2,520. How much profit/loss did we make?

Solution

X sold one futures contract costing in ₹5,38,000. At a market lot of 200, this works out to be ₹2,690 per Nifty future. On the futures expiration day, the futures price converges to the spot price. If the index closed at 2,520 this must be the futures close price as well. Hence, he would have made profit of (₹2,690 – ₹2,520) × 200 = ₹34,000.

Example 17.5 On January 15, X bought one January Nifty futures contract that cost him ₹2,69,000. For this he had to pay an initial margin of ₹21,520 to his broker. Each Nifty contract is for the delivery of 200 Nifties. On January 25, the index closed at 1,280. How much profit/loss did he make?

Solution

X bought one futures contract for ₹2,69,000. At a market lot of 200, this means he paid ₹1,345 per Nifty future. On the futures expiration day, the futures price converges to the spot price. If the index closed at 1,280, this must be the futures close price as well. Hence, he made of loss of (₹1,345 – ₹1,280) × 200 = ₹13,000.

Example 17.6 X sold one January Nifty futures contract for ₹2,69,000, on January 15. For this he had to pay an initial margin of ₹21,520 to his broker. Each Nifty futures contract is for the delivery of 200 Nifties. On January 25, the index closed at 1,390. How much profit/loss did he make?

Solution

X sold one futures contract for ₹2,69,000. In a market lot of 200, this works out to be ₹1,345 per Nifty future. On the futures expiration day, the futures price converges to the spot price. If the index closed at 1,390, this must be the futures close price as well. Hence, he made of loss of (₹1,390 – ₹1,345) × 200 = ₹9,000.

Pricing Futures

The pricing of futures is illustrated below with reference to **(1)** The Cost-of-Carry Model, **(2)** Pricing equity index futures and **(3)** Pricing stock futures.

The Cost-of-Carry Model The cost-of-carry model explains the dynamics of pricing that constitute the estimation of the fair value of futures. The fair value calculation of futures is used to decide the no arbitrage limits on the price of a future contract. According to this model, using discrete compounding, where interest rates are compounded at discrete intervals, (for example, annually/ semi-annually) the price of the contract is defined as:

$$F = S + C \tag{17.6}$$

where

F = Futures price

S = Spot price

C = Holdings costs or carry posts

This can also be expressed as:

$$F = S(1 + r)T \tag{17.6.1}$$

where

r = Cost of financing

T = Time till expiration

If $F < S(1 + r)T$ or $F > S(1 + r)T$, arbitrage opportunities would exist, that is, whenever the futures price moves away from the fair value, there would be chances for arbitrage. The components of holding cost vary with contracts on different assets. At times, the holding cost may even be negative. In the case of commodity futures, the holding cost is the cost of financing plus cost of storage and insurance purchased and so on. In the case of equity futures, the holding cost is the cost of financing minus the dividends returns.

Using continuous compounding, the Equation 5.6 would be expressed as

$$F = Se^{rT} \tag{17.7}$$

where

r = Cost of financing (using continuously compounded interest rate)

T = Time till expiration

e = 2.71828

To illustrate cost of carry, let us take an example of a futures contract on a commodity and work out the cost of contract. The spot price January 1, Year 1, of silver is assumed to be ₹7,000/ kg. Assuming an annual cost of financing of 15 per cent and no storage cost, the fair value of the future price of 100 gms of silver one month hence (January 30, Year 1) would be as follows:

$$F = S(1 + r)T + C = ₹700\ (₹7{,}000 \div 10)\ [1.15] \times \frac{30}{365} = ₹708$$

If the contract is for a three month period expiring on March 30, Year 1, the cost of financing would increase the future price, that is, F = ₹700 (1.15) × 90/365 = ₹724.5. If, however, the one month contract was for 10,000 kgs, it would involve storage cost and the price of the future contract would be ₹708 plus the cost of storage.

Pricing Equity Index Futures A futures contract on the stock market gives its owner the right and obligation to buy or sell the portfolio of stocks characterised by the index. Stock index futures are cash settled; there is no delivery of the underlying stocks. The main differences between commodity and equity index futures are that: **(i)** There are no costs of storage involved in holding equity and **(ii)** Equity comes with a dividend stream, which is a negative cost if you are long the stock and a positive cost if you are short the stock. Therefore, cost of carry = financing cost – dividends. Thus, a crucial aspect of dealing with equity futures, as opposed to commodity futures, is an accurate forecasting of dividends. The better the forecast of dividend offered by a security, the better is the estimate of the futures price. The pricing of equity index futures is illustrated below with reference to **(i)** expected dividend amount and **(ii)** expected dividend yield.

Pricing Index Futures Given Expected Dividend Amount The pricing of index futures is also based on the cost-of-carry model, where the carrying cost is the cost of financing the purchase of the portfolio underlying the index, minus the present value of dividends obtained from the stocks in the index portfolio. Consider Example 17.7.

Example 17.7 Nifty futures trades on a stock exchange (NSE) as one, two and three-month contracts. Money can be borrowed at a rate of 15 per cent per annum. Compute the price of a new two month futures contract on Nifty of X Ltd (XL).

Solution

Let us assume that XL will be declaring a dividend of ₹10 per share after 15 days of purchasing the contract. The current value of Nifty is 1,200 and Nifty trades with a multiplier of 200. The value of the contract is 200 × ₹1200 = ₹2,40,000. If XL has a weight of 7 per cent in Nifty, its value in Nifty is ₹16,800 (₹2,40,000 × 0.07). If the market price of XL is ₹140, a traded unit of Nifty involves 120 shares (₹16,800/140). To calculate the futures price, we need to reduce the cost-of-carry to the extent of the dividend received. The amount of dividend received is ₹1,200 (120 × ₹10). The dividend is received 15 days later and, hence, compounded only for the reminder of the 45 days. To calculate the futures price we need to compute the amount of dividend received per unit of Nifty. Hence, we divide the compounded dividend figure by 200. Thus, the futures price is

$$F = 1{,}200\ (1.15)\ 60/365 - \frac{[120 \times 10(1.15) \times 45.365]}{200} = ₹1{,}221.80$$

Pricing Index Futures Given Expected Dividend Yield If the dividend flow throughout the year is generally uniform, that is, there are few historical cases of clustering of dividends in any particular month, it is useful to calculate the annual dividend yield.

$$F = S(1 + r - q)T \tag{17.8}$$

where

F = futures price
S = spot index value
r = cost of financing
q = expected dividend yield
T = holding period

Example 17.8 A two month futures contract trades on the NSE. The cost of financing is 15 per cent and the dividend yield on Nifty is 2 per cent annualised. The spot value of Nifty is ₹1,200. What is the fair value of the futures contract?

Solution

Fair value = ₹1,200 (1 + 0.15 – 0.02) × 60.365 = ₹1,224.35

The cost-of-carry model explicitly defines the relationship between the futures price and the related spot price. The difference between the spot price and the futures price is called the basis. As the date of expiration comes near, the basis reduces: there is a convergence of the futures price towards the spot price. On the date of expiration, the basis is zero. If it is not, then there is an arbitrage opportunity. Arbitrage opportunities can also arise when the basis (difference between spot and futures price) or the spreads (difference between prices of two futures contracts) during the life of a contract are incorrect. How these arbitrage opportunities can be exploited is discussed subsequently. There is nothing but cost-of-carry related arbitrage that drives the behaviour of the futures price. Moreover, transactions costs are very important in the business of arbitrage. However, these pricing models give an approximate idea about the true future price. The price observed in the market is the outcome of the price discovery mechanism (demand-supply principle) and may differ from the so called true price.

Pricing Stock Futures A futures contract on a stock gives its owner the right and obligation to buy or sell the stocks. Like index futures, stock futures are also cash settled; there is no delivery of the underlying stocks. Just as in the case of index futures, the main difference between commodity and stock futures are that: **(i)** There are no costs of storage involved in holding stock, and **(ii)** Stocks come with a dividend stream, which is a negative cost if you are long) the stock and a positive cost if you are short the stock. Therefore, cost of carry = financing cost – dividends. Thus, a crucial aspect of dealing with stock futures, as opposed to commodity futures, is an accurate forecasting of dividends. The better the forecast of dividend offered by a security, the better is the estimate of the futures price. The pricing of stock futures is discussed below when **(i)** no dividend is expected, **(ii)** when dividend is expected.

Pricing Stock Futures When No Dividend Expected The pricing of stock futures is also based on the cost-of-carry model, where the carrying cost is the cost of financing the purchase of the stock, minus the present value of dividends obtained from the stock. If no dividends are expected during the life of the contract, pricing futures on that stock is very simple. It simply involves multiplying the spot price by the cost of carry.

Example 17.9 SBI futures trade on NSE as one, two and three-month contracts. Money can be borrowed at 15 per cent per annum. What will the price of a unit of new two month futures contract on the SBI be if no dividends are expected during the two month period, assuming spot price of the SBI is ₹228?

Solution

Futures price, F = ₹228 × (1.15) × 60/365 = ₹233.30

Pricing Stock Futures When Dividends are Expected When dividends are expected during the life of the futures contract, pricing involves reducing the cost of carry to the extent of the dividends. The net carrying cost is the cost of financing the purchase of the stock, minus the present value of dividends obtained from the stock.

Example 17.10 XL futures trade on NSE as one, two and three month contracts. What will the price of a unit of new two-month futures contract on XL be if dividends are expected during the two month period? Assume that XL will be declaring a dividend of ₹10 per share after 15 days of purchasing the contract. The market price of XL may be assumed as ₹140.

Solution

To calculate the futures price, we need to reduce the cost-of-carry to the extent of dividend received. The amount of dividend received is ₹10. The dividend is received 15 days later and, hence, compounded only for the remainder of 45 days. Thus, the futures price, F = ₹140 × (1.15) × 60/365 – [10 × (1.15) × 45/365] = ₹133.08.

OPTIONS/OPTIONS CONTRACTS

Options are fundamentally different from forward and futures contracts. An option gives the holder of the option the right to do something. The holder does not have to necessarily exercise this right. In contrast, in a forward or futures contract, the two parties have committed themselves to doing something. Whereas it costs nothing (except margin requirements) to enter into a futures contract, the purchase of an option requires an up front payment. This section discusses and illustrates options as a derivative contract, with reference to **(i)** Option terminology, **(ii)** Comparison of options and futures, **(iii)** Option payoffs, **(iv)** Pricing options and **(v)** Using stock options.

Option Terminology

Index Options These options have the index as the underlying. Some options are European while others are American. American options can be exercised at any time upto the expiration date. Most exchange traded options are American. European options can be exercised only on the expiration date itself. European options are easier to analyse than American options, and properties of an American option are frequently deduced from those of its European counterpart. Like index futures contracts, index options contracts are also cash settled.

Stock Options Stock options are options on individual stocks. A contract gives the holder the right to buy or sell shares at the specified price.

Buyer of an Option The buyer of an option is the one who by paying the option premium buys the right but not the obligation to exercise his option on the seller/writer.

Writer of an Option The writer of a call/put option is the one who receives the option premium and is thereby obliged to sell/buy the asset if the buyer exercises the option on him.

There are two basic types of options, call options and put options.

Call Option A call option gives the holder the right but not the obligation to buy an asset by a certain date for a certain price.

Put Option A put option gives the holder the right but not the obligation to sell an asset by a certain date for a certain price.

Option Price Option price is the price that the option buyer pays to the option seller. It is also referred to as the option premium.

Expiration Date The date specified in the options contract is known as the expiration date, the exercise date, the strike date or the maturity.

Strike Price The price specified in the options contract is known as the strike price or the exercise price.

In-the-Money Option An in-the-money (ITM) option is an option that would lead to a positive cashflow to the holder if it were exercised immediately. A call option on the index is said to be in-the-money when the current index stands at a level higher than the strike price (that is, spot price > strike price). If the index is much higher than the strike price, the call is said to be deep ITM. In the case of a put, the put is ITM if the index is below the strike price.

At-the-Money Option An at-the-money (ATM) option is an option that would lead to zero cashflow if it were exercised immediately. An option on the index is at-the-money when the current index equals the strike price (that is, spot price = strike price).

Out-of-the-Money Option An out-of-the-money (OTM) option is an option that would lead to a negative cashflow if it were exercised immediately. A call option on the index is out-of-the-money when the current index stands at a level that is less than the strike price (that is, spot price < strike price). If the index is much lower than the strike price, the call is said to be deep OTM. In the case of a put, the put is OTM if the index is above the strike price.

Intrinsic Value of an Option The option premium can be broken down into two components **(i)** intrinsic value and **(ii)** time value. The intrinsic value of a call is the amount the option is ITM, if it is ITM. If the call is OTM, its intrinsic value is zero. Putting it another way, the intrinsic value of a call is Max[0,(St – K)] which means the intrinsic value of a call is the greater of 0 or (St – K). Similarly, the intrinsic value of a put is Max[0, K – St], that is, the greater of 0 or (K – St). K is the strike price and St is the spot price.

Time Value of an Option The time value of an option is the difference between its premium and its intrinsic value. Both calls and puts have time value. An option that is OTM or ATM only has time value. Usually, the maximum time value exists when the option is ATM. The longer the time to expiration, the greater is an option's time value, other things being equal. At expiration, an option would have no time value.

Futures Vs. Options

Options are different from futures in several respects. At a practical level, the option buyer pays for the option in full at the time it is purchased. After this, he only has an upside. There is no possibility of the options position generating any further loss to him (other than the funds already paid for the option). In contrast, futures are free to enter into but can generate very large losses. This characteristic makes options attractive to many occasional market participants who cannot put in the time to closely monitor their futures positions.

Buying put options is buying insurance. To buy a put option on the Nifty is to buy insurance that reimburses the full extent to which the Nifty drops below the strike price of the put option. This is attractive to many people and to mutual funds creating "guaranteed return products". The Nifty index fund industry will find it very useful to make a bundle of a Nifty index fund and a Nifty put option to create a new kind of Nifty index fund, which gives the investor protection against extreme drops in the Nifty. Selling put options is selling insurance. Anyone who feels like earning revenues by selling insurance can set himself up to do so on the index options market.

More generally, options offer "non-linear payoffs", whereas futures only have "linear payoffs". By combining futures and options, a wide variety of innovative and useful payoff structures can be created. The distinction between futures and option is summarised in **Table 17.2.**

Table 17.2 Distinction between Futures and Options

Futures	*Options*
1. Exchange traded, with novation	**1.** Same as futures
2. Exchange defines the product	**2.** Same as futures
3. Price is zero, strike price moves	**3.** Strike price is fixed, price moves
4. Price is zero	**4.** Price is always positive
5. Linear payoff	**5.** Non linear payoff
6. Both long and short at risk	**6.** Only short at risk

Options Pay-Offs

A pay off for derivative contacts is the likely profit/loss that would accrue to the market participant with change in the price of the underlying asset. The optionality characteristic of options results in a non-linear pay off for options. In simple words, it means that the losses for the buyer of an option are limited. However, the profits are potentially unlimited. For a writer, the pay off is exactly the opposite. His profits are limited to the option premium. However, his losses are potentially unlimited. These non-linear pay offs are fascinating as they lend themselves to be used to generate various pay offs by using combinations of options and the underlying. We illustrate below six basic pay offs.

Pay Off Profile of Buyer of Asset: *Long Asset* In this basic position, an investor buys the underlying asset, the Nifty for instance, for 1,220 and sells it at a future date at an unknown price, St. Once it is purchased, the investor is aid to be 'long' the asset. The investor would make profit if the index goes up. If the index falls he would lose.

Pay Off Profile for Seller of Asset: *Short Asset* In this basic position, an investor shorts the underlying asset, the Nifty for instance, for 1,220 and buys it back at a future date at an unknown price, St. Once it is sold, the investor is said to be 'short' the asset. The investor sold the index at 1,220. If the index falls, he profits. If the index rises, he loses.

Pay Off Profile for Buyer of Call Options: *Long Call* A call option gives the buyer the right to pay the underlying asset at the strike price specified in the option. The profit/loss that the buyer makes on the option depends on the spot price of the underlying. If upon expiration, the spot price exceeds the strike price, he makes a profit. The higher the spot price, the more profit he makes. If the spot price of the underlying is less than the strike price, he lets his option expire unexercised. His loss in this case is the premium he paid for buying the option.

Pay Off Profile for Writer to Call Options: *Short Call* A call option gives the buyer the right to buy the underlying asset at the strike price specified in the option. For selling the option, the writer of the option charges a premium. The profit/loss that the buyer makes on the option depends on the spot price of the underlying. Whatever is the buyer's profit is the seller's loss. If upon expiration, the spot price exceeds the strike price, the buyer will exercise the option on the writer. Hence, as the spot price increases, the writer of the option starts making losses. The higher the spot price, the more is the loss he makes. If upon expiration the spot price of the underlying is less than the strike price, the buyer lets his option expire unexercised and the writer gets to keep the premium.

Pay Off Profile for Buyer of Put Options: *Long Put* A put option gives the buyer the right to sell the underlying asset at the strike price specified in the option. The profit/loss that the buyer makes on the option depends on the spot price of the underlying. If upon expiration the spot price is below the strike price, he makes a profit. The lower the spot price, the more is the profit he makes. If the spot price of the underlying is higher than the strike price, he lets his option expire unexercised. His loss in the case is the premium he paid for buying the option.

Pay Off Profile for Writer of Put Options: *Short Put* A put option gives the buyer the right to sell the underlying asset at the strike price specified in the option. For selling the option, the writer of the option charges a premium. The profit/loss that the buyer makes on the option depends on the spot price of the underlying. The buyer's profit is the seller's loss. If upon expiration the spot price happens to be below the strike price, the buyer will exercise the option on the writer. If upon expiration the spot price of the underlying is more than the strike price, the buyer gets his option expire unexercised and the writer gets to keep the premium.

Pricing Options

An option buyer has the right but not the obligation to exercise on the seller. The worst that can happen to a buyer is the loss of the premium paid by him. His downside is limited to this premium, but his upside is potentially unlimited. This optionality has a value expressed in terms of the option price. Just like in other free markets, it is the supply and demand in the secondary market that drives the price of an option. There are various models that help us get close to the true price of an option. Most of these are variants of the celebrated Black-Scholes Model for pricing European options.

Black-Scholes Option Pricing Model/Formulae Black and Scholes start by specifying a simple and well known equation that models the way in which stock prices fluctuate. This equation, called Geometric Brownian Motion, implies that stock returns will have a lognormal distribution, meaning that the logarithm of the stock's return will follow the normal (bell shaped) distribution. They then propose that the option's price is determined by only two variables that are allowed to change: time and the underlying stock price. The other factors, namely, the volatility, the exercise price, and the risk free rate do affect the option's price but they are not allowed to change. By forming a portfolio consisting of a long position in stock and a short position in calls, the risk associated with the stock is eliminated. This hedged portfolio is obtained by setting the number of shares of stock equal to the approximate change in the call price for a change in the stock price. This mix of stock and calls must be revised continuously. This process is known as delta hedging. They then turn to a little known result in a specialised field of probability known as stochastic calculus. This result defines how the option price changes in terms of the change in the stock price and time to expiration. They then reason that this hedged combination of options and stock should grow in value at the risk free rate. The result then is a partial differential equation. The solution is found by forcing a condition called a boundary condition on the model that requires the option price to converge to the exercise value at expiration. The end result is the Black and Scholes Model.

The Black-Scholes formulas for the prices of European calls and puts on a non-dividend paying stock are:

$$C = SN(d_1) - Xe^{-rT} N(d_2) \tag{17.9}$$

$$P = Xe^{-rT} N(-d_2) - SN(-d_1)$$

where $d1 = \dfrac{\ln \dfrac{S}{X} + (r + \sigma^2/2)T}{\sigma\sqrt{T}}$

and $d = d_1 - \sigma\sqrt{T}$

- The Black-Scholes equation is done in continuous time. This requires continuous compounding. The r that figures in this is 1n(1 + r). Example, if the interest rate per annum is 12 per cent, you need to use 1n 1.12 or 0.1133, which is the continuously compounded equivalent of 12 per cent per annum.
- N () is the cumulative normal distribution. N (d1) is called the delta of the option, which is a measure of change in option price with respect to change in the price of the underlying asset.
- σ a measure of volatility, is the annualised standard deviation of continuously compounded returns on the underlying. When daily sigma are given, they need to be converted into annualised sigma.
- $\text{Sigma}_{\text{annual}} = \text{sigma}_{\text{daily}} \times \sqrt{\text{Number of trading days per year}}$. On a average there are 250 trading days in a year.
- X is the exercise price, S the spot price and T the time to expiration measured in years.

Pricing Index Options Under the assumption of the Black-Scholes Options Pricing Model, index options should be valued in the same way as ordinary options on common stock, the assumption being that investors can purchase, without cost, the underlying stocks in the exact amount necessary to replicate the index, that is, stocks are infinitely divisible and the index follows a diffusion process such that the continuously compounded returns distribution of the index is normally distributed. To use the Black-Scholes formula for index options we must, however, make adjustments for the dividend payments, replacing the current index value S in the model with Se–qT where q is the annual dividend yield and T is the time to expiration in years. Consider Example 17.11

Example 17.11 A three-month call option on the Nifty with a strike of 1,180 is available for trading. The Nifty stands at ₹1,150, and it has a volatility of 30 per cent per annum. The annual risk free rate is 12 per cent. We can calculate the price of the 1,180 option using the Black-Scholes option pricing formula. We take T = 0.25, S = 1,150, X = 1,180, r =1n(1.12), and s = 0.3. Substituting these values in the formula, we get the call price as ₹70.15. The put price on an option with the same strike works out to be ₹67.19.

Pricing Stock Options Much of what was discussed about index options also applies to stock options. The factors that affect option prices are listed below.

The Stock Price The payoff from a call option will be the amount by which the stock prices exceeds the strike price. Call option, therefore, becomes more valuable as the stock price increases and less valuable as the stock prices decreases. The payoff from a put option will be the amount by which the strike price exceeds the stock price. Put options, therefore, become more valuable as the stock price decreases and less valuable as the stock price increases.

The Strike Price In the case of a call, as the strike price increases, the stock price has to make a larger upward move for the option to go in-the-money. Therefore, for a call option, as the strike price increases, options become less valuable and as the strike price decreases they become more valuable. Put options behave exactly in the opposite way to call options.

Time to Expiration Both put and call American options become more valuable as the time to expiration increases. Consider the case of two options that differ only as far as their expiration date is concerned. The owner of the long-life option has all the exercise opportunities open to the owner of the short-life option, and more. The long-life option must, therefore, always be worth at least as much as the short life option.

Volatility The volatility of a stock price is a measure of how uncertain we are about future stock price movements. As volatility increases, the chance that the stock will do very well or very poorly increases. The value of both calls and puts, therefore, increases as volatility increases.

Risk Free Interest Rate The affect of the risk free interest rate is less clear cut. It is found that the put option prices decline as the risk free rate increases, whereas the prices of calls always increase as the risk free interest rate increases.

Dividends Dividends have the effect of reducing the stock price on the ex-dividend date. This has a negative affect on the value of call options and a positive affect on the value of put options.

Application of Black-Scholes Option Pricing Formula to Stock Options The Black-Scholes option pricing formula, with some adjustment, can be used to price American calls and puts options on stocks. Pricing American options becomes a little difficult because unlike European options, American options can be exercised any time prior to expiration. However, it is never optimal to exercise a call option on a non-dividend paying stock before expiration. When no dividends are expected during the life of the option, the option can be valued simply by substituting the values of the stock price, strike price, stock volatility, risk free rate and time-to-expiration in the Black-Scholes formula. However, when dividends are expected during the life of the option, it is sometimes optimal to exercise the option just before the underlying stock goes ex-dividend. Hence, when valuing options on dividend paying stock, we should consider exercise possibilities at to times: **(i)** just before the underlying stock goes ex-dividend and **(ii)** at the expiration of the options contract.

Therefore, owning an option on a dividend paying stock today is like owning two options: one being a long maturity option with a time-to-maturity from the starting date till the expiration day, and the other being a short maturity option with a time-to-maturity from the starting date till just before the stock goes ex-dividend.

Some adjustment needs to be made before using the Black-Scholes formula. The first step is to value the option on the assumption that it will be exercised on expiry. Thus, the present value of the dividends is deducted from the stock price and the adjusted value, Sd, is used in the Black-Scholes Model. The second step is to assume that the option will be exercised just before the ex-dividend date. The unadjusted stock price is used. In addition, the time to expiry is shortened to be the period up to the ex-dividend date. Following these adjustments, the Black-Scholes model can be applied. The actual value of the option will be the highest of the two valuations. Consider Example 17.12.

Example 17.12 Assume that the price of a stock is ₹50, the exercise price is ₹45, the risk free rate of interest is 6 per cent per annum and that the ex dividend adjustment of 2.5 will occur 0.1644 years hence. The volatility of the stock is 20 per cent. The discount rate on dividend is also taken to be 6 per cent. We have now two call options, a long maturity call option with a maturity of 0.25 years, which can be exercised on the expiration date, and a short maturity call option with a maturity of 0.166 years, which can be exercised just before the ex-dividend date. We will now value both these options.

- The details of the long option are: T = 0.25, r = 0.06, D = 2.5, S = ₹50, X = ₹45, and Sd = [S – D/(1 = r)T] = ₹47.52. The stock price to be used in the Black-Scholes option pricing formula is Sd, the adjusted price of the stock after deducing the present value of the dividends. Using these values, we get the price of the long option as ₹3.84.
- The details of the short option are: T = 0.166, r = 0.06, D = 2.5, S = ₹50 and X = ₹45. Since the option is exercised just before the stock goes ex-dividend, the unadjusted stock price of ₹50 is used. Using these values, we get the price of the short option as ₹5.56.

Thus, using the above approximation, the American option on the dividend paying stock would be valued at the higher of the two options, that is, at ₹5.58.

CONCLUDING OBSERVATIONS

- Equity/ordinary share capital represents ownership capital and its owners—equity-holders/ordinary shareholders—share the reward and risk associated with the ownership of corporate enterprises.
- The ordinary shares have some special features in terms of the rights and claims of their holders: **(i)** residual claim to income, **(ii)** residual claim on assets, **(iii)** right to control, **(iv)** pre-emptive rights and **(v)** limited liability.
- A shareholder can **(1)** exercise **(2)** sell in the market and **(3)** renounce/forfeit his pre-emptive right partially/completely. He dos not gain/lose from rights issues. However, he would suffer dilution of financial interest if he does not exercise his pre-emptive right.
- Ordinary share capital is a high-risk-high-reward source of finance for corporates. The shareholders share the risk, return and control associated with ownership of companies.
- Term loans/term/project finance are negotiated loans between the borrower and the lenders with a maturity of up to 10 years. They are employed to finance acquisition of fixed assets and working capital margin. All term loans are secured. The asset security stipulations are reinforced by a number of positive/affirmative and negative covenants. While negative covenants are **(i)** asset-related, **(ii)** liability-related, **(iii)** cashflow-related and **(iv)** control-related, the positive covenants relate to maintenance of **(i)** networth, **(ii)** level of working capital, **(iii)** creation of redemption funds and so on. The term loans have to be amortised according to the predetermined schedule. They carry low cost and involve high risk. They have no adverse effect on control but there is a moderate restraint on managerial freedom.
- Debentures represent creditorship securities and debentureholders are long-term creditors of the company. As long-term source of finance, debentures have some contrasting features compared to equity shares. When they are sold to public, a trustee is appointed through a trust deed/indenture to ensure that the borrower fulfills all contractual obligations. The coupon rate of interest is legally enforceable as well as tax-deductible. A typical non-convertible debenture (NCD) has a maturity of 7–10 years. The redemption of debentures can be accomplished in either of the two ways: **(i)** debenture redemption reserves (sinking fund) and **(ii)** call and put (buy-back) provision. They are generally secured by way of an equitable mortgage. All debentures must be rated by a rating agency. As long-term source of funds, debentures **(i)** have low cost, **(ii)** do not dilute control, **(iii)** involve high risk and **(iv)** put some restraint on managerial freedom. To improve the attractiveness of debentures, a wide range of innovative instruments have emerged such as deep discount bonds, secured premium notes and floating rate bonds.
- The main attributes of preference shares **(i)** prior claim on income/assets, **(ii)** cumulative dividends, **(iii)** redeemability, **(iv)** volting rights when preference dividend is in arrears, **(v)** participation in surplus profits/excess assets and so on.

- Preference capital involves high cost, does not dilute owners control of the company, has negligible risk and puts no restraint on managerial freedom. The shareholders receive modest return and are vulnerable to arbitrary managerial actions. It is not a popular source of long-term finance in India.
- Convertible debentures (CDs) confer on their holders the right/option to convert them partly (PCDs)/fully (FCDs) into equity at a later date on specified terms/conditions.
- Their operational features, namely, conversion ratio, conversion premium and conversion timing are specified in advance. The call option gives the issuer the right to redeem the debentures prematurely. The investor has also the right to prematurely sell them back.
- The value of a compulsorily/fully/partly CDs.

$$V_0 = \sum_{t=1}^{n} \frac{I_t}{(1+k_d)^t} + \frac{aP_i}{(1+k_e)^l} + \sum_{j=m} \frac{F_j}{(1+k_d)^t}$$

- The cost of a PCDs,

$$K_C S_0 = \sum_{t=1}^{N} \frac{I_t(1-T)}{(1+k_d)^t} + \frac{aP_i b}{(1+k_e)^l} + \sum_{j=m}^{n} \frac{F_j}{(1+k_d)^t}$$

- The value of optionally CDs depends upon three factors: **(i)** straight debenture value, **(ii)** conversion value and **(iii)** option value.
- The reasons for the popularity of CDs are **(1)** cashflow matching of firms, **(2)** financial synergy and **(3)** mitigation of agency problem.
- A warrant entitles its holders to subscribe to the equity capital of a company during a specified period at a stated/particular/striking price. It differs from a CD in that while debenture and conversion option are inseparable, a warrant can be detached. Unlike CDs, warrants can be offered independently also.
- The important features of warrants are **(1)** exercise, price, **(2)** exercise ratio and **(3)** expiry date.
- The implied price of an attached warrant is the price effectively paid for each warrant. It is equal to price of bond with attached warrants less straight debenture/warrant value.
- A warrant has a market value and a theoretical value. The difference between them is the warrant premium.
- The theoretical value of a warrant = $(P0 - E) \times N$.
- Derivative instruments include (i) a security derived from a debt instrument, share, secured/unsecured loan, risk instrument or contract for differences or any other form of security and (ii) a contract that derives value from the prices/index of prices of underlying securities.
- Derivative market performs a number of functions: (i) prices in an organised derivative market reflect the perception of the participants about the future and lead the prices of the underlying to the perceived future level, (ii) risks are transferred to those who have an apetite for them; (iii) the underlying cash market witnesses higher volume, (iv) speculative trades shift to more controlled environment and (v) it helps increase savings and investments in the long-run.
- There are three broad categories of participants in the derivative market. Hedgers try to reduce/eliminate risk associated with the price of an asset. Speculators wish to bet on future movements in the price of an asset. Arbitrageurs take advantage of a discrepancy between prices in two different markets.
- The most common variants of derivative contracts are: forwards, futures and options.

- A forward contract is an agreement to buy or sell an asset on a specified date for a specified price. The contract details like delivery date, price and quantity are negotiated bilaterally by the parties to the contract. Each contract is bilateral and unique in term of size, expiration.
- A payoff for derivative contracts is the likely profit/loss that would accrue to the market participant with change in the price of the underlying asset. Due to optional nature, options result in a non-linear payoff in the sense that the losses for the buyer of the option are limited but the profit potentials are unlimited. For the writer of the option, the payoff is exactly opposite, that is, profit potential is limited to the option premium but losses are potentially unlimited.
- Pricing of options is based on the Black-Scholes Model. The formula for the prices of option on a non-dividend pay stock are:

$$C = SN(d_1) - X_e^{-rT}N(d_2)$$

$$P = X_e^{-rT}\, N(-d_2) - SN(-d_1)$$

where $$d_1 = \frac{\ln\frac{S}{X} + (r + \sigma^2/2)T}{\sigma\sqrt{T}}$$

and $$d = d_1 - \sigma\sqrt{T}$$

Part 5

Private Foreign Investment

Investment is usually understood as financial contribution to the equity capital of, or purchase of shares in, the enterprises. **Foreign investment** is investmsnt in an enterprise by a non-resident in the form of new equity or re-investment of earnings. Private foreign investment played a rather marginal role in corporate financing in India. The inflow of foreign funds in the country was partly bilateral at Government-to-Government level but mainly routed through multilateral institutions such as the World Bank. Asian Development Bank (ABD), International Development Association (IDA) and so on. But in the post-1991 period, a congenial climate for the sustained flow of foreign investment has been created through liberalisation in the foreign investment policy of the Government. The capital market has also been opened to foreign investment. Foreign investment by Indians in the form of wholly owned subsidiaries and joint ventures abroad is also encouraged within the framework of Government/RBI guidelines. This part of the book which is devoted to foreign investment focusses on policy framework and not on quantitative flows. Chapter 18 discusses the current policy framework on foreign direct investment (FDI). The other forms/sources of foreign investment in India/abroad are covered in Chapter 19.

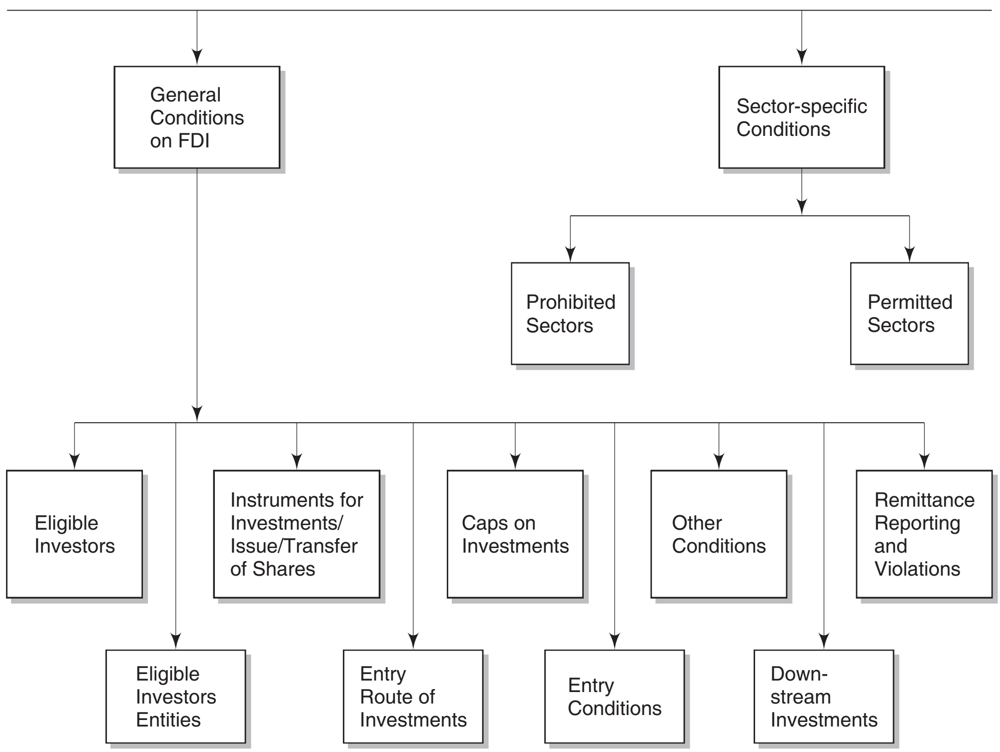
CHAPTER 18

Foreign Direct Investments

INTRODUCTION

Foreign direct investment (FDI) means an investment by a non-resident entity/person resident outside India in the capital (i.e. equity shares, and fully, compulsorily and mandatorily convertible preference shares/debentures and warrants) of an Indian company. **Person** includes an individual, a Hindu Undivided Family, company, firm, an association of persons/body of individuals, whether incorporated or not, every artificial judicial person and any agency/office/branch owned or controlled by such person. As a cross border investment by a resident in one economy in an enterprise that is resident in an economy other than that of the investor, the motivation is a strategic long-term relationship with the concerned enterprise to ensure a significant degree of influence in its management. The policy of the Government of India is to attract/promote productive **FDI** in activities which significantly contribute to industrialisation and socio-economic development. The **FDI** supplements the domestic capital and technology. It is sought to be promoted through a transparent, predictable, simple and clear policy framework and reduced regulatory burden. The regulatory framework consists of the Foreign Exchange Management Act (**FEMA**) and its various regulations, press notes/releases/clarifications by the Government/RBI. The main elements of the current policy framework on **FDI** are: **(i)** general conditions on FDI **(ii)** for FIPB, and **(iii)** sector-specific conditions on FDI. The FIPB (Foreign Investment Promotion Board) has been abolished since June 2017. Its powers/functions have now been transferred to the concerned Ministries of the Government of India. **These are portrayed in Exhibit 18.1** and elaborated in Sections 1–2 of the Chapter. The last Section contains some concluding observations.

Exhibit 18.1 FDI Policy



GENERAL CONDITIONS ON FDI

The general conditions on FDI are: **(i)** eligible investors, **(ii)** eligible investor entities, **(iii)** instruments of investments/issue/transfer of shares, **(iv)** entry routes of investments, **(v)** caps on investments, **(vi)** entry conditions, **(vii)** other conditions, **(viii)** foreign investment into downstream investment and **(ix)** remittances, reporting and violation.

Eligible Investors

The eligible foreign investors in Indian companies are: **(i)** persons resident outside India (non-resident entity), **(ii)** NRIs/PIOs, **(iii)** company/trust/LLP incorporated outside India, **(iv)** FIIs/FPIs, and **(v)** FVCI.

A **non-resident entity** (i.e., a person resident outside India) can invest in India, subject to the FDI Policy except in those sectors/activities which are prohibited. However, a citizen of, an entity incorporated in, Bangladesh can invest only under the **Government route**. A citizen of, an entity incorporated in Pakistan, can invest only under the Government route, in sectors/activities other than defence, space and atomic energy and sectors/activities prohibited for foreign investment. The **NRIs** [i.e. a citizen/overseas citizen of India/person of Indian origin (PIO)] resident in Nepal and Bhutan as well as citizens of Nepal and Bhutan are permitted to invest in the capital of Indian companies on **repatriation basis**, subject to the condition that the amount of consideration for the investment would be paid only by way of inward remittance in free foreign exchange through normal banking channels. **PIO** means a citizen of any country other than Bangladesh/Pakistan if **(i)** he at any time held Indian passport **(ii)** he/parents/grandparents was a citizen of India, **(iii)** the person is spouse of an Indian citizen or a person in **(i)** and **(ii).**

A company/trust/limited liability partnership (**LLP**) firm incorporated outside India and owned and controlled by NRIs can invest in India with the special dispensation available to them under the FDI policy. A company/LLP is considered **owned** if at least 50 per cent of its capital/investment is beneficially owned/contributed by resident Indian citizens/companies/entities which are ultimately owned and controlled by resident Indian citizens/have majority of the profit share. **Control** includes the right to appoint a majority of the directors/partners, control the management/policy decisions. A **person resident in India** means any person **(i)** residing in India for at least 182 days during the preceding financial year or a body corporate, **(ii)** registered/incorporated in India, **(iii)** an office/branch/agency in India owned/controlled by a person resident outside India/an office/branch/agency outside India owned/controlled by a person resident in India.

A Foreign Institutional Investor (FII)/Foreign Portfolio Investor (FPI) may invest in the capital of an Indian company under the portfolio investment scheme which limits their individual holding below 10 per cent and the aggregate limit to 24 per cent of the capital of the company. This aggregate limit can be increased to the sectoral cap/statutory ceiling through a resolution by its Board of Directors followed by a special resolution to that effect by its general body and subject to prior intimation to the RBI. The aggregate FII/FPI investment, individually or in conjunction with other kinds of foreign investment, should not exceed sectoral/statutory cap. An Indian company which has issued shares to FIIs/FPIs under the FDI policy for which the payment has been received directly into its account should report these figures separately. A daily statement in respect of all transactions (except derivative trade) has to be submitted by the custodian bank in soft copy in the prescribed format directly to RBI/uploaded on the website.

Only registered FIIs/FPIs and NRIs can invest/trade through a registered broker in the capital of Indian companies on recognised Indian stock exchanges. A SEBI-registered foreign venture capital investor (FVCI) may contribute up to 100 per cent of the capital of an Indian company engaged in any activity, including startups, irrespective of the sector in which it is engaged, under the **automatic route**. It can invest in a domestic venture capital fund/a Category- I alternative investment fund. They would also be subject to the applicable FEMA regulations and FDI policy including sectoral caps, etc. The investment can be made in equities or equity-linked/debt instruments issued by the company (including start-ups and if a startup is organised as a partnership firm or an LLP, the investment can be made in the capital or through any profit-sharing arrangement) or units issued by a VCF or by a Category-I AIF either through purchase by private arrangement either from the issuer of the security or from any other person holding the security or on a recognised stock exchange. It may also set up a domestic asset management company to manage its investments. The FVCIs are also allowed to invest, as non-resident entities, in other companies, subject to FDI Policy and FEMA regulations. A **VCF** means an **AIF** which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertaking mainly involved in new products/services, technology/intellectual property right-based activities or a new business model including angel funds. **Indian venture capital undertaking (IVCU)** means an Indian company **(i)** whose shares are not listed, **(ii)** which is engaged in the business of providing services/production/manufacture of articles/things excluding these activities/sectors specified in the negative list by the SEBI.

A NRI may subscribe to national pension system governed and administered by the Pension Fund Regulatory and Development Authority (PFRDA), provided the subscriptions are made through normal banking channels and the person is eligible to invest as per the provisions of the PFRDA Act. The annuity/ accumulated saving will be **repatriable**, that is, the sale proceeds net of taxes can be repatriated out of India.

Eligible Investee Entities

The eligible investee entities are: **(i)** Indian company, **(ii)** partnership firms/proprietary concerns, **(iii)** trusts, **(iv)** LLPs, **(v)** investment vehicles.

FDI in an Indian Company Indian companies can issue capital against the FDI.

FDI in Partnership Firm/Proprietary Concern A NRI/PIO resident outside India can invest in the capital of a firm or a proprietary concern in India on **non-repatriation basis** provided the **(a)** amount is invested by inward remittance or out of NRE/FCNR(B)/NRO account maintained with authorised dealers/banks and would not be eligible for repatriation outside India, **(b)** firm/ proprietary concern is not engaged in agricultural/plantation/real estate business/print media sector. They may seek prior permission of the RBI for investment with repatriation option. A person resident outside India other than NRIs/PIOs would require prior approval of the RBI for making investment in the capital of a firm or a proprietorship concern or any association of persons in India.

FDI in Trusts The FDI is not permitted in trusts other than in 'VCF' registered and regulated by the SEBI and **investment vehicle**, that is, an entity registered/regulated by the SEBI/other designated authority including real estate investment trusts, infrastructure investment trusts and AIFS (alternative investment funds).

FDI in Limited Liability Partnerships (LLPs) The FDI in LLPs is permitted under the automatic route operating in sectors/activities where 100 per cent FDI is allowed and there are no FDI-linked performance conditions.

An Indian company/LLP, having foreign investment, is also permitted to make **downstream investment** in another company or LLP in sectors in which 100 per cent FDI is allowed under the automatic route and there are no FDI-linked performance conditions.

Investment Vehicle An investment vehicle is permitted to receive foreign investment from a person resident outside India (other than an individual who is citizen of or any other entity which is registered/incorporated in Pakistan or Bangladesh), including registered foreign portfolio investor (RFPI) or NRI.

Instruments of Investments, Issue/Transfer of Shares

The main elements are: **(i)** types of instruments for investment, **(ii)** provisions relating to issue/ transfer of shares and **(iii)** other specific conditions of compliance for certain cases.

Types of Instruments Included in the instruments of investment are equity shares, fully/ compulsorily/mandatorily convertible debentures/preference share, warrants, FCCBs, ADRs/ GDRS.

Indian companies can issue equity shares, fully, compulsorily and mandatorily convertible debentures/preference shares subject to the pricing guidelines/valuation norms prescribed under the FEMA Regulations. The price/conversion formula of convertible capital instruments should be determined upfront at the time of their issue. It should not in any case be lower than the **fair value**, at the time of their issuance in accordance with the applicable regulations. Optionality clauses are allowed subject to a minimum lock-in period of one year effective from the date of their allotment. After the lock-in period and subject to FDI policy provisions, the non-resident investor would be eligible to exit without any assured return.

Other types of preference shares/debentures, that is, non-convertible optionally/partially convertible are considered as debt. Accordingly, all norms applicable for ECBs (external commercial borrowings) relating to eligible borrowers, recognised lenders, amount and maturity, end-use stipulations would apply. The inward remittance received by the Indian company vide issuance of the DRs (depository receipts) and FCCBs (foreign currency convertible bonds) are treated and counted towards FDI.

Acquisition of Warrants and Partly Paid Shares An Indian company may issue warrants and partly-paid shares to a person resident outside India subject to the terms and conditions as stipulated by the RBI.

Issue of Foreign Currency Convertible Bonds (FCCBs) and Depository Receipts (DRs) The FCCBs/DRs may be issued in accordance with the Scheme for Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme and DR Scheme 2014 respectively (**detailed in Chapter 19**).

Two-way Fungibility Scheme A limited two-way fungibility scheme has been put in place by the Government for ADRs/GDRs under which a SEBI-registered stock broker in India can purchase shares of an Indian company from the market for conversion into ADRs/GDRs based on instructions received from the overseas investors. Their issuance would be permitted to the extent to which they have been redeemed into underlying shares and sold in the Indian market. An Indian company can also sponsor an issue of ADR (American Depository Receipt)/GDR (Global Depository Receipt) and offers its resident shareholders a choice to submit their shares back to the company so that on that basis, ADRs/GDRs can be issued abroad. The proceeds are remitted back to India and distributed among the resident investors who had offered their rupee denominated shares for conversion. These proceeds can be kept in resident foreign currency (domestic) accounts.

Provisions Relating to Issue/ Transfer of Shares Included in the provisions are issued procedure/ issue price, transfer of shares and convertible debentures, RBI's permission, and conversion FCB/royalty/lump sum into equity.

The capital instruments should be issued within 180 days from the date of receipt of the inward remittance received through normal banking channels including escrow account opened and maintained for the purpose or by debit to the NRE/FCNR (B) account of the non-resident investor, failing which the amount of consideration should be refunded immediately. Non-compliance would be reckoned as a contravention under the FEMA and attract penal provisions.

Issue Price of Shares Price of shares issued to persons resident outside India under the FDI policy, should not be less than the **(a)** price worked out in accordance with the applicable SEBI guidelines in case of listed shares, **(b)** fair valuation of shares done by a SEBI-registered merchant banker or a chartered accountant as per any internationally accepted pricing methodology on arm's length basis in case of unlisted shares, and **(c)** price applicable to transfer of shares from resident to non-resident as per the pricing guidelines laid down by the RBI, where the issue of shares is on preferential allotment. However, investments in an Indian company, in compliance with the provisions of the Companies Act, by way of subscription to its memorandum of association, may be made at **face value** subject to their eligibility to invest under the FDI scheme.

Transfer of Shares and Convertible Debentures Subject to the FDI sectoral policy (relating to sectoral caps and entry routes), the applicable laws and other conditionalities including security conditions, the non-resident investors can also invest in Indian companies by purchasing/acquiring existing shares from Indian/other non-resident shareholders subject to the stipulated conditions. A person resident outside India, other than NRI, may transfer by way of sale or gift, the shares/convertible debentures to any person resident outside India including NRIs without Government approval in sectors which are under the automatic route. The NRIs may transfer by way of sale or gift the shares or convertible debentures held by them to another NRI. A person resident outside India can transfer any security to a person resident in India by way of gift. He can sell the listed shares and convertible debentures through a SEBI-registered stock broker/merchant banker. Transfer of shares/convertible debentures, by way of sale under private arrangement by a person resident outside India to a person resident in India are also permitted.

Prior Permission of RBI The following cases require prior approval of the RBI: **(i)** Transfer of capital instruments from resident to non-residents by way of sale where it: **(a)** is at a price which falls outside the pricing guidelines specified by the RBI, **(b)** involves deferment of payment of the amount of considerations; **(ii)** Transfer of any capital instrument, by way of gift by a person resident in India to a person resident outside India, if the: **(a)** proposed transferee (donee) is eligible to hold them, **(b)** gift does not exceed 5 per cent of the paid-up capital/each series of debentures/each mutual fund scheme, **(c)** applicable sectoral cap limit is not breached, **(d)** transferor (donor) and the proposed transferee (donee) are close relatives, **(e)** value of capital instruments to be transferred together with any already transferred by the transferor, as gift, to any person residing outside India does not exceed the rupee equivalent of USD 50,000 during the financial year; **(iii)** Transfer of shares from NRI to non-resident.

Conversion of ECB/Lump Sum Fee/Royalty into Equity Indian companies are permitted to convert external commercial borrowings (ECB) (excluding those deemed as ECB) in convertible foreign currency into equity shares/fully compulsorily and mandatorily convertible preference shares, subject to the following conditions and reporting requirements: **(a)** the activity of the company is covered under the automatic route for FDI or it has obtained Government approval for foreign equity in the company, **(b)** the foreign equity after conversion of ECB into equity is within the sectoral cap, **(c)** pricing of shares is as per the applicable provision, **(d)** compliance with the requirements prescribed under any other statute and regulation in force; and **(e)** the conversion facility is available for ECBs availed under the automatic or Government route and is applicable to ECBs, due for payment or not, as well as secured/unsecured loans availed from non-resident collaborators.

The companies are also permitted to issue shares/preference shares against lump sum technical know-how fee, royalty due for payment, subject to entry route/sectoral cap and pricing guidelines and compliance with the applicable tax laws. Further, issue of equity shares against any other funds payable by the investee company, remittance of which does not require prior permission of the Government/RBI provided that: **(i)** they would be issued in accordance with the FDI guidelines on sectoral caps, pricing guidelines etc., **(ii)** the issue would be subject to tax laws as applicable to the funds payable and the conversion to equity should be net of applicable taxes.

The issue of equity shares under the FDI policy is allowed under the Government route for the following: **(i)** import of capital goods/ machinery/ equipment (excluding second-hand machinery), subject to compliance with the following conditions: **(a)** any import of capital goods/ machinery has to be in accordance with the export/import policy of the Government, **(b)** the application clearly indicating the beneficial ownership and identity of the importer company as well as the overseas entity, and **(c)** applications complete in all respects, for conversions of import payables for capital goods into FDI being made within 180 days from the date of shipment of goods; **(ii)** pre-operative/pre-incorporation expenses (including payments of rent etc.), subject to compliance with the following conditions: **(a)** submission of FIRC for remittance of funds by the overseas promoters for the expenditure incurred, **(b)** verification and certification of the pre-incorporation/pre-operative expenses by the statutory auditor, **(c)** payments should be made by the foreign investor to the company directly or through the bank account as provided under FEMA regulations, and **(d)** the applications, complete in all respects, for capitalisation being made within 180 days from the date of incorporation of the company. All requests for conversion should be accompanied by a special resolution of the company. The Government's approval would be subject to the pricing guidelines of the RBI and appropriate tax clearance.

Specific Conditions in Certain Cases The specific conditions relates to **(i)** issue of rights/bonus shares, **(ii)** additional allocation of rights shares, **(iii)** acquisition of shares under scheme of merger/demerger/amalgamation, **(iv)** issue of ESOP, **(v)** pledge of shares, and **(vi)** share swap.

Issue of Rights/Bonus Shares Indian companies can freely issue rights/bonus shares to the existing non-resident shareholders, subject to adherence to the sectoral cap. However, it has to be in accordance with other laws/statutes like the Companies Act/SEBI ICDR Regulations in case of listed companies and so on. The offer on right basis to the persons resident outside India should be in the case of shares of a company **(a)** listed in India, at a price as determined by the company, **(b)** not listed, at price not below the price at which the offer is made to the resident shareholders.

Additional/Allocation of Rights Share by Residents to Non-residents The existing non-resident shareholders are allowed to apply for issue of additional shares, fully/compulsorily and mandatorily convertible debentures/preference shares over and above their rights share entitlements. The investee company can allot them out of unsubscribed portion, subject to the condition that the overall issue of shares to non-residents in the total paid-up capital of the company does not exceed the sectoral cap.

Acquisition of Shares Under Scheme of Merger/Demerger/Amalgamation The mergers/demergers/ amalgamations of companies in India are usually governed by an order issued by a competent court on the basis of the scheme submitted by the concerned companies. Once the scheme has been approved by a court in India, the transferee/new company is allowed to issue shares to the shareholders of the transferor company resident outside India, subject to the conditions that: **(i)** their percentage of shareholding does not exceed the sectoral cap, and **(ii)** the transferor/ transferee/new company is not engaged in activities which are prohibited under the FDI policy.

The FIPB approval would not be required in case of mergers and acquisitions taking place in sectors under automatic route.

Indian companies can also issue non-convertible/redeemable preference shares/debentures to non-resident shareholders, including the depositories that act as trustees for the ADR/GDR holders, by way of distribution as bonus from its general reserves under a scheme of arrangement approved by a court in India under the provisions of the Companies Act, subject to no-objection from the Income-tax authorities.

Issue of Employees Stock Option Scheme (ESOPs)/Sweat Equity The **sweat equity shares** mean equity shares issued by a company to its directors/employees at a discount or for consideration other than cash for providing know-how/making available rights in the nature of property rights/value additions. An Indian company may issue employees' stock option and/or sweat equity shares to its employees/directors or employees/directors of its holding company or joint venture or wholly owned overseas subsidiary(ies) who are resident outside India, provided the: **(a)** scheme has been drawn either in terms of regulations issued under the SEBI/Companies Act, **(b)** applicable rules/regulations are in compliance with the sectoral cap applicable to the company, **(c)** issue where foreign investment is under the approval route/to a citizen of Bangladesh/Pakistan, would require prior approval of the Foreign Investment Promotion Board (FIPB) (**discussed later**).

Share Swap In cases of investment by way of swap of shares, irrespective of the amount, their valuation will have to be made by a SEBI-registered merchant banker or an investment banker outside India registered with the appropriate regulatory authority in the host country. The approval of the Government will also be a prerequisite for investment by swap of shares for sectors under the Government approval route.

Pledge of Shares A person/promoter of a company registered in India (borrowing company), which has raised external commercial borrowings, may pledge its shares or that of its associate resident companies for securing the ECB raised with a no objection from a bank which is an authorised dealer. It should issue the no objection after having satisfied itself that the ECB is in line with the FEMA regulations for ECBs and that: **(i)** the loan agreement has been signed by both the lender and the borrower, **(ii)** there exists a security clause in the loan agreement requiring the borrower to create charge on financial securities, and **(iii)** the borrower has obtained a loan registration number from the RBI and the pledge would be subject to the following conditions: **(a)** the period would be co-terminus with the maturity of the underlying ECB, **(b)** in case of invocation of pledge, the transfer would be in accordance with the FDI policy and directions issued by the RBI, **(c)** the statutory auditor has certified that the proceeds of the ECB would be utilised for the permitted end-use(s) only.

The non-residents holding shares of an Indian company can pledge them in favour of the **AD bank** authorised to undertake all current/capital account transactions according to the RBI directions in India to secure credit facilities being extended to the resident investee company for bonafide business purpose, subject to the following conditions: **(i)** in case of invocation of pledge, transfer of shares should be in accordance with the FDI policy in vogue at the time of creation of pledge, **(ii)** submission of a declaration/annual certificate from the statutory auditor of the investee company that the loan proceeds will be/have been utilised for the declared purpose, **(iii)** it has to follow the relevant SEBI disclosure norms, and **(iv)** pledge of shares in favour of the lender (bank) would be subject to the Banking Regulation Act. They can also pledge these shares in favour of an overseas bank to secure the credit facilities being extended to the non-resident investor/non-resident promoter of the Indian company or its overseas **group company** (i.e. two/more enterprises which directly/indirectly are in a position to **(1)** exercise at least 26 per cent of voting rights, **(2)** appoint more than 50 per cent of the Board of Directors in the other enterprise) subject to the following: **(i)** loan is **(a)** availed of only from an overseas bank, **(b)** utilised for genuine business purposes overseas and not for any investments either directly or indirectly in India, **(ii)** overseas investment should not result in any capital inflow into India, **(iii)** in case of invocation of pledge, transfer should be in accordance with the FDI policy in vogue at the time of creation of pledge, and **(iv)** submission of a declaration/annual certificate from a chartered accountant/certified public accountant of the non-resident borrower that the loan proceeds will be/have been utilised for the declared purpose.

Entry Routes for Investment

Investments can be made by non-residents in the equity shares, fully, compulsorily and mandatorily convertible debentures/preference shares of an Indian company, through the **automatic route** or the **Government route**. Under the automatic route, the non-resident investor/Indian company does not require any approval from Government of India for the investment. Under the Government route, prior approval of the Government of India is required. The proposals for foreign investment under Government route, which were considered by the FIPB would now be considered by the concerned Ministry.

The foreign investment in sectors/activities will be subject to Government approval where:

- Indian company is being established with foreign investment and is not owned/controlled by a resident entity;
- The control/ownership of an existing Indian company, currently owned or controlled by resident Indian citizens/Indian companies, which are owned/controlled by resident Indian citizens, will be/is being transferred/passed on to a non-resident entity as a consequence of transfer of and/or fresh issue of shares to non-resident entities through amalgamation, merger/demerger, acquisition and so on. Foreign investment would include all types of foreign investments, direct and indirect. The FCCBs and DRs having underlying of instruments being in the nature of debt, would not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from conversion of any debt instrument under any arrangement should be reckoned as foreign investment;
- Investment by NRIs will be deemed to be domestic investment at par with the investment made by residents;
- A company/trust/partnership firm incorporated outside India and owned and controlled by non-resident Indians will be eligible for investments and will also be deemed domestic investment at par with the investment made by residents.

Caps on Investments

Investments can be made by non-residents in the capital of a resident entity only to the extent of the percentage of the total capital as specified in the FDI policy **[detailed in the subsequent Section of this Chapter]**.

Entry Conditions on Investment

Investments by non-residents can be permitted in the capital of a resident entity in certain sectors/activity with entry conditions. Such conditions may include norms for minimum capitalisation, lock-in period and so on. **They are detailed in the next Section of this Chapter**.

Other Conditions on Investment Besides Entry Conditions

Besides the entry conditions on foreign investment, the investment/investors are required to comply with all the relevant sectoral laws/regulations/rules/security conditions, and state/local laws/regulations.

Foreign Investment Into/Downstream Investment by Eligible Indian Entities

The guidelines relate to calculation of total foreign investment, both direct and indirect in an Indian company/LLP, at every stage of investment, including **downstream investment** (i.e. indirect foreign investment by an eligible Indian entity into another Indian company/LLP by way of subscription/acquisition).

Total (Direct and Indirect) Foreign Investment Investment in an eligible Indian entity can be made both by non-resident as well as resident Indian entities. Any non-resident investment is **direct foreign investment**. Investment by resident Indian entities could comprise of both resident and non-resident investment. Thus, an Indian company would have indirect foreign investment if the Indian investing company has foreign investment in it. The indirect investment can also be a cascading investment, that is, through multi-layered structure. The indirect foreign investment in an Indian company would include all types of foreign investments, namely, FDI, investment by FIIs/FPIs/NRIs/ADRs/GDRs/FCCBs/investment vehicles fully, compulsorily and mandatorily convertible preference shares/debentures or units of an investment vehicle.

Guidelines for Calculation of Total Foreign Investment All investment directly by a non-resident entity into the Indian company/LLP would be counted towards foreign investment. The foreign investment through the investing Indian company/LLP would not be considered as indirect foreign investment in case of its being **owned and controlled** by resident Indian citizens/companies/LLPs which are owned and controlled by resident Indian citizens. The downstream investment by an investment vehicle would be regarded as foreign investment if the sponsor/manager/investment manager is not Indian 'owned and controlled'. Where the above condition is not satisfied or if the investing company is owned **or** controlled by 'non-resident entities', the entire investment by the investing company/LLP into the subject Indian company would be considered as indirect foreign investment, provided that, as an exception, the indirect foreign investment in only the 100 per cent owned subsidiaries of operating-cum-investing/investing companies, will be limited to the foreign investment in the operating-cum-investing/investing company.

Illustration To illustrate, if the indirect foreign investment is being calculated for Company X which has investment through an investing Company Y having foreign investment, the following would be the method of calculation:

(A) Where Company Y has foreign investment less than 50 per cent: Company X would not be taken as having any indirect foreign investment through Company Y.

(B) Where Company Y has foreign investment of, say, 75 per cent and:

(I) invests 26 per cent in Company X, the entire 26 per cent investment by Company Y would be treated as indirect foreign investment in Company X;

(II) invests 80 per cent in Company X, the indirect foreign investment in Company X would be taken as 80 per cent;

(III) Where Company X is a wholly owned subsidiary of Company Y (i.e. Company Y owns 100 per cent shares of Company X), then only 75 per cent would be treated as indirect foreign equity and the balance 25 per cent would be treated as resident held equity. The indirect foreign equity in Company X would be computed in the ratio of 75 : 25 in the total investment of Company Y in Company X.

The total foreign investment would be the sum total of direct and indirect foreign investment. The above methodology of calculation would apply at every stage of investment in Indian companies and thus to each and every Indian company.

Additional Conditions The full details about the foreign investment including ownership details and information about the control of the Indian company(ies) would be furnished to the Government at the time of seeking approval. In any sector/activity, where Government approval is required and in cases where there are any *inter-se* agreements between/amongst shareholders which have an effect on the appointment of the Board of Directors or on the exercise of voting rights or of creating voting rights disproportionate to shareholding or any incidental matter thereof, they will have to be informed to the approving authority, which will consider them for determining ownership and control when considering the case for approval of foreign investment. In all sectors attracting sectoral caps, the balance equity, that is, beyond the sectoral foreign investment cap, would specifically be beneficially owned by/held with/in the hands of resident Indian citizens/companies, owned and controlled by resident Indian citizens. In the Information and Broadcasting sector where the sectoral cap is upto 49 per cent, the company would need to be 'owned **and** controlled' by resident Indian citizens/companies, which are owned and controlled by resident Indian citizens. The equity held by the largest Indian shareholder would have to be at least 51 per cent of the total equity, excluding the equity held by public sector banks/ financial institutions. The term **largest Indian shareholder** will include any or a combination of the following: **(1)** In the case of an individual shareholder, **(i)** the individual shareholder, **(ii)** a relative of the shareholder, **(iii)** a company/group of companies in which the individual shareholder/HUF to which he belongs has management and controlling interest; **(2)** In the case of an Indian company, **(i)** the Indian company, **(ii)** a group of Indian companies under the same management and ownership control. **Indian company** means a company which must have a resident Indian or a relative/HUF, either singly or in combination, holding at least 51 per cent of the shares. Each of the above parties should enter into a legally binding agreement to act as a single unit in managing the matters of the applicant company.

The above mentioned policy/methodology would be applicable for determining the total foreign investment in all sectors, except where it is specified in a statute/rule. It, therefore, does not apply to the insurance sector. Similarly, it will also not apply to downstream investments by an investment vehicle. It would be regarded as foreign investment if either its sponsor/manager/ investment manager is not Indian 'owned and controlled'. If reckoned as foreign investment, it will have to conform to the sectoral caps and conditions/restrictionsas applicable to the company in which the downstream investment is made as per the FDI policy. It will be required to make a report and in a format prescribed by RBI/SEBI.

Foreign Investment into an Indian Company Engaged only in the Activity of Investing in the Capital of Other Indian company(ies) (Regardless of its Ownership or Control): Foreign investment into an Indian company, engaged only in investing in the capital of other Indian company(ies)/ LLP, will require prior Government/FIPB approval, regardless of its amount/extent. The core investment companies (CICs), will have to additionally follow the RBI's regulatory framework. For undertaking activities which are under automatic route and without foreign investment-linked performance conditions, an Indian company which does not have any operations and also does not have any downstream investments, will be permitted to have infusion of foreign investment under automatic route. However approval of the Government will be required for infusion of foreign investment for undertaking activities which are under Government route. Further, as and when it commences business(es)/makes downstream investment, it will have to comply with the relevant sectoral conditions on entry route, conditionalities and caps.

Downstream Investment by an Eligible Indian Entity Which is Not Owned and/or Controlled by Resident Entity(ies) The downstream investment by an eligible Indian entity, which is not owned and/ or controlled by resident entity(ies), into another Indian company, would be in accordance/ compliance with the relevant sectoral conditions on entry route, conditionalities and caps, with regard to the sectors in which the latter Indian company is operating. The eligible Indian entities/ LLPs will have to notify the SIA/DIPP/FIPB of its downstream investment in within 30 days, even if capital instruments have not been allotted along with the modality of investment in new/ existing ventures. The downstream investment by way of induction of foreign investment in an existing Indian company should be duly supported by a resolution of the Board of Directors as also a shareholders agreement. Issue/transfer/pricing/valuation of capital should be in accordance with applicable SEBI/RBI guidelines. The eligible Indian entities would have to bring in requisite funds from abroad and not leverage funds from the domestic market. This would, however, not preclude downstream companies/LLPs, with operations, from raising debt in the domestic market. Downstream investments through internal accruals (i.e. after-tax profits transferred to reserve account) are permissible.

Remittance, Reporting and Violation

The main elements are **(i)** remittance and repatriation, **(ii)** reporting of FDI, and **(iii)** penalties.

Remittance and Repatriation: ***Remittance of Sale Proceeds/Remittance on Winding Up/Liquidation of Companies*** Sale proceeds of shares and securities and their remittance is "remittance of assets" governed by the FEMA regulations. **AD Category-I** bank can allow the remittance of sale proceeds of a security (net of applicable taxes) to the seller of shares resident outside India, provided the **(i)** security has been held on **repatriation basis**, **(ii)** sale of security has been made in accordance with the prescribed guidelines and **(iii)** no objection certificate (NOC)/tax clearance certificate from the Income-tax department has been produced.

Remittance on Winding Up/Liquidation of Companies: AD Category-I banks have been allowed to remit winding-up proceeds of companies in India, which are under liquidation, subject to payment of applicable taxes. Liquidation may be subject to any order issued by the court winding up the company or the official liquidator in case of voluntary winding up under the provisions of the Companies Act. The remittance would be allowed provided the applicant submits: **(a)** No objection or tax clearance certificate from Income-tax department for the remittance, **(b)** Auditor's certificate **(i)** confirming that all liabilities in India have been either fully paid or adequately provided for, **(ii)** to the effect that the winding up is in accordance with the provisions of the Companies Act, and **(iii)** In case of winding up of otherwise than by a court, there are no legal proceedings pending in any court in India against the applicant or the company under liquidation and there is no legal impediment in permitting the remittance.

Repatriation of Dividend and Interest Dividends and interest are freely repatriable without any restrictions (net after tax deduction at source or dividend distribution tax).

Reporting of FDI: ***Reporting of Inflow*** Indian company(s) receiving investment from outside India for issuing shares/convertible debentures/preference shares under the FDI scheme, should report the details of the amount of consideration to the RBI not later than 30 days from the date of receipt.

Reporting of Issue of Shares After issue of shares (including bonus sand shares issued on rights basis and shares issued under ESOP)/fully, mandatorily and compulsorily convertible debentures/preference shares, the Indian company has to file the report not later than 30 days from the date of their issue. The following documents have to be submitted: **(a)** A certificate from the company secretary certifying that: **(1)** all the requirements of the Companies Act, and terms and conditions of the Government's approval, have been complied with; **(2)** The company is eligible to issue shares under these regulations; and it has all original certificates issued by authorised dealers in India evidencing receipt of amount of consideration. For companies with paid-up capital of less than ₹5 crore, the above mentioned certificate can be given by a practicing company secretary: **(b)** A certificate from statutory auditor or chartered accountant indicating the manner of arriving at the price of the shares issued to the persons resident outside India, **(c)** The report of receipt of considerations and required report have to be submitted by the AD category-I bank to the RBI, **(d)** The report should be filed on an annual basis by the Indian company, directly with the RBI. This is an annual return pertaining to all investments by way of direct/portfolio investments/ reinvested earnings/other capital in the Indian company made during the previous years. The details of the investments to be reported would include all foreign investments made into the company which is outstanding as on the balance sheet date. The details of overseas investments in the company both under direct/portfolio investment may be separately indicated, and **(e)** Issue of bonus/rights shares or stock options to persons resident outside India directly or on amalgamation/merger/demerger with an existing Indian company, as well as issue of shares on conversion of ECB/royalty/lump sum technical know-how fee/import of capital goods by units in SEZs has to be reported.

Reporting of Transfer of Shares Reporting of transfer of shares between resident and non-residents and *vice versa* should be submitted to the AD Category-I bank, within 60 days from the date of receipt of the amount of consideration. The onus of submission within the given time frame would be on the transferor/transferee, resident in India. The AD Category-I bank, would forward the same to its link office which would consolidate and submit a monthly report to the RBI.

Reporting of Non-Cash Share Details of issue of shares against conversion of ECB has to be reported to the RBI: **(i)** In case of full conversion of ECB into equity, the company should report the conversion to the RBI, within seven working days from the close of month to which it relates, **(ii)** In case of partial conversion of ECB, the company should report the converted portion clearly differentiating the converted portion from the non-converted portion. In the subsequent months, the outstanding balance of the ECB should be reported.

Reporting of FCCB/ADR/GDR Issues The Indian company issuing ADRs/GDRs has to furnish to the RBI, full details of such issue in the prescribed form, within 30 days from the date of its closing. It should also furnish a quarterly return in the prescribed form within 15 days of the close of the calendar quarter. The quarterly return has to be submitted till the entire amount raised through ADR/GDR mechanism is either repatriated to India or utilised abroad as per the RBI guidelines.

Adherence to Guidelines/Orders and Consequences of Violation The FDI is a capital account transaction and, thus, any violation of its regulations are covered by the penal provisions of the FEMA. The RBI administers the FEMA and Directorate of Enforcement under the Ministry of Finance is the authority for the enforcement of FEMA. The Directorate takes up investigation in any contravention of FEMA.

Penalties If a person violates/contravenes any FDI regulations, by way of breach/non-adherence/non-compliance/contravention of any rule, regulation, notification, press note/release, circular, direction or order issued in exercise of the powers under FEMA or contravenes any conditions subject to which an authorisation is issued by the Government of India/FIPB/RBI, he would, upon adjudication, be liable to a penalty up to thrice the sum involved in such contravention where such amount is quantifiable, or up to two lakh rupees where the amount is not quantifiable, and where such contravention is a continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues.

Where a person committing a contravention of any provisions of FEMA/any rule, direction or order is a **company** (company means any body corporate and includes a firm or other association of individuals as defined in the Companies Act), every person who, at the time the contravention was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company as well as the company, would be deemed to be guilty of the contravention and would be liable to be proceeded against and punished accordingly.

Any adjudicating authority adjudicating any contravention may, if he thinks fit in addition to any penalty which he may impose for such contravention, direct that any currency, security or any other money or property in respect of which the contravention has taken place should be confiscated by the Central Government.

Adjudication and Appeals For the purpose of adjudication of any contravention of FEMA, the Ministry of Finance appoints officers of the Central Government as the Adjudicating Authorities for holding an enquiry in the prescribed manner. A reasonable opportunity has to given to the person alleged to have committed contravention against whom a complaint has been made for being heard before imposing any penalty. The Central Government may appoint an appealing authority/appellate tribunal to hear appeals against the orders of the adjudicating authority.

Compounding Proceedings The Central Government may appoint "Compounding Authority" an officer either from Enforcement Directorate or RBI for any person contravening any provisions of the FEMA. The compounding authorities are authorised to compound the amount involved in the contravention to the FEMA made by the person. No contravention would be compounded unless the amount involved in such contravention is quantifiable. Any second or subsequent contravention committed after the expiry of a period of three years from the date on which the contravention was previously compounded would be deemed to be a first contravention. The compounding authority may call for any information, record or any other documents relevant to the compounding proceedings. The compounding authority should pass an order of compounding after affording an opportunity of being heard to all the concerned as expeditiously and not later than 180 days from the date of application made to it. It should issue order specifying the provisions of the FEMA or of the rules, directions, requisitions or orders made in respect of which contravention has taken place along with details of the alleged contraventions.

SECTOR SPECIFIC CONDITIONS ON FDI

The sector specific conditions or FDI relate to **(i)** prohibited sectors and, **(ii)** permitted sectors.

Prohibited Sectors

FDI is prohibited in the following activities/sectors: **(a)** Lottery business including Government/private lottery, online lotteries, etc., **(b)** Gambling and betting including casinos, etc. **(c)** Chit fund, **(d)** Nidhi company, **(e)** Trading in transferable development rights (TDRs), **(f**) Real estate business or construction of farm houses, **(g)** Manufacturing of cigars, cheroots, cigarillos and cigarettes of tobacco/tobacco substitutes, **(h)** Activities/sectors not opened to private sector investment, for example, atomic energy and railway operations (other than permitted activities).

Transferable development rights means certificates issued in respect of category of land acquired for public purposes by the Government in consideration of surrender of land by the owner without monetary compensation which are transferable in part/whole. Foreign technology collaboration in any form including licensing for franchise, trademark, brand name, management contract is also completely prohibited for lottery business and gambling and betting activities. Real estate business would not include development of township, construction of residential/commercial premises, roads/bridges and SEBI-registered real estate investment trusts (REITs).

Permitted Sectors

The FDI upto the limit indicated against each sector/activity is allowed, subject to applicable laws/regulations, security and other conditionalities. **It is permitted up to 100 per cent, on the automatic route, in other sectors/activities not listed below.**

The requirement of minimum capitalisation would include share premium when received by the company upon shares issued to the non-resident investor. The **sectoral cap**, that is, the maximum amount which can be invested by foreign investors in an entity, is composite and includes all types of direct/indirect investments, namely, FDI, FII/FPI, NRI, FVCI, LLPs, DRs and investment vehicles. The FCCBs/DRs, being in the nature of debt, would be excluded. Any equity holding resulting from conversion of debt instruments would, however, be included.

Foreign investments in sectors under **(i)** Government approval route, **(ii)** automatic route resulting in transfer of ownership to non-resident entities would be subject to Government approval and compliance of the sectoral conditionalities respectively. Portfolio investment upto 49 per cent of the aggregate investment or sectoral/statutory cap whichever is lower would be exempt if it does not result in transfer of ownership and/or control.

The onus of compliance of these provisions would be on the investee company.

1. Agriculture and Animal Husbandry (100 per cent automatic route): **(a)** Floriculture, horticulture, agriculture and cultivation of vegetables and mushrooms under controlled conditions; **(b)** Development and production of seeds and planting material; **(c)** Animal husbandry (including breeding of dogs), pisciculture, aquaculture, under controlled conditions; and **(d)** Services related to agro and allied sectors. The FDI is not allowed in any other agriculture sector/activity.

The term '**under controlled conditions**' covers the following: **(a)** For floriculture, horticulture, cultivation of vegetables and mushrooms is the practice of cultivation wherein rainfall, temperature, solar radiation, air humidity and culture medium are controlled artificially; **(b)** In case of animal husbandry, covers: **(i)** Rearing of animals under intensive farming systems with stall-feeding, **(ii)** Poultry breeding farms and hatcheries where micro-climate is controlled through advanced technologies like incubators, ventilation systems and so on; **(c)** In case of pisculture and aquaculture: **(i)** Aquariums, **(ii)** Hatcheries where eggs are artificially fertilised and fry are hatched and incubated in an enclosed environment with artificial climate control, **(iii)** In the case of agriculture: Production of honey by bee-keeping, except in forest/wild, in designated spaces with control of temperatures and climate factors like humidity and artificial feeding during lean seasons.

2. Plantation Sector: (i) tea sector including tea plantations, **(ii)** coffee/rubber/cardamom/palm oil tree/olive oil tree plantations but not allowed in any other plantation sector/activity. **(100 per cent Automatic route)** Prior approval of the State Government concerned in case of any future land use change.

3. Mining (100 per cent Automatic route): (a) Mining and Exploration of metal and non-metal ores including diamond, gold, silver and precious ores but excluding titanium bearing minerals and its ores, subject to the Mines and Minerals (Development and Regulation) Act; **(b) Coal and Lignite: (1)** Coal and Lignite mining for captive consumption by power projects, iron and steel and cement units and other eligible activities permitted under and subject to the provisions of Coal Mines (Nationalisation) Act; **(2)** Setting up coal processing plants like washeries subject to the condition that the company would not do coal mining and sell washed/sized coal from its coal processing plants in the open market and supply the washed/sized coal to those parties who are supplying raw coal to coal processing plants for washing or sizing; **(c) Mining and Mineral Separation of Titanium Bearing Minerals and Ores, Its value Addition and Integrated Activities (100 per cent Government route)** subject to sectoral regulations and the Mines and Minerals (Development and Regulation) Act.

4. Petroleum & Natural Gas (100 per cent Automatic route): Exploration activities of oil and natural gas fields, infrastructure related to marketing of petroleum products and natural gas, marketing of natural gas and petroleum products, petroleum product pipelines, natural gas/pipelines, LNG Regasification infrastructure, market study and formulation and petroleum refining in the private sector, subject to the existing sectoral policy and regulatory framework in the oil marketing sector and the policy of the Government on private participation in exploration of oil and the discovered fields of national oil companies.

Petroleum Refining by the Public Sector Undertakings (PSUs), without any disinvestment or dilution of domestic equity in the existing PSUs (**49 per cent Automatic route**).

5. Manufacturing (under Automatic route): A manufacturer is permitted to sell its products manufactured in India through wholesale and/or retail including through e-commerce without Government approval.

6. Defence: Defence Industry (49 per cent Automatic route) subject to industrial license under the Industries (Development & Regulatory) Act; Above 49 per cent under Government route on case to case basis wherever it is likely to result in access to modern and state-of-art technology in the country.

Other Conditions: Infusion of fresh investment within the permitted automatic route level in a company not seeking industrial license resulting in-change in the ownership pattern/transfer of stake by existing investor to new foreign investor will require Government approval. Foreign investment is subject to security clearance/guidelines of the Ministry of Defence. The investee company should be self-sufficient in areas of product design/development and also have maintenance and life cycle support facility of the product being manufactured in India.

7. Broadcasting: (A) Broadcasting Carriage Services (100 per cent, Automatic up to 49 per cent and Government route beyond 49 per cent): (a) Teleports (setting up of up-linking HUBs/Teleports); **(b) Direct to Home** (DTH); **(c) Cable Networks** [Multi System Operators (MSOs) operating at national or state or district level and undertaking upgradation of networks towards digitalisation and addressability]; **(d) Mobile TV; and (e) Headend-in-the Sky Broadcasting** Service (HITS).

(B) Cable Networks: 100 per cent (upto 49 per cent automatic, Government route beyond 49 per cent).

(C) Broadcasting Content Services: (a) Terrestrial Broadcasting FM (FM Radio) (49 per cent automatic route), subject to terms and conditions specified by Ministry of Information and Broadcasting.

(b) Up-linking of 'News & Current Affairs' TC Channels (49 per cent Government route)

(c) Up-linking a Non-'News & Current Affairs' TV Channels/Down-linking of TV Channels (100 per cent automatic route)

The FDI for up-linking/down-linking TV channels will be subject to compliance with the relevant policy notified by the Ministry of Information and Broadcasting.

Foreign investment in all companies will be subject to the relevant regulations/terms and conditions specified by the Ministry. It will include FDI, investments by FIIs/FPIs/QFIs/NRIs/FCCBs/ADRs and convertible preference shares.

The investment in companies engaged in all the aforesaid services will be subject to the following security conditions/terms:

(i) Mandatory Requirement for Key Executives of the Company: The majority of Directors on the Board of the company should be Indian citizens and the Chief Executive Officer (CEO), Chief Officer-In-Charge of technical network operations and Chief Security Officer should be resident Indian citizens;

(ii) Security Clearance of Personnel: The Company, all Directors and key executives like Managing Directors/Chief Executive Officer, Chief Financial Officer (CFO), Chief Security Officer (CSO), Chief Technical Officer (CTO), Chief Operating Officer (COO), shareholders who individually hold 10 per cent or more paid-up capital in the company and any other category specified by the Ministry of Information and Broadcasting require to be security cleared. Prior permission of the Ministry would also be required for their appointment and also before effecting any change in the Board of Directors. The Company would be required to obtain security clearance every two years of all foreign personnel likely to be deployed for more than 60 days in a year way of appointment contract/consulting or in any other capacity for installation, maintenance, operation or any other services prior to their deployment.

(iii) Permission vis-à-vis Security Clearance: The permission would be subject to permission holder/license remaining security cleared throughout the currency of permission. In case the security clearance is withdrawn the permission granted is liable to be terminated forthwith. In the event of security clearance of any of the persons associated with the permission holder/ license or foreign personnel is denied or withdrawn for any reasons, the permission holder/ license will ensure that the concerned person resigns or his services terminated forthwith after receiving such directives from the Government, failing which the permission/license would be revoked and the company disqualified for a period of five years.

(iv) Infrastructure/Network/Software Related Requirement: The officer/officials of the licensee companies dealing with the lawful interception of services will be resident Indian citizens. Details of infrastructure/network diagram (technical details of the network) could be provided, on a need basis only, to equipment suppliers/manufacturers and the affiliate of the licensee company. Clearance from the licensor would be required if such information is to be provided to anybody else. The company should not transfer the subscribers' database to any person/place outside India unless permitted by relevant Law. It must provide traceable identity of their subscribers.

(v) Monitoring, Inspection and Submission of Information: The company should ensure that necessary (hardware/software) is available in their equipment for doing the lawful interception and monitoring from a centralised location as and when required by Government. It, at its own costs, should, on demand by the Government or its authorised representative, provide the necessary equipment, services and facilities at designated place(s) for continuous monitoring or the broadcasting service by or under supervision of the Government or its authorised representative. The Government of India would have the right to inspect the broadcasting facilities. No prior permission/intimation would be required to exercise the right of Government or its authorised representative, provide necessary facilities for continuous monitoring for any particular aspect of the company's activities and operations. Continuous monitoring, however, will be confined only to security related aspects, including screening of objectionable content. The inspection will ordinarily be carried out after reasonable notice, except in circumstances where giving such a notice will defeat the very purpose of the inspection. The company should submit such information with respect to its services as may be required by the Government or its authorised representative, in the required format. The permission holder/ licensee would be liable to furnish the Government of India or its authorised representative or TRAI or its authorised representative, such reports, accounts, estimates, returns or such other relevant information and at such periodic intervals or such times as may be required. The service providers should familiarise/train designated officials of the Government or officials of TRAI or its authorised representative(s) in respect of relevant operations/features of their systems.

(vi) National Security Conditions: It would be open to the licensor to restrict the licensee company from operating in any sensitive areas from the national security angle. The Government of India would have the right to temporarily suspend the permission in public interest or for national security for such period or periods as it may direct. The company should immediately comply with any directives issued in this regard failing which the permission would be revoked and the company disqualified to hold any such permission, in future, for a period of five years. The company should not import or utilise any equipment, which are identified as unlawful and/or render network security vulnerable.

(vii) Other Conditions: The licensor reserves the right to modify these conditions or incorporate new conditions considered necessary in the interest of national security and public interest or for proper provision of broadcasting services. The licensee will ensure that broadcasting service installation carried out by it should not become a safety hazard and is not in contravention of any statute, rule or regulation and public policy.

8. Print Media [26 per cent Government route]

(i) Publishing of Newspaper and periodicals dealing with news and current affairs; **(ii)** Publication of Indian editions of foreign magazines dealing with news and current affairs. 'Magazine' is defined as a periodical publication, brought out on non-daily basis, containing public news or comments on public news. Foreign investment would also be subject to the Guidelines for Publication of Indian editions of foreign magazines dealing with news and current affairs; **(iii) Publishing/Printing of Scientific and Technical Magazines/Specialty Journals/Periodicals (100 per cent Government route)**, subject to compliance with the legal framework as applicable and guidelines. **(iv) Publication of facsimile edition of foreign newspapers. (100 per cent Government route).** The FDI should be made by the owner of the original foreign newspapers whose facsimile edition is proposed to be brought out in India. Publication of facsimile edition of foreign newspapers can be undertaken only by an entity incorporated or registered in India under the provisions of the Companies Act and would also be subject to the guidelines for publication of newspapers and periodicals dealing with news and current affairs and publication of facsimile edition of foreign newspapers.

9. Civil Aviation: The civil aviation sector includes airports, scheduled and non-scheduled domestic passenger airlines, helicopter services/seaplane services, ground handling services, maintenance and repair organisations; Flying training institutes; and technical training institutions.

(A) Airports: (a) Greenfield projects **(100 per cent Automatic route) (b)** Existing projects **(100 per cent, Automatic route up to 74 per cent Government route beyond 74 per cent)**.

(B) Air Transport Services: (1) Scheduled air transport service/domestic scheduled passenger airline/regional air transport services **[49 per cent FDI (100 per cent for NRIS) Automatic route]; (2)** Non-Scheduled Air Transport Service **[100 per cent FDI, Automatic route]**; **(3)** Helicopter services/aeroplane services requiring DGCA approval **(100 per cent automatic route)**.

Other Conditions: Foreign airlines are allowed to participate in the equity of companies operating cargo airlines, helicopter and seaplane service. They are also allowed to invest in the capital of Indian companies, operating scheduled and non-scheduled air transport services, up to the limit of 49 per cent of their paid-up capital subject to the following conditions: **(i)** under the Government approval route, **(ii)** the limit will subsume FDI and FII investment, **(iii)** compliance with the relevant SEBI regulations.

A scheduled operator's permit can be granted only to a company **(a)** that is registered and has its principal place of business within India; **(b)** the Chairman and at least two-thirds of the Directors are citizens of India; and **(c)** the substantial ownership and effective control is vested in Indian nationals.

All foreign nationals would be cleared from security view point before deployment. All technical equipment imported into India would require clearance from the Government.

(C) Other Services under Civil Aviation Sector: (1) Ground Handling Services **subject to** sectoral regulations and security clearance; **(2)** Maintenance and repair organisations; flying training institutes; and technical training institutions **(100 per cent Automatic route)**.

10. Construction Development: Townships, Housing, Built-up infrastructure: Townships, housing, built-up infrastructure and construction-development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure) **(100 per cent Automatic route)**. Each phase of the construction development project would be considered a separate project. The investment will be subject to the following conditions: The investor would be permitted to exit on completion of the project/after development of trunk infrastructure, that is, roads/water supply/street lighting/drainage/sewerage. He can exit and repatriate investment before completion of the project under automatic route on completion of 3-year lock-in period for each tranche completed. Transfer of stake from one to another non-resident without repatriation would not be subject to lock-in/Government approval. The project should conform to the norms and standards, including land use requirements and provision of community amenities and common facilities, as laid down in the applicable building control regulations, bye-laws, rules, and other regulations of the State Government/Municipal/Local body concerned. The investee company can sell only developed plots, that is, plots where trunk infrastructure have been made available. The investor/investee company would be responsible for obtaining all necessary approvals, including those of the building/layout plans, developing internal and peripheral areas and other infrastructure facilities, payment of development, external development and other charges and complying with all other requirements as prescribed under applicable rules/bye-laws/regulations of the State Government/Municipal/Local body concerned. The State Government/Municipal/Local body concerned, which approves the building/development plans, would monitor compliance of the above conditions by the developer.

The conditions of lock-in would not apply to hotels and tourism, hospitals, special economic zones (SEZs), education sector, old age homes and investment by NRIs. FDI is not allowed in real estate business/construction of farm houses and trading in TDRs.

11. Industrial Parks – New and Existing (100 per cent automatic route)
The FDI in industrial parks would not be subject to the conditionalities applicable for construction development projects provided they meet with the under-mentioned conditions: **(i)** it would comprise of a minimum of 10 units and no single unit would occupy more than 50 per cent of the allocable area; **(ii)** the minimum percentage of the area to be allocated for industrial activity would not be less than 66 per cent of the total allocable area.

12. Satellites – Establishment and Operation subject to the sectoral guidelines Department of Space/ISRO **(100 per cent Government route)**.

13. Private Security Agencies (49 per cent Government route)

14. Telecom Services (100 per cent, Automatic route up to 49 per cent, Government route beyond 49 per cent). This is applicable in case of basic, cellular, unified access services, national/international long distance, V-sat, public mobile radio trunked services (PMRTS), global mobile personal communications services (GMPCS) and other value added services. The

FDI in the sector is subject to observance of licensing and security conditions by licensee/investors notified by the DOT except other service providers which are allowed 100 per cent FCI on the automatic route.

15. Trading: (A) Cash and Carry Wholesale Trading/Wholesale Trading (including sourcing from MSEs) (100 per cent Automatic route). Cash and carry wholesale trading/wholesale trading **(WT)**, would mean sale of goods/merchandise to retailers, industrial, commercial, institutional or other professional business users or to other wholesalers and related subordinated service providers. Wholesale trading would, accordingly, be sales for the purpose of trade, business and profession, as opposed to sales for the purpose of personal consumption. Wholesale trading would include resale, processing and thereafter sale, bulk imports with export/ex-bonded warehouse business sales and B2B e-Commerce.

For undertaking WT, requisite licenses/registration/permits should be obtained. Except in case of sales to Government, sales made by the wholesaler would be considered as '**cash & carry wholesale trading/wholesale trading**' with valid business customers, only when WT are made to the following entities: Entities holding **(i)** sales tax/VAT registration/service tax/excise duty registration; or **(ii)** trade licenses reflecting that the entity/person holding the license/registration certificate/ membership certificate is itself/himself/herself engaged in a business involving commercial activity; or **(iii)** permits/license etc. for undertaking retail trade, and **(iv)** institutions having certificate of incorporation or registration as a society or registration as public trust for their self consumption.

Full records indicating all the details of such sales like name of entity, kind of entity, registration/license/permit etc. number, amount of sale etc. should be maintained on a day to day basis.

The WT of goods would be permitted among companies of the same group. However, such WT to group companies taken together should not exceed 25 per cent of the total turnover of the wholesale venture. The WT can be undertaken as per normal business practice, including extending credit facilities subject to applicable regulations. A wholesale/cash and carry trader cannot open retail shops to sell to the consumer directly.

(B) E-commerce activities (100 per cent Automatic route) E-commerce activities refer to the activity of buying and selling by a company through the e-commerce platform. Such companies would engage only in business to business (B2B) e-commerce and not in retail trading, *inter-alia,* implying that existing restrictions on FDI in domestic trading would be applicable to e-commerce as well.

Test marketing of such items for which a company has approval for manufacture, provided such test marketing facility will be for a period of two years, and investment in setting up manufacturing facility commences simultaneously with test marketing (**100 per cent Government route)**.

(C) Single Brand Product Retail Trading (100 per cent, automatic, upto 49 per cent and beyond 49 per cent Government route). The FDI in single brand product retail trading would be subject to the following conditions: **(a)** Products to be sold should be of a 'single brand' only, **(b)** They should be sold under the same brand internationally, that is, products should be sold under the same brand in one or more countries other than India, **(c)** The 'single brand' product-retail trading would cover only products which are branded during manufacturing, **(d)** The foreign investor should be the owner of the brand, **(e)** In respect of proposals involving FDI beyond 51 per cent, mandatory sourcing of at least 30 per cent of the value of products sold would have to be done from Indian 'small industries/village and cottage industries, artisans and craftsmen'.

(D) Multi-Brand Retail Trading (51 per cent Government route) The FDI in multi-brand retail trading, in all products, will be permitted, subject to the following conditions:

- **(i)** Fresh agricultural produce, including fruits, vegetables, flowers, grains, pulses, fresh poultry, fishery and meat products, may be unbranded,
- **(ii)** Minimum amount to be brought in, as FDI, by the foreign investor, would be US $ 100 million,
- **(iii)** At least 50 per cent of total FDI should be invested within three years of the first tranche of FDI on 'backend infrastructure', including capital expenditure on all activities, excluding that on front-end units; for instance, back-end infrastructure will include investment made towards processing, manufacturing, distribution, design, improvement, quality control, packaging, logistics, storage, warehouse, agriculture market produce infrastructure etc. However, expenditure on land cost and rentals will not be counted for purposes of back end infrastructure.
- **(iv)** At least 30 per cent of the value of procurement of manufactured/processed products purchased should be sourced from Indian 'small industries' which have a total investment in plant and machinery not exceeding US $1.00 million. This procurement requirement would have to be met, in the first instance, as an average of five years' total value of the manufactured/processed products purchased, beginning 1st April of the year during which the first tranche of FDI is received. Thereafter, it would have to be met on an annual basis.
- **(v)** Self-certification by the company, to ensure compliance of the conditions at **(ii), (iii)** and **(iv)** above, which could be cross-checked, as and when required. Accordingly, the investors should maintain accounts, duly certified by statutory auditors, and
- **(vi)** Retail sales outlets may be set up only in cities with a population of more than 10 lakh and may also cover an area of 10 kms around the municipal/urban agglomeration limits of such cities. Retail locations will be restricted to conforming areas as per the master/zonal plans of the concerned cities and provisions will be made for requisite facilities such as transport connectivity and parking; In states/Union territories not having cities with population of more than 10 lakh, retail sales outlets may be set up in the cities choice, preferably the largest city and may also cover an areas of 10 kms around the municipal/urban agglomeration limits of such cities.
- **(vii)** Government will have the first right to procurement of agriculture products.
- **(viii)** The above policy is an enabling policy only and the State Governments/Union territories would be free to take their own decisions in regard to implementation of the policy.
- **(ix)** Retail trading, in any form, by means of e-commerce, would not be permissible, for companies with FDI, engaged in the activity of multi-brand retail trading.

(E) Duty Free Shops (100 per cent automatic): Shops set up in custom bonded area at international airports/seaports and land custom stations where there is a transit of international passengers. The FDI is subject to compliance of conditions stipulated in the Customs Act/other laws/rules/regulations. They would not engage in retail trading activity in the domestic tariff area.

16. Railway Infrastructure (100 per cent, automatic): Construction/operation/maintenance of **(i)** suburban corridor projects through PPP, **(ii)** high speed train projects, **(iii)** dedicated freight lines, **(iv)** rolling stock, **(v)** electrification, **(vi)** signalling system, **(vii)** freight/passenger terminals, **(viii)** infrastructure in industrial park and **(ix)** mass rapid transport system. The FDI in activities open to private sector participation is subject to sectoral guidelines of the Ministry of Railways. Proposal for FDI beyond 49 per cent in sensitive areas from security point of view will require the approval of the Cabinet Committee on Security.

17. Financial Services The FI in financial services other than the following would require prior approval of Government: Asset Reconstruction Companies (100 per cent of paid-up capital of ARC, Automatic route).

Other Conditions: Persons resident outside India, can invest in the capital of the ARCs upto 100 per cent. Investment **(i)** limits of a sponsor in their capital **(ii)** by institutional investors will be governed by the provisions of the SRFAESI Act. The total shareholding of an individual/FII/FPI should be below 10 per cent of the paid-up capital. The FIIs/FPIs can invest upto 100 per cent of each tranche in security receipts issued by the ARCs subject to RBI guidelines/directions. All investments would be subject to the provisions of the SRFAESI Act.

18. Banking- Private Sector (74 per cent, Automatic route up to 49 per cent, Government route beyond 49 per cent).

Other Conditions: This 74 per cent limit will include investment under the portfolio investment scheme (PIS) by FIIs, NRIs include IPOs, Private placements, GDR/ADRs and acquisition of shares from existing shareholders. The aggregate foreign investment in a private bank from all sources will be allowed up to a maximum of 74 per cent of the paid up capital of the Bank. At all times, at least 26 per cent of the paid up capital will have to be held by residents, except in regard to a wholly-owned subsidiary of a foreign bank.

The permissible limits under portfolio investment schemes through stock exchanges for FIIs/FPIs and NRIs setting up a subsidiary by foreign banks and limits in respect of voting rights are as follows:

(a) In the case of FIIs/FPIs, individual FII/FPI holding is restricted to 10 per cent of the total paid-up capital, aggregate limit for all FIIs cannot exceed 24 per cent of the total, which can be raised to 74 per cent by the bank concerned through a resolution of its Board of Directors followed by a special resolution to that effect by its general body. In the case of NRIs, individual holdings is restricted to 5 per cent and aggregate limit cannot exceed 10 per cent of the total paid-up capital both on repatriation and non-repatriation basis. However, NRI holding can be allowed up to 24 per cent provided the banking company passes a special resolution to that effect in the general body.

The FDI in private banks having joint venture/subsidiary in insurance sector would be subject to the 49 per cent of foreign shareholding in the insurance sector. Transfer of shares under FDI from residents to non-residents will continue to require approval of RBI and Government. The policies and procedures prescribed by the RBI/SEBI/IRDA on these matters will continue to apply. The RBI guidelines relating to acquisition by purchase or otherwise of shares of a private bank, if such acquisition results in any person owning or controlling 5 per cent or more of the paid up capital of the private bank, will apply to non-resident investors as well.

(b) Setting up of a subsidiary by foreign banks: Foreign banks will be permitted to either have branches or subsidiaries but not both. Foreign banks regulated by banking supervisory authority in the home country and meeting the RBI's licensing criteria will be allowed to hold 100 per cent paid up capital to enable them to set up a wholly-owned subsidiary in India. A foreign bank may operate in India through only one of the three channels, namely, **(1)** branches, **(2)** a wholly-owned subsidiary and **(3)** a subsidiary with aggregate foreign investment up to a maximum of 74 per cent in a private bank. It will be permitted to establish a wholly-owned subsidiary either through conversion of existing branches into a subsidiary or through a fresh banking license. It can establish a subsidiary through acquisition of shares of an existing private sector bank provided at least 26 per cent of the paid capital of the private sector bank is held by residents at all times. A subsidiary of a foreign bank will be subject to the licensing requirements and conditions broadly consistent with those for new private sector banks.

(c) There is a limit of 10 per cent on voting rights in respect of banking companies.

19. Banking – Public Sector [20 per cent Government route).

20. Credit Information Companies (CIC) [100 per cent automatic route].

Other Conditions: The investment is subject to the CIC Regulation and regulatory clearance from the RBI. Such FII/FPI investment would be permitted subject to the conditions that: **(a)** No single entity should directly or indirectly hold more than 10 per cent equity, **(b)** Any acquisition in excess of 1 per cent will have to be reported to the RBI as a mandatory requirement; and **(c)** FIIs/FPIs investing in CICs would not seek a representation on the Board of Directors based upon their shareholding.

21. Infrastructure Company in the Securities Market, namely, stock exchanges, commodity exchanges, depositories and clearing corporation, in compliance with SEBI regulations **[49 per cent, automatic route]**.

22. Insurance (49 per cent Automatic route) subject to approval/verification by IRDA): Insurance company/brokers, third party administrators, surveyors and loss assessors and other insurance intermediaries. Foreign investment would be subject to compliance with the provisions of the Insurance Act and necessary license/approval from IRDA for undertaking insurance and related activities. It should be ensured that the ownership of the company remains in the hands of resident Indian entities. The FPI would be governed by the FEMA/SEBI IFPI regulations. An increase in foreign investment in the company would be in accordance with the RBI's pricing guidelines. In case of a bank which functions as an insurance intermediary, the cap applicable to banks would continue to apply and their revenue from their primary/non-insurance related business must remain above 50 per cent of their total income. The bank promoted insurance companies would be subject to **(i)** 49 per cent ceiling on foreign shareholding and **(ii)** policies/procedures prescribed by the RBI/SEBI/IRDA/Ministry of Corporate Affairs.

23. Pension Sector (49 per cent automatic route): Foreign investment is allowed as per the PFRDA Act. The entity bringing in the equity investment should be registered with the PFRDA, comply with the PFRDA Act/rules/regulations and participate in pension fund management activities. The approval of the Government would be required if the investment involves control/ownership by the foreign investor or transfer of control/ownership of an existing pension fund from resident Indians/companies to the foreign entity including through transfer/fresh issue of shares through acquisition/amalgamation/merger and so on.

24. Power Exchanges (49 per cent through automatic route): The investment would be subject to the conditions as are applicable to infrastructure company in the securities market.

25. White Label ATM (WLAs) Operations (100 per cent automatic): The minimum networth requirement of the non-bank entity intending to set up WLAs is ₹100 crore. The FDI will also be subject to specific criteria/guidelines issued by the RBI.

26. Non-Banking Finance Companies (NBFC): (i) Merchant banking, **(ii)** Underwriting, **(iii)** Portfolio management services, **(iv)** Investment advisory services, **(v)** Financial consultancy, **(vi)** Stock broking, **(vii)** Asset management, **(viii)** Venture capital, **(ix)** Custodian services, **(x)** Factoring, **(xi)** Credit rating agencies, **(xii)** Leasing & finance, **(xiii)** Housing finance, **(xiv)** Forex broking, **(xv)** Credit card business, **(xvi)** Money changing business, **(xvii)** Micro credit, and **(xviii)** Rural credit **(100 per cent Automatic route)**.

Other Conditions: (1) Investment would be subject to the following minimum capitalisation norms: **(i)** US $ 0.5 million for foreign capital up to 51 per cent to be brought upfront, **(ii)** US $ 5 million for foreign capital more than 51 per cent and up to 75 per cent to be brought upfront, **(iii)** US $ 50 million for foreign capital more than 75 per cent out of which US $ 7.5 million to be brought upfront and the balance in 24 months, **(iv)** NBFCs **(i)** having foreign investment more than 75 per cent and up to 100 per cent, and **(ii)** with a minimum capitalisation of US $ 50 million, can set up step down subsidiaries for specific NBFC activities, without any restriction on the number of operating subsidiaries and without bringing in additional capital. The minimum capitalisation condition would not apply to downstream subsidiaries, **(v)** Joint venture operating NBFCs that have 75 per cent foreign investment can also set up subaidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capitalisation norm mentioned in **(i), (ii)** and **(iii)** above and **(vi)** below.

(vi) Non-fund based activities: US $ 0.5 million to be brought upfront for all permitted non-fund based NBFCs irrespective of the level of foreign investment subject to the condition that such a company would not set up any subsidiary for any other activity, nor it can participate in any equity of an NBFC holding/operating company.

The following activities would be classified as non-fund based activities: **(a)** Investment advisory services, **(b)** Financial consultancy, **(c)** Forex broking, **(d)** Money changing business, and **(e)** Credit rating agencies.

27. Pharmaceuticals: Greenfield (100 per cent Automatic route), Brownfield (100 per cent Government route).

Other Conditions: Non-compete clause would not be allowed except in special circumstances. The prospective investor/investee should provide the required certificate along with the application. It may incorporate appropriate conditions for FDI in brownfield cases. The above conditions would not apply to manufacturing of medical devices.

CONCLUDING OBSERVATIONS

- Foreign direct investment means an investment by a non-resident entity/person resident outside India in the shares and fully, compulsorily and mandatorily convertible preference shares/debentures of an Indian company. The motivation is a strategic long-term cross border relationship to ensure a significant degree of influence in management of the concerned enterprise. The regulatory framework in India consists of FEMA/regulations/press notes/releases/clarifications by the Government/RBI to promote FDI through a transparent, predictable, simple, clear policy framework and reduced regulatory burden. The main elements of the current policy framework on FDI are: **(A)** general conditions on FDI, and **(B)** sector-specific conditions on FDI.

(A) The general conditions on FDI are: **(i)** eligible investors, **(ii)** eligible investor entities, **(iii)** instruments of investments/issue/transfer of shares, **(iv)** entry routes of investments, **(v)** caps on investments, **(vi)** entry conditions, **(vii)** other conditions, **(viii)** foreign investment into downstream investment and **(ix)** remittances, reporting and violation.

- The eligible foreign investors in Indian companies are: **(i)** persons resident outside India (non-resident entity), **(ii)** NRIs/PIOs, **(iii)** company/trust/LLP incorporated outside India, **(iv)** FIIs/FPIs, and **(v)** FVCI.
- The eligible investee entities are: **(i)** Indian company, **(ii)** partnership firms/proprietary concerns, **(iii)** trusts, **(iv)** LLPs, **(v)** investment vehicles.
- The main elements of instruments of investment, issue/transfer of shares are: **(i)** types of instruments for investment **(ii)** provisions relating to issue/ transfer of shares and **(iii)** other specific conditions of compliance for certain cases.
- Included in the instruments of investment are equity shares, fully/compulsorily/mandatorily convertible debentures/preference share, warrants, FCCBs, ADRs/GDRS.
- Included in the provisions relating to issue/transfer of shares are issued procedure/issue price, transfer of shares and convertible debentures, RBI's permission, and conversion FCB/royalty/lump sum into equity.
- The specific conditions in certain cases relates to **(i)** issue of rights/bonus shares, **(ii)** additional allocation of rights shares, **(iii)** acquisition of shares under scheme of merger/demerger/amalgamation, **(iv)** issue of ESOP, **(v)** pledge of shares, and **(vi)** share swap.
- Investments can be made by non-residents in the equity shares, fully, compulsorily and mandatorily convertible debentures/preference shares of an Indian company, through the **automatic route** or the **Government route**. Under the automatic route, the non-resident investor/Indian company does not require any approval from Government of India for the investment. Under the Government route, prior approval of the Government of India is required. The proposals for foreign investment under Government route, are considered by the FIPB.
- Investments can be made by non-residents in the capital of a resident entity only to the extent of the percentage of the total capital as specified in the FDI policy **[detailed in the subsequent Section of this Chapter]**.
- Investments by non-residents can be permitted in the capital of a resident entity in certain sectors/activity with entry conditions. Such conditions may include norms for minimum capitalisation, lock-in period and so on. **They are detailed in the next Section of this Chapter**.
- Besides the entry conditions on foreign investment, the investment/investors are required to comply with all the relevant sectoral laws/regulations/rules/security conditions, and state/local laws/regulations.

- The guidelines pertaining to downstream investment relate to calculation of total foreign investment, both direct and indirect in an Indian company/LLP, at every stage of investment, including **downstream investment** (i.e. indirect foreign investment by an eligible Indian entity into another Indian company/LLP by way of subscription/acquisition).
- Sales proceeds of shares/securities held on repatriation basis can be remitted to the non-residents (net of applicable tax). Similarly, winding-up proceeds, net of taxes, can be remitted, subject to a certificate from the auditors to the effect that **(i)** all liabilities in India have been fully paid/adequately provided for, **(ii)** winding-up accords with the provisions of the Companies Act, **(iii)** there are no legal proceedings pending in any court in India/legal impediments in permitting the remittance. Dividends and interests are freely repatriable without restrictions subject to applicable taxes.
- The amount received from non-residents on account of investment under the FDI should be reported to the RBI within 30 days from the date of receipt. A similar report should also be filed after issue of shares and fully/compulsorily/ mandatorily convertible debentures/preference shares. Transfer of shares between residents and non-residents should be reported to the AD Category-I bank within 60 days from the date of receipt of consideration. Details of issue of shares against conversion of ECB should reported to the RBI within 7 days from the close of the related month in case of full conversion. The converted portion in case of partial conversion should be reported clearly differentiating from the non-converted portion and the outstanding balance of the ECB should be reported in the subsequent month. Full details of ADRs/GDRs issues should be furnished to the RBI within 30 days from the closure date and a quarterly return within 15 days of the close of the calendar quarter. The quarterly return has to be submitted till the entire amount raised is repatriated to India/utilised abroad as per the RBI guidelines. The FDI is a capital account transaction and any violation of its regulations are covered by the penal provisions of the FEMA.
- Violation/contravention of FDI regulations by way of breach, non-adherence/compliance, contravention of any rule/regulation/notification/press note (releases)/circular/direction/order or contravention of condition(s) subject to which an authorisation is issued by Government/ RBI would be liable to a penalty up to thrice the amount involved or ₹2 lakh where the amount is **(i)** quantifiable and **(ii)** not quantifiable respectively. In case of continuing contravention, a further penalty up to ₹5,000 for each day during which it continues, may be levied. Where the contravention is by a company, every person incharge of, and responsible to the company, for the conduct of its business as well as the company would be deemed to be guilty and liable to be punished. An adjudicating authority appointed by the Government consisting of officers may, in addition to imposing any penalty, direct confiscation by the Government of currency/ security/money/property relating to the contravention. Appeals against the orders can be preferred to an appellate tribunal. A compounding authority may compound the quantifiable amount involved in the contravention.

(B) The elements of the sector-specific conditions on FDI are: **(i)** prohibited sectors, **(ii)** permitted sectors.

- FDI is prohibited in the following activities/sectors: **(i)** retail trading (except single brand product retailing, **(ii)** atomic energy, **(iii)** lottery business, **(iv)** gambling and betting including casinos, **(v)** chit fund, **(vi)** trading in transferable development rights (i.e. partly/wholly transferable certificates issued in respect of land acquired for public purpose in consideration of surrender of land by the owner without monetary compensation).

- There are sector/activity-wise limits on FDI subject to other conditions. An illustrative list is given below:

Automatic Route:	
Limit: 100	Agriculture, Plantation, Mining, Petroleum and Natural Gas, Manufacturing, Airports, Constuction, Development, Industrial Parks, ARCs, CICs, NFCs, Pharmaceuticals
49	Petroleum Refining by PSUs, Defence, Broadcasting, Telecom, Single Brand Trading, Private Sector Banks
Government Route:	
Limit: 100	satellites
74	Defence, Broadcasting, Telecom, Single Brand Trading, Private Sector Banks
51	Multi Brand Trading
49	Private Security
26	Print Media
20	Public Sector Banks

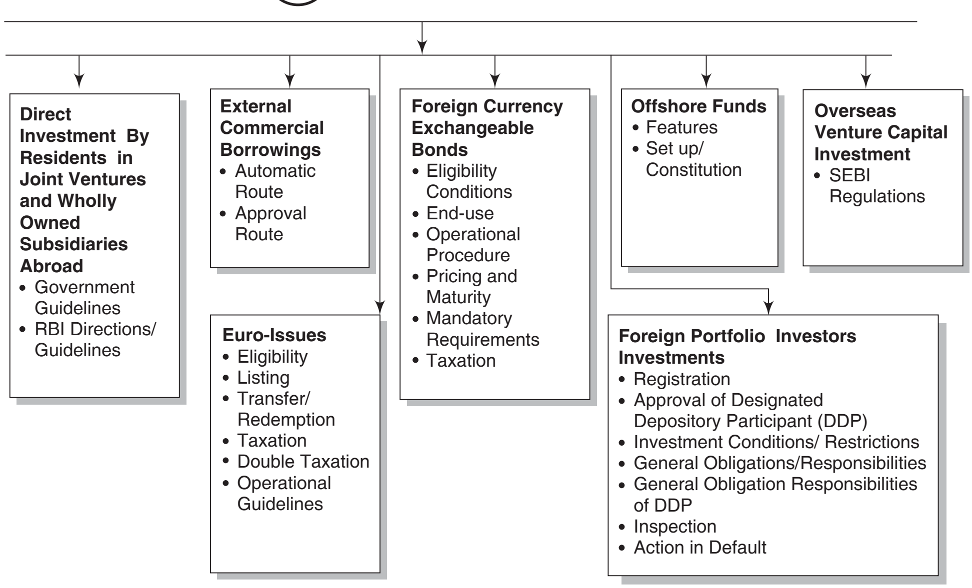
CHAPTER 19

Other Forms of Foreign Investment in India/Abroad

INTRODUCTION

The purpose of this Chapter is to examine the other forms of foreign investment in India/abroad. **The major sources are depicted in Exhibit 19.1.** Sections 1-8 analyse the policy framework for Indian direct investment abroad, external commercial borrowings, Euro-issues, foreign currency, exchangeable bonds, Indian depository receipts, FII investments, offshore funds and overseas venture capital investments respectively. The last Section contains concluding observations.

Exhibit 19.1 Other Forms of Foreign Investment in India/Abroad



DIRECT INVESTMENT BY RESIDENTS IN JOINT VENTURES AND WHOLLY OWNED SUBSIDIARIES ABROAD

In order to encourage Indian firms and businesses to grow into strong, based-in-India multinationals and to accord Indian firms flexibility to undertake capital account transactions, especially for acquisitions abroad, Indian direct investment in joint ventures (JVs) and wholly owned subsidiaries (WOSs) are encouraged within the framework of the Government/RBI guidelines. With reference to these guidelines, direct investment means investment by an Indian party in the equity share capital of the foreign concern with a view to acquiring a long-term interest in that concern. Besides equity stake, such long-term interest may be reflected through representation on the Board of Directors of the foreign concern and the supply of technical know-how, capital goods, components, raw materials and so on and managerial personnel to the foreign concern.

A **joint venture** means a foreign concern formed/registered/incorporated in accordance with the laws/regulations of the host country (i.e., the country in which the foreign concern is registered) in which the Indian party (i.e., a public/private limited company/a group of body corporates incorporated in accordance with the laws in India) makes a direct investment, whether such investment amounts to a majority or minority shareholding. A **wholly owned subsidiary** means a foreign concern formed/registered/incorporated in accordance with the laws/regulation of the host country, whose entire equity share capital is owned by the Indian party. Apart from direct investment by way of setting up of JVs/WOSs, Indian residents, corporates, individuals and mutual funds can also invest in the equity of companies registered overseas.

The main elements of the Government/RBI guidelines on Indian direct investment in JVs and WOSs abroad/foreign concerns as also investment by a person (corporates, individuals and mutual funds) resident in India in shares/securities of listed companies outside India are discussed in this Section.

Government Guidelines

The government guidelines for Indian direct investment in JVs and WOSs abroad/in foreign concerns are summarised below.

Objectives The basic objectives of these guidelines, for a trans-parent policy towards overseas investment from India, are:

(a) Recognising the link between trade and investment flows, to provide a framework for Indian industry and business to access global networks;

(b) To ensure that such flows, though determined by commercial interest, and consistent with the macro-economic and balance of payment compulsions of the country, particularly in terms of the magnitude of the capital flows;

(c) To provide a transparent mechanism of knowing the priorities of the Government with regard to overseas investment, so as to influence the stakeholders, including financial institutions/banking sector and embassies, so that there is an understanding and alignment between the macro-economic objectives and the individual business decisions;

(d) To give liberal access to Indian business for technology sourcing, resource-seeking or market-seeking as strategic responses to the emerging global opportunities for trade in goods or services;

(e) To give a signal that there is a qualitative change in government approach from one of a regulator or controller, to one of a facilitator, and

(f) To encourage Indian industry to adopt a spirit of self-regulation and collective effort for improving the image of Indian industry abroad.

In the light of the above, these guidelines elaborate the policy framework. The RBI would accord all necessary approvals and monitor the progress by prescribing the reporting obligations. These guidelines apply to direct investment by Indian parties in newly promoted foreign concerns, to make initial or additional direct investment by Indian parties in existing foreign concerns and to investment in acquisitions of overseas business. The foreign concern in which the direct investment is proposed to be made may be engaged in industrial, commercial, trading or service activity, including the hotel or tourism industry, financial services such as insurance, mutual funds and so on. However, they do not apply to **(i)** portfolio investment by Indian parties in foreign concerns and **(ii)** direct investment in foreign concerns engaged in the banking sector.

Categories of Applications Processed by the RBI There are two categories of applications for setting up overseas JVs and WOSs, namely, Category 'A' Automatic Route and Category 'B' Normal Route. All applications are to be processed by the RBI.

RBI Guidelines/Directions

The main features of the RBI directions relating to direct in-vestment in JVs and WOSs abroad by Indian companies, currently in force are discussed below.

General Overseas investments in Joint Ventures (JVs) and Wholly Owned Subsidiaries (WOS) have been recognised as important avenues for promoting global business by Indian entrepreneurs. The JVs are perceived as a medium of economic cooperation between India and other countries. Transfer of technology and skill, sharing of results of R&D, access to wider global market, promotion of brand image, generation of employment and utilisation of raw materials available in India and in the host country are other significant benefits arising out of such overseas investments. They are also important drivers of foreign trade through increased export of plant and machinery and goods from India and also a source of foreign exchange by way of dividend earnings, royalty, technical know-how fee and other entitlements on such investments.

Prohibition Indian parties are prohibited from making investment in a foreign entity engaged in real estate business or banking business without the prior approval of the RBI.

General Permission Residents have general permissions for purchase/acquisition of securities and sale of shares/securities so acquired **(a)** out of funds held in RFC ac-count; and **(b)** as bonus shares on existing holding of foreign currency shares and **(c)** out of their foreign currency resources outside India, when not permanently resident in India. General permission is also available to sell these purchased/acquired shares.

Direct Investment Outside India Direct investment outside India can be made through **(a)** the automatic route or **(b)** RBI's prior approval.

Automatic Route Any Indian party can invest in overseas JV/WOS through the automatic route without the RBI's prior approval upto 400 per cent of its networth as on the last date of its audited balance sheet. This ceiling is not applicable if the investment is made out of the balances held in Exchange Earners Foreign Currency Account (EEFCA) or out of funds raised through ADRs/GDRs. Such investments include contribution to the capital of the overseas JV/WOS, loan granted to the JV/WOS and 100 per cent of guarantees issued to or on behalf of the JV/WOS. They are, however, subject to the following conditions:

(a) The Indian party may only extend loan/guarantee to an over-seas concern in which it has equity participation. The Indian entities may offer any form of guarantee: corporate/personal, primary/collateral, by group/promoter company/sister concern/associate company in India subject to the following conditions: **(a)** all financial commitments including all forms of guarantee are within the over all ceiling of 400 per cent of the networth, **(b)** no guarantee is **open-ended**, that is, the amount should be specified upfront, and **(c)** As in case of corporate guarantees, all guarantees should be reported to the RBI. However, guarantees by bank in India in favour of JVs/WOSs outside India would be outside this ceiling subject to prudential norms issued by the RBI. Specific approval of the RBI would be required for creating charge on immovable property and pledge of shares of the Indian party/group companies in favour of a non-resident party.

(b) The Indian party should not be on the RBI's exporter's caution list or list of defaulters to the banking system circu-lated by RBI/CIBIL or any other credit information company approved by the RBI or under investigation by an investigation/enforcement agency/regulatory body.

(c) All transactions relating to the JV/WOS should be routed through a branch of an authorised dealer, designated by the Indian party.

(d) In case of partial/full acquisition of an existing foreign company, where the investment is more than 5 million US dollars, valuation of the shares of the company should be made by a Category I Merchant Banker registered with SEBI or an Investment/Merchant Banker outside India registered with the appropriate regulatory authority in the host country and in all other cases by a Chartered Accountant (CA)/Certified Public Accountant (CPA).

(e) In case of investment by way of swap of shares, in all cases irrespective of the amount, valuation should be done similarly. The approval of the FIPB is also a precondition.

(f) Where the entire funding of a JV/WOS is done by a partnership firm, individual partners can hold shares for/on behalf of the firm if the host countries' regulations/operational requirements warrant such holding.

(g) Investments in JVs/WOSs abroad through a special purpose vehicle (SPV) can be made if the Indian party is **(i)** not included in the RBI's cautious list, **(ii)** under investigation by the ED, **(iii)** included in the list of defaulters to the banking system circulated by the RBI/any RBI-approved credit information company. Parties in the defaulters list require the prior approval of the RBI.

(h) An Indian party can also acquire shares of a foreign company engaged in a *bona fide* business activity in exchange of ADRs/GDRs issued to the latter in accordance with the scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through the Depository Receipt Mechanism) Scheme 1993, and the guidelines issued thereunder from time to time by the Central Government, subject to compliance with the following conditions:

(i) The ADRs/GDRs are currently listed on the stock exchange outside India;

(ii) Their issue for the purpose of acquisition is backed by underlying fresh equity shares issued by the Indian party;

(iii) The total holding in the Indian entity by persons resident outside India in the expanded capital base, after the new ADR and/or GDR issue, does not exceed the sectoral cap prescribed under the relevant regulations for such investment under the FDI:

(iv) The valuation of the shares of the foreign company is made: **(a)** as per the recommendations of the investment banker, if the shares are not listed on stock exchange; or **(b)** are based on the current market capitalisation of the foreign company, arrived at on the basis of the monthly average price on any stock exchange abroad for the three months preceding the month in which the acquisition is committed and over and above the premium, if any, as recommended by the investment banker in its due diligence report in other cases.

The Indian party is required to report such acquisition to the RBI within a period of 30 days from the date of the transaction.

Investments in Nepal are permitted only in rupees. Investments in Bhutan are permitted in rupees as well as in freely convertible currencies. All dues receivables on investments made in freely convertible currencies as well as their sale/winding up proceeds should be repatriated in India only in freely convertible currencies. **The automatic route facility is not available for investment in Pakistan.**

Investments in Unincorporated Entities Overseas in Oil Sector If approved by the competent authority, such investments by Navaratna PSUs (i.e. ONGC Videsh Ltd and Oil India Ltd) can be made without any limit. Other Indian companies can invest in this sector upto 400 per cent of net worth if the proposal is approved by the competent authority and duly supported by certified copy of the resolution of its Board of Directors approving the investment. Investments exceeding 400 per cent of the net worth would require prior approval of the RBI.

Method of Funding Investments in overseas JVs/WOSs may be funded out of the following sources: **(i)** drawl of foreign exchange from a bank in India, **(ii)** capitalisation of exports, **(iii)** swap of shares, **(iv)** utilisation of proceeds of ECBs/FCCBs; **(v)** in exchange of ADRs/GDRs, **(vi)** balances held in EEFC account of the Indian party, and **(vii)** utilisation of proceeds of foreign currency funds raised through ADR/GDR issues. In respect of **(vi)** and **(vii)**, the ceiling of 400 per cent of net worth would not apply.

Capitalisation of Exports and Other Dues Indian parties can capitalise the payments due from the foreign entity towards exports made to it, fees/royalties/any other entitlements from the foreign entity for supplying technical know-how, consultancy, managerial and other services within the applicable ceiling. Unrealised export proceeds beyond the prescribed period of realisation would require of RBI's prior approval for capitalisation. Indian software exporters can receive 25 per cent of the value of their exports to an overseas software company as shares without a joint venture agreement with the prior approval of the RBI.

Investment in Equities of Companies Registered Overseas/Rated Debt Instruments

(i) **Portfolio Investment:** Listed Indian companies are permitted to invest upto 50 per cent of their networth in shares/bonds/fixed income securities rated not below investment grade by accredited/registered rating agencies, issued by listed overseas companies.

(ii) **Investment by Mutual Fund:** The SEBI-registered mutual funds can invest within an overall cap of 7 billion US dollars in: **(1)** ADRs/GDRs of Indian/foreign companies, **(2)** equity of overseas companies listed on a overseas stock exchange, **(3)** initial and follow on public offerings for listing on a overseas stock exchange, **(4)** foreign short and long-term debt securities in countries with fully convertible currencies, with rating not below investment grade, **(5)** money market instruments rated investment grade, **(6)** repos in the form of investment where the counterparty is rated not below investment grade, but they should not involve any borrowing of funds by the mutual funds, **(7)** Government securities with country rating at least investment grade, **(8)** derivatives traded on a recognised stock exchange overseas only for hedging and portfolio balancing with underlying as securities, **(9)** short-term deposits with overseas banks rated not below investment grade, **(10)** units/ securities issued by overseas mutual funds/unit trusts registered with overseas regulators and investing in **(a)** above-mentioned securities, **(b)** real estate investment trusts listed on a recognised overseas stock exchange or **(c)** unlisted overseas securities not exceeding 10 per cent of their NAV.

A limited number of qualified mutual funds can also invest upto one billion US dollars in overseas exchange traded funds as permitted by the SEBI.

(iii) Domestic Venture Capital Funds: registered with the SEBI may invest in equity-linked instruments of off-shore venture capital undertakings subject to an overall limit of 500 million US dollars.

The mutual funds and venture capital funds would require SEBI's permission.

General permission is available to the above categories of inves-tors for sale of securities so acquired.

Approval of RBI In all other cases of direct investment abroad, the RBI's prior approval would be required. For this purpose, applications together with documents should be made in separate prescribed forms. The RBI, *inter-alia*, would take the following factors into account while considering such applications:

(a) *Prima facie* viability of the JV/WOS outside India;

(b) Contribution to external trade and other benefits that would accrue to India through such investment;

(c) Financial position and business track record of the Indian party and the foreign entity;

(d) Expertise and experience of the Indian party in the same or related line of activity of the JV or WOS outside India.

Investment in the Financial Services Sector An Indian party seeking to invest in an entity engaged in the financial sector should also fulfil the following additional conditions:

(i) Be registered with the appropriate regulatory authority in India for conducting financial sector activities;

(ii) Earned net profit during the preceding three financial years from the financial services activities;

(iii) Have obtained approval from concerned regulatory authori-ties in India and abroad.

(iv) Should have fulfilled the prudential norms relating to capital adequacy, as prescribed by the concerned regulatory authority in India.

A step down subsidiary of JV/WOS investing in the financial services sector should also comply with these conditions. Regulated entities in the financial sector making investment in any activity overseas should also comply with these guidelines. Unregulated entities in the financial sector in India may invest in non-financial sector activities subject to compliance with the specified regulations. Trading in commodity exchanges overseas and setting up of JVs/WOSs for such trading would be reckoned as financial services activity and require clearance from the Forward Markets Commission.

Investment in Energy and Natural Resources Sector The RBI would consider proposals for overseas JVs/WOS in the energy and natural resources sector (e.g., oil, gas, coal and mineral ores) in excess of 400 per cent of the networth of the Indian companies.

Overseas Investment By Proprietorship Concerns With a view to enabling recognised star exporters with a proven track record and consistently high export performance to reap the benefit of globalisation/liberalisation, proprietorship concerns/unregistered partnership firms can set up a JV/WOS outside India with the prior approval of the RBI subject to satisfying certain eligibility criteria. Investments by them would be subject to the following criteria: **(i)** The firm is DGFT-recognised Star export house (exports exceeding ₹15 crore per annum), **(ii)** the AD bank is satisfied that the exporter is KYC-compliant, is engaged in the proposed business and has the indicated turnover, **(iii)** the export has proven track record, that is, export outstanding does not exceed 10 per cent of the average export realisation in the preceding three financial years, **(iv)** it has not come under any adverse notice of any Government agency like ED and CBI and does not appear in the exporters' cautious list of the RBI or in the list of defaulters to the banking systems and **(v)** the investment outside India does not exceed 10 per cent of the average of the three financial years export realisation or 200 per cent of the not owned fund whichever is lower.

Overseas Investments By Registered Trust/Society Registered trusts/societies engaged in manufacturing/educational/hospital sector can make investments in the same sector(s) in a JV/WOS outside India with the prior approval of the RBI. They should satisfy the eligibility criteria specified below. The trust/society **(i)** should be registered under the Indian Trust Act/Societies Registration Act, **(ii)** has been in existence for at least three years, **(iii)** has not come under the adverse notice of any regulatory/enforcement agency like the ED/CBI. The trust deed/memorandum of association and rules an regulations of the society permit the proposed investment overseas which should also be approved by the governing body/council or managing/executive committee of the society and the trustees. Finally, the AD Bank is satisfied that trust/society is engaged in *bonafide* activity. The bank should also ensure that the activities which require special license/permission from the Ministry of Home Affairs/relevant local authority have been obtained.

Post Investment Changes/Additional Investment in Existing JVs/WOS A JV/WOS set up by an Indian party may diversify its activities/set up step down subsidiary/alter the shareholding pattern in the overseas entity with the approval of the competent authority in the host country. The details should be reported to the RBI within 30 days.

Acquisition of a Foreign Company through Bidding or Tender Proce-dure An Indian party may remit earnest money deposit or issue a bid bond guarantee for acquisition of a foreign company through bidding and tender procedure and also make subsequent remittances through an authorised dealer bank.

Obligations of Indian Party An Indian party, which has made direct investment abroad, is under obligation to: **(a)** receive shares certificates or any other document as an evidence of investment, **(b)** repatriate the dues receivable from the foreign entity to India and **(c)** submit the documents/Annual Performance Report to the RBI. The reporting requriements are also applicable for investors in unincorporated entities of the oil sector.

Transfer by Way of Sale of Shares of a JV/WOS Indian parties may also disinvest without the prior approval of the RBI in the under-noted categories: **(i)** where the JV is listed in the overseas stock exchange, **(ii)** the Indian promoter company is listed on a stock exchange in India and has a minimum networth of ₹100 crore, and **(iii)** Indian promoter is an unlisted company and the investment in overseas venture does not exceed US 10 million dollars. The disinvestments would be subject to the following conditions: **(i)** The sale should be effected through the stock exchange where the shares were listed, **(ii)** in case of unlisted shares disinvested by a private arrangement, the share price should not be less than fair value as certified by a CA/CPA, **(iii)** the overseas concern has been in operation for at least one full year and the annual performance report together with the audited accounts has been submitted to the RBI, and **(iv)** the party is not under investigation by CBI/ED/SEBI/IRDA/any other regulatory authority in India.

The party concerned should submit details of the disinvestments within 30 days from the date of disinvestments. A party which does not satisfy these conditions would require RBI's prior permission.

Pledge of Shares An Indian party may pledge the shares of a JV/WOS to an AD bank or a public financial institution in India for availing of any credit facility for itself or for the JV/WOS abroad. They may also transfer by way of pledge the shares held in the JV/WOS to an overseas lender if the lender is regulated/supervised as a bank and the total financial commitments remain within the limit stipulated by the RBI for overseas investment from time to time.

Hedging of Overseas Direct Investment The resident entities can hedge the exchange risk arising out of such investments. The AD banks may enter into forwarded/option contracts with resident entities who wish to hedge their overseas direct investment in equity/loan subject to verification of such exposure. Cancellation of such forward contracts and re-booking of 50 per cent of the cancelled contracts may be permitted/allowed. If a hedge becomes naked owing to shrinking of the market value, it may continue to the original maturity. Rollovers on the due date are permitted upto the extent of the market value on that date.

Other Investment in Foreign Securities The stipulations relating to other investment in foreign securities, are as follows.

Permission for Purchase/Acquisition of Foreign Securities in Certain Cases General permission has been granted to a person resident in India, who is an individual,

(a) To acquire foreign securities as a gift from any person resident outside India; or

(b) To acquire shares under the cashless employees stock option scheme, issued by a company outside India, provided it does not involve any remittance from India; or

(c) To acquire shares by way of inheritance from a person resi-dent in or outside India; or

(d) To purchase equity shares offered by a foreign company under its ESOP Scheme if he is an employee or a director of an Indian office or branch of a foreign company or of an Indian subsidiary of a foreign company or an Indian company in which foreign equity holding, either direct or through a holding company/special purpose vehicle (SPV) is not less than 51 per cent. Remittances for purchase of shares by eligible persons would be allowed irrespective of the method of operationalisation of the scheme, that is, whether the shares are offered by the issuing company directly or indirectly through a trust/SPV/step-down subsidiary provided **(i)** the issuing company, effectively, directly/indirectly, holds in the Indian company, whose employees/directors are being offered shares at least 51 per cent of its equity, **(ii)** the shares under the ESOP scheme are offered globally on uniform basis, and **(iii)** an annual return in the prescribed format is submitted by the Indian company to the RBI giving details of remittances/beneficiaries and so on.

The resident Indian may transfer by way of sale these shares provided the sale proceeds are repatriated within a maximum of 90 days from the date of sale.

(e) Foreign companies can repurchase the shares issued to the residents in India under the ESOP scheme if they **(i)** were issued in accordance with the RBI rules/regulations,

(ii) are being repurchased in terms of the initial offer document and **(iii)** an annual return is submitted giving details of remittances/beneficiaries and so on.

(f) In all other cases, approval of the RBI is required to be obtained before acquisition of foreign security.

Pledge of a Foreign Security by a Person Resident in India The shares acquired by persons resident in India, in accordance with the provisions of Foreign Exchange Management Act, 1999 or Rules or regulations made thereunder, are allowed to be pledged for obtaining credit facilities in India from an authorised dealer bank/public financial institution.

General Permission in Certain Cases Residents are permitted to acquire foreign securities if it represents:

(a) Qualification shares for becoming a director of a company outside India provided it does not exceed 1 per cent of the capital and consideration does not exceed US dollars 20,000 in a calendar year.

(b) Rights shares, provided the shares are being issued for holding shares.

(c) Purchase of shares of a JV/WOS, of the Indian promoter compa-ny by the employees/directors of the Indian promoter company, which is engaged in the field of software, where the considera-tion for purchase does not exceed US dollar 10,000 or its equiva-lent per employee in a block of five calendar years; the shares so acquired do not exceed 5 per cent of the paid-up capital of the JV/WOS outside India; and after allotment of such shares the percentage of shares held by the Indian promoter company, to-gether with shares allotted to its employees is not less than the percentage of shares held by the Indian promoter company prior to such allotment.

(d) Purchase of foreign securities under ADR/GDR linked stock option schemes by resident employees of Indian companies in the knowledge-based sectors including working directors, provided the purchase consideration does not exceed US $ 50,000 or its equiva-lent in a block of five calendar years.

EXTERNAL COMMERCIAL BORROWINGS (ECBs) AND TRADE CREDITS (TCs)

The framework relating to ECBs and TCs are discussed below.

External Commercial Borrowings

External commercial borrowings (ECBs) refer to commercial loans [in the form of bank loans, buyer's credit, supplier's credit, securities instrument (for example, floating rates notes and fixed interest bonds)] availed from none-resident lenders with minimum average maturity of 3 years. **The policy for ECB is also applicable to FCCBs (foreign currency convertible bonds)**. **Foreign Currency Convertible Bonds (FCCBs)** mean a bond issued by an Indian company expressed in foreign currency and the principal and the interest in respect of which is payable in foreign currency. These bonds are required to be issued in accordance with the: **Issue of FCCBs and Ordinary Shares Through Depository Receipt Mechanism Scheme** and subscribed by a non-resident in foreign currency and convertible into ordinary shares of the issuing company in any manner, either in whole or in part, on the basis of an equity related warrants attached to the debt instruments. They can be accessed under two routes: Automatic and Approval.

Automatic Route The ECBs under the automatic route do not required RBI/Government approval. The ECBs for investment in real sector—industrial sector and especially infrastructure sector in India—are under automatic route.

Eligible Borrowers Only corporates registered under the Companies Act other than financial intermediaries such as banks, FIs, housing finance companies and NBFCs. Units in SEZs can raise ECBs for their own requirements. They cannot transfer or on-lend ECBs further to sister concerns or any unit in the Domestic Tariff Area. Individuals/trusts/non-profit making organisations are not eligible.

Recognised Lenders The ECBs can be raised from internationally recognised sources such as international banks/capital markets, multilateral financial institutions such as IFC, ADB, CDC and so on, export credit agencies, suppliers of equipment, foreign collaborators and foreign equityholders other than the erstwhile Overseas Corporate Bodies (OCBs). To be eligible as a recognised lender, the foreign equity holders' direct holding in the borrower's company should be at least 25 per cent for ECB upto US dollars 5 million. In case of ECB exceeding US dollars 5 million, in addition to minimum equity of 25 per cent, the debt-equity ratio should not exceed 4:1, that is, the proposed ECB should not exceed 4 times the direct foreign equityholding.

Amount and Maturity The maturity of ECBs would range between 3 years and 5 years for amount up to US dollars/equivalent 20 million and 500 million respectively. The maximum amount of ECB during a financial year by a corporate would be US dollars 500 million for rupee and/or foreign currency expenditure for permissible end-uses. The ECBs upto US dollars 20 million can have call/put option provided the minimum average maturity of 3 years is complied before exercise of the option.

All-in-Cost Ceilings All-in cost include interest, other fees and expenses in foreign currency but exclude commitment fee, prepay-ment fee and fee/withholding tax payable in Indian rupees. The ceiling over 6 month LIBOR for the respective currency of borrowing or applicable benchmark currently valid are 300 basic points for average maturity period of 3-5 years and 500 basic points for 5-7 years and 450 bps for more than 7 years. The requirement of all-in cost ceiling on ECBs have been dispenced with relaxed until June 2009.

End-Use The ECBs can be raised for the following purposes only: **(i)** for investment (e.g. import of capital goods by new or existing production units) in real sector (i.e. industrial sector including small and medium enterprises and infrastructure sector comprising of power/telecom/railways/roads including bridges/sea port and airport/industrial parks/urban infrastructure in terms of water supply, sanitation and sewage project and mining, exploration and refining); and **(ii)** for overseas direct investment in JVs/WOSs subject to applicable guidelines. Telecom companies can now use the ECB window for raising money for licence/permit for 3G spectrum. The ECB proceeds cannot be utilised **(a)** for on-lending/investment in capital market/acquiring a company in India by a corporate, **(b)** in real estate and **(c)** for working capital/general corporate purpose/repayment of existing rupee loans. Corporates engaged in the development of integrated township can now avail of ECBs under the approval route. Integrated township includes housing, commercial premises hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transport systems, manufacture of building materials, development of land and providing allied infrastructure and so on. The minimum area to be developed should be 100 acres for which norms and standards are to be followed as per local bye-laws/rules. A minimum of 2,000 dwelling units for about 10,000 population will need to be developed.

Guarantee/Security Guarantee, standby letter of credit, letter of undertaking/comfort by banks/FIs/NBFCs relating to ECBs is not permitted. The choice of security to be provided to the lender/supplier is left to the borrower. However, creation of charge over immovable assets and financial securities such as shares in favour of the overseas lender is subject to regulations specified below:

(a) *Creation of Charge on Immovable Assets* The period of charge should be co-terminus with the maturity of the underlying ECB. The overseas lender/security trustee cannot acquire immovable assets/property in India. In the event of enforcement/invocation of the charge, the property would have to be sold only to a person resident in India and the sale proceeds would be repatriated to liquidate the outstanding ECB.

(b) *Creation of Charge Over Financial Securities* The charge can be created by pledge of shares of the borrowing company held by promoters as well as in domestic associate companies of the borrower to secure the ECB. The period of the pledge should be co-terminus with the maturity of the underlying ECB. In case of invocation of pledge, transfer would be in accordance with the FDI policy. A certificate from the statutory auditors of the company that the ECB proceeds have been/would be utilised for the permitted end-use(s).

(c) *Issue of Corporate/Personal Guarantee* A resolution of the Board of Directors would be required to issue corporate guarantee, specifying the name(s) of the official(s) authorised to execute the guarantee on behalf of the company/in individual capacity. Special requests from individuals to issue personal guarantee indicating details of the ECB would be necessary. The period of the guarantee should be co-termius with the maturity of the underlying ECB.

Parking of ECB Proceeds Until their actual requirements in India, the ECB proceeds should be parked overseas in **(a)** liquid assets such as deposits/CDs/other products offered by banks rated not below **AA**-by SP/FITCH IBCA or **Aa3** by Moody's; **(b)** deposits with overseas branch of an Authorised Dealer in India, **(c)** T-bills/other monetary instruments of one year maturity having the above minimum ratings **as indicated above**. The funds should be invested in such a way that the investment can be liquidated as and when funds are required by the borrower in India. Corporates are also now permitted to remit these funds to India for credit to their rupee accounts pending their utilisation for permissible end-use.

Prepayment Prepayment of ECBs upto US dollar 500 million are permitted subject to compliance with the stipulated applicable minimum average maturity period as applicable to the loan.

Refinance of Existing ECBs Refinancing of existing ECBs by fresh ECBs at lower all-in-cost is permitted subject to the maintenance of the outstanding maturity of the original loan.

Debt Servicing The designated AD bank has the general permission to remit instalments of principal/interest/other charges in conformity with a ECB of guidelines.

Procedure The borrower may enter into loan agreement complying with the ECB guidelines with the recognised lender without prior approval of RBI. The borrow must obtain a Loan Registration Number from the RBI before drawing down the ECB.

Approval Route The eligible borrowers for ECBs with Governme nt's/RBI's prior approval are **(a)** financial institutions dealing exclusively with infrastructure/export finance, such as IDFC, ILFS, Power Finance Corporation, IRCON and Exim Bank, on a case by case basis, **(b)** banks and financial institution's which participated in the textile/steel sector restructuring package approved by the

Government to the extent of their investment in the package and assessment by RBI on prudential norms. Any ECB availed for the purpose so far will be deducted from the entitlement, **(c)** ECBs with minimum average maturity of 5 years by NBFCs from multilateral financial institutions, reputable regional institu-tions, official export credit agencies and international banks to finance import of infrastructure equipment for leasing to in-frastructure projects; NBFCs which are exclusively involved in financing of the infrastructure sector are now allowed to avail of ECBs for on-lending to the borrowers in the infrastructure sector under the approval route, **(d)** FCCBs (foreign currency convertible bonds) by housing finance companies which satisfy the minimum criteria of networth during the previous 3 years of ₹500 crore, listing on BSE/NSE, minimum size of ECB of US dollars 100 million and submission of purpose/plan of utilisation of funds, **(e)** special purpose vehicles (SPVs)/any other entity set up to finance infrastructure companies/projects exclusively. **(f)** multi-state cooperative societies engaged in manufacturing activity if they are financially solvent and submit their up-to-date balance sheet, **(g)** cases following outside the purview of automatic route limits and maturity period, **(h)** corporates in the services sector, namely, hotels, hospitals and software companies for import of capital goods; they are now permitted to avail of them under the automatic route for foreign currency and/or rupee capital expenditure for permissible end-uses. The proceeds should not be used for acquisition of land, **(i)** corporates engaged in industrial/infrastructure sector for rupee expenditure for permissible end-uses, and **(j)** Non-government organisations (NGOs) engaged in micro-finance activities for rupee expenditure for permissible end-uses. They **(1)** should have a satisfactory borrowing relationship for at least three years with a bank authorised to deal in foreign exchange and **(2)** would require a certificate of due diligence on fit and proper person status of the Board/ Committee of Management of the borrowing entity from the designated AD bank.

Recognised Lenders Borrowers can raise ECBs from internationally recognised sources specified under the automatic route. However, NGOs can raise ECBs from overseas organisations and individuals subject to the safeguards listed below.

Overseas Organisations proposing to lend to NGOs would have to furnish a certificate of due diligence from an overseas bank which is subject to regulation of host-country regulator and adhere to Financial Action Task Force (FATF) guidelines to the AD bank of the borrower. The certificate should mention that **(i)** the lender maintains an account for at least two years, **(ii)** the lender is organised as per the local law and held in good esteem by the business/local community and **(iii)** there is no pending criminal action against it.

Individual Lender has to obtain a certificate of due diligence from an overseas bank that he maintain's an account for at least two years. The bank should also certify and forward other evidence/documents such as audited statement of accounts and income-tax return. Individual lenders from countries wherein banks are not required to adhere to Know Your Customer (KYC) guidelines are not eligible to extend ECBs.

Amount and Maturity Corporates can avail of ECB of an amount of US $250 million with average maturity of 10 years under the approval route over and above the existing limit of US $500 million under the automatic route during a financial year. The ECBs upto 500 million US dollars per borrower per financial year are also now permitted for rupee expenditure/foreign currency expenditure for permissible end-uses under the automatic route. The other ECB criteria such as end-use, all-in-cost ceiling, recognised lender and so on need to be complied with. Prepayment and call/put options, however, would not be permissible for such ECB upto 10 years. Corporates in infrastructure sector and industrial sector can avail ECB upto US 500 million and 50 million respectively for rupee capital expenditure for permissible end-uses within the overall limit of US 500 million dollar per borrower per year under the automatic route. The NGOs can raise ECBs upto 5 million US dollars. The designated AD bank has to ensure that at the time of draw-down the forex exposure of the borrower is hedged. Corporates in service sector can avail ECB upto 100 million US dollars per borrower per year.

Guarantee Issuance of guarantee, standby letters of credit/undertaking/comfort by banks/FIs/NBFCs relating to ECBs are normally not permitted. Applications for permitting these in case of small and medium enterprises would be considered on merit subject to prudential norms. Further, with a view to facilitating capacity expansion and technological upgradation in Indian textile industry, applications for these by banks would be considered subject to prudential norms.

The stipulations relating to all-in costs ceilings, end-use, guarantee/security, refinancing of existing ECBs and prepayment upto US dollars 500 million applicable to the au-tomatic are also applicable to the approval route. Prepayment in excess of US dollars 500 million would be considered by the RBI. The first stage acquisition of shares in the disinvestment process and also in the mandatory stage offer to the public under the government disinvestment programme of PSU shares is also a permissible end-use of ECB proceeds under the approval route.

The RBI has constituted an Empowered Committee to consider propo-sals in the prescribe from.

Structured Obligations To enable corporates to raise resources domestically and hedge exchange rate risks, rupee denominated structured obligations are permitted to be credit-enhanced by international banks/FIs, joint ventures partners with the approval route.

Compliance with ECB Guidelines The prime responsibility to ensure compliance with the ECB guidelines/RBI regulations/directions is that of the concerned borrower and any contravention would be viewed seriously and invite penal action. The AD bank has to ensure compliance at the time of certification.

Conversion of ECBs Into Equity The conversion of the ECBs into equity is permitted subject to the following: **(i)** the activity of the company is covered under the automatic route of FDI or Government approval for foreign equity participation has been obtained, **(ii)** the foreign equity holding after conversion is within the sectoral gap, **(iii)** pricing of shares is as per the SEBI guidelines/regulations in case of listed/unlisted companies. Such conversion should be reported to the RBI.

Trade Credits (TCs) For Imports into India

Trade credits refer to credits extended for imports directly by the overseas supplier/bank/FI for less than 3 years maturity. Depending on the source, TCs include **(i)** suppliers', **(ii)** buyers credit. **Suppliers credit** relates to credit for imports into India extended by the overseas supplier, while **Buyers credit** refers to loans for payment of imports into India arranged by the importer from a bank/FI outside India for less than 3 years maturity. **Such credits for 3 years and above come under the category of ECBs**.

Amount and Maturity The AD banks can approve trade credits for imports into India upto US$ 20 million per import transaction with maturity upto one year from the date of shipment. For import of capital goods, the maturity period could be 1-3 years. No roll-over/extension will be permitted beyond the poermissible period.

All-in-Cost Ceilings The current ceiling over 6 months **LIBOR** for the respective currency of credit or applicable benchmark for maturity period **(1)** upto one year and **(2)** 1-3 years is 75 and 200 basis points respectively. The all-in-cost includes arrangers/upfront/management fee, handling/processing charges, out of pocket and legal charges.

Guarantees Banks can issue letters of credit/guarantee/undertakig/comfort upto US 20 million dollars per transaction in favour of the overseas supplier/bank/FI upto one year for import of all on-capital goods and upto 3 years for import of capital goods. The period should be coterminous with the period of credit reckoned from the date of shipment.

EURO ISSUES

As a part of globalising the Indian economy after 1991, Indian corporates are permitted to float their securities in, and raise funds from, the Euro markets. The two long-term primary instruments of Euro issues are Foreign Currency Bonds (FCCBs) and Global Depository Receipts/Certificates (GDRs)/American Depository Receipts/Certificates (ADRs). **A FCCB** means a bond subscribed by an non-resident in foreign currency and convertible into ordinary shares of the issuing company in India in any manner, wholly or in part, on the basis of any equity related warrants attached to the debt instruments. A GDR/ADR means any instrument in the form of a depository receipt/certificate, by whatever name called, created by the Overseas Depository Bank (ODB) outside India and issued to non-resident investors against the issue of ordinary shares or FCCBs of the issuing company. A bank authorised by the issuing company to issue GDRs/ADRs against the issue of FCCBs/ordinary shares of the issuing company is known as an ODB. The scheme for facilitating issue of FCCBs and ordinary shares through the GDR/ADR mechanism by Indian companies is discussed in this Section.

Eligibility for Issue of Convertible Bonds or Ordinary Shares of Issuing Company

An issuing company desirous of raising funds by issuing FCCBs or ordinary shares for equity issues through GDR/ADR is required to obtain the prior permission of the Department of Economic Affairs, Ministry of Finance, Government of India. It may sponsor an issue of ADRs/GDRs with an overseas depository against shares held by its shareholders, at a price determined by the lead manager with respect to disinvestment of their holdings by shareholders of Indian companies that are **(i)** listed in India, **(ii)** not listed in India, but listed overseas. Such a facility would be available *pari passu* to all categories of shareholders of the company whose shares are being sold in the ADR/GDR market over-seas. An approved intermediary under the scheme would be an investment banker registered with the Securities and Exchange Commission in the USA, or under the Financial Services Authority in UK, or the appropriate regulatory authority in Germany, France, Singapore or in Japan. Such issues would need to conform to the foreign direct investment policy and other mandatory statutory requirements and detailed guidelines issued in this regard.

An Indian company which is not eligible to raise funds from the Indian capital including a company restrained by the SEBI from accessing the securities market would not be eligible to issue FCCBs and ordinary shares through GDRs. Unlisted Indian companies issuing GDRs/FCCBs should be simultaneously listed in the Indian stock exchange(s). However, if they have taken verifiable *effec-tive steps* would be exempt from the requirement of simultaneous listing.

Effective steps mean that **(1)** it has completed due diligence and filed offering circular in the overseas exchange(s), or **(2)** the approval of the overseas stock exchange(s) has been obtained, or, **(3)** the listing fee is paid, or **(4)** approval of the RBI for meeting issue-related expenses has been obtained. Private placement of issues, where no offering circular was placed before the overseas stock exchange(s), would not qualify for effective steps.

The issuing company should have a consistent track record of good performance (financial or otherwise) for a minimum period of three years, on the basis of which an approval for finalising the issue structure would be issued to the company. On finalising the issue structure (discussed subsequently in this Section) in consultation with the lead manager to the issue, the issuing company should obtain the final approval from the Government for proceeding ahead with the issue.

The FCCBs should be denominated in any convertible foreign currency and ordinary shares of an issuing company should be denominated in Indian rupees. The issued ordinary shares or bonds should be delivered to a DCB who would instruct the ODB to issue GDR/ADR certificates to non-resident investors against the shares or bonds held by it. A DCB means a banking company that acts as a custodian for ordinary shares/FCCBs of an Indian company, which are issued by it against GDRs/ADRs certificates. A GDR may be issued in negotiable form and may be listed on any international stock exchange for trading outside India. The provision of any law relating to the issue of capital by an Indian company would apply in relation to the issue of FCCBs or ordinary shares of an issuing company and it should obtain the necessary permission or exemption from the appropriate authority, under the relevant law, in this regard.

An Indian company which is not eligible to raise funds from the Indian capital market cannot issue FCCBs and ordinary shares through GDRs. Unlisted Indian companies issuing GDRs/ FCCBs should be simultaneously listed in the Indian stock exchange(s). The OCBs (overseas corporate bodies) who are not eligible to invest in India through portfolio routes and entities prohibited by SEBI to buy/sell/deal in securities are not eligible to subscribe to FCCBs/ ordinary shares through GDRs/ADRs.

Issue of GDRs/ADRs by IT Software/Services Companies Indian companies engaged in information technology software and informa-tion technology services (IT software/services) are eligible to offer their non-resident/resident permanent employees (including Indian and overseas working directors) GDRs/ADRs against the issue of ordinary shares, subject to the operational guidelines/ conditions issued from time to time by the Government. A software company is one engaged in the manufacture/pro-duction of software and at least 80 per cent of its turnover is from software related activities. Information technology software/services include means companies that deal with such activities as defined in recommendation 19(a) and (b) of the notification issued by the Planning Commission on July 25, 1998. According to recommendation 19(a), IT software means any repre-sentation of instructions; data; sound/image, including source code and object code recorded in a machine in readable form and capable of being manipulated or providing interactive features to a user by means of a automatic data processing machine fall under the heading of IT products, but does not include non-IT products. IT service is defined as any service that results from the use of any IT software over a system of IT products for realising value additions. The term IT industry would cover development, produc-tion and services related to IT products; the term IT software should replace computer software. According to 19(b), IT products include computer, digital/data communication and digital/data broadcasting products. Such companies are also eligible to offer GDRs to the non-resident/resident permanent employees (including

Indian and overseas working directors) of their subsidiary compa-nies, incorporated in India or abroad and engaged in IT Software/Services, against the issue of ordinary shares, subject to the evligibility conditions and operational guidelines/condi-tionalities announced from time to time by the Government. Simi-larly, Indian companies registered in India and engaged in the following sectors/areas where 80 per cent of turnover is from these sector/areas of the operation/business of the company in the three previous financial years, are eligible to offer GDRs/ADRs against the issue of ordinary shares to their non-resident/resident permanent employees (including Indian and overseas working directors) and also to their subsidiary compa-nies, incorporated in India or abroad, subject to the eligibility conditions and operational guidelines/conditionalities announced from time to time by the Government: **(i)** Information Technology (as defined in the recommendation. 19(a) and (b) of Gazette Notification dated 25-7-1999, issued by the Planning Commission) and Entertainment Software, **(ii)** Pharmaceuticals, **(iii)** Biotech-nology, **(iv)** Any other activities within the knowledge based sector, as notified by the Government from time to time. These norms would also be available for multi-product diversified companies that do not conform to the criteria of 80 per cent turnover as mentioned above but have an average annual export earning of ₹100 crore, from the sectors mentioned above, in the three previous financial years.

Limits of Foreign Investment in the Issuing Company The ordinary shares and FCCBs issued against CDRs/ADRs should be treated as direct foreign investment in the issuing company. The aggregate of the foreign investment, made either directly or indirectly through GDR/ADR mechanism, should not exceed 51 per cent of the issue and the subscribed capital of the issuing company.

Issue Structure of the GDRs/ADRs A GDR/ADR may be issued for one or more underlying shares or bonds held with the domestic custodian bank (DCB). GDRs/FCCBs may be denominated in any freely convertible foreign currency. The ordinary shares underlying the GDRs and the shares issued upon conversion of the FCCBs should be denominated only in Indian currency. The following issues would be decided by the issuing company with the lead manager to the issue, namely: **(a)** public or private placement; **(b)** number of GDRs/ADRs to be issued; **(c)** the issue price. For listed companies, the pricing should not be less than the higher of the average of weekly high and low of the closing prices of the related shares quoted on the stock exchange during **(i)** the 2 months, **(ii)** the two weeks preceding the relevant date (i.e. the date 30 days prior to the date on which the meet-ing of the shareholders is held to consider the proposed issue). Companies issuing GDRs that have taken verifiable "effective steps" would be exempt from these requirements. For unlisted companies: the pricing should be in accordance with the RBI regulations. Listed companies going in for an offering in the domestic market and a simultaneous or immediately following on offering (i.e. within 30 days of domestic issue) through ADRs/GDRs issues wher-ein GDRs/ADRs are priced at/above the domestic price would be exempt from the above requirement. Such companies would have to take SEBI's approval for such issue which would specify the percentage to be offered in the domestic and ADR/GDR markets; **(d)** the rate of interest payable on FCCBs; and **(e)** the conversion price, coupon rate, and the pricing of the conversion options of the FCCBs. The conversion price of the FCCBs of listed companies should be similar to the issue price. They would be exempt from this requirement if they have taken the verifiable effective steps. The conversion price of FCCBs of unlisted companies should be in accordance with the RBI regulations. There would be no lock-in period for GDRs/ADRs. The pricing for listed companies as well as the conversion price of the FCCBs should not be less than the higher of the average of the weekly high and low of the closing prices of the related shares quoted in the stock exchange during **(i)** 2 weeks or **(ii)** 6 months preceding the relevant date (i.e. the date 30 days prior to the date on which the proposed issue is considered in the general meeting of the shareholders). The pricing for unlisted companies as well as the conversion price of the FCCBs should be according to the RBI regulations under FEMA. There would be no lock-in period for the GDRs issued under the Scheme.

Listing

The GDRs/ADRs may be listed on any of the overseas stock exchanges, or over the counter exchanges or through the book entry transfer system prevalent abroad. They may be purchased, possessed and freely transferable by a person who is a non-resident.

Transfer and Redemption

A non-resident holder of GDRs/ADRs may transfer them, or may ask the ODB to redeem them. In the case of redemption, the ODB should requires the DCB to get the corresponding underlying shares released in favour of the non-resident investor, for being sold directly on his behalf, or transferring them in the name of the non-resident in the books of account of the issuing company. The redeemed GDRs and underlying shares sold may be re-issued to the extent of such redemption and sale made in the domestic market. Such re-issuance should be in terms of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, as amended from time to time, and the guidelines issued in this regard. In case of redemption of the GDRs/ADRs into underlying shares, a request for the same should be transmitted by the ODB to the DCB in India, with a copy of the same being sent to the issuing company for information and record. On redemption, the cost of acquisition of the shares underlying the GDRs/ADRs would be reckoned as the cost on the date on which the ODB advises the DCB regarding redemption. The price of the ordinary shares of the issuing company prevailing in the Bombay Stock Exchange or the National Stock Exchange on the date of the advice of redemption should be taken as the cost of acquisition of the underlying ordinary shares. For the purpose of conversion of FCCBs, the cost of acquisition in the hands of non-resident investors would be the conversion price which is deter-mined on the basis of the price of the shares at the Bombay Stock Exchange or the National Stock Exchange on the date of conversion into shares.

Taxation of Foreign Currency Convertible Bonds

Interest payments on bonds, until the conversion option is exercised, would be subject to deduction of tax at source at the rate of ten per cent. Tax on dividend on the converted portion of the FCCB would be subject to deduction of tax at source at the rate of ten per cent. Conversion of FCCBs into shares would not give rise to any capital gains liable to income tax in India. Transfer of FCCBs made outside India by a non-resident investor to another non-resident investor would not give rise to any capital gains liable to tax in India.

Taxation on Shares Issued Under GDR Mechanism

Under the provisions of the Income tax Act, income by way of dividend on shares issued under the GDR/ADR mechanism would be taxed at the rate of 10 per cent. The issuing company should transfer the net dividend payments after remitting tax at source to the ODB. On receipt of these payments, the ODB should distrib-ute them to non-resident investors, proportionate to their hold-ings of GDRs/ADRs evidencing relevant shares. The holders may take credit for the tax deducted at source on the basis of cer-tification by the ODB, if permitted by the country of their residence. All trading transactions of GDRs/ADRs outside India, among non-resident inves-tors, would be free from any liability to income-tax in India on capital gains therefrom. If any capital gains arise from the transfer of the aforesaid shares in India to the non-resident investor, he would be liable to income tax under the provisions of the Income tax Act. If the aforesaid shares are held by the non-resident investor for a period of more than twelve months from the date of advice of their redemption by the ODB, the capital gains arising from the sale thereof would be treated as long-term capital gains and would be subject to income tax at the rate of 10 per cent under the provisions of Section 115-AC of the Income tax Act. If such shares are held for a period of less than twelve months from the date of redemption advice, the capital gains arising from the sale thereof would be treated as short-term capital gains and would be subject to tax at the normal rates of income tax applicable to non-residents under the provisions of the Income tax Act. After the redemption of GDRs/ADRs into underlying shares, during the period, if any, in which these shares are held by the redeeming non-resident foreign investor who has paid for them in foreign exchange at the time of its purchase, the rate of taxation of income by way of dividend on these shares would continue to be at the rate of 10 per cent, in accordance with Section 115-AC(1) of the Income tax Act. The long-term capital gains on the sale of these redeemed underlying shares held by non-resident investors in the domestic market would also be charged tax to the rate of 10 per cent, in accordance with the provisions of Section 115-AC(1). When the redeemed shares are sold on Indian stock exchanges against pay-ment in rupees, these shares would go out of the purview of Section 115-AC of the Income tax Act and income therefrom would not be eligible for concessional tax treatment provided thereun-der. After the transfer of shares, where consideration is in terms of rupees payment, normal tax rates would apply to the income arising or accruing from these shares. Deduction of tax at source on the amount of capital gains accruing from transfer of the shares would be made in accordance with Sections 195 and 196-C of the Income tax Act.

Application of Avoidance of Double Taxation Agreement in Case of Global/American Depository Receipts

During the period of fiduciary ownership of shares in the hands of the ODB, the provisions of Avoidance of Double Taxation Agreement, entered into by the Government of India with the country of residence of the ODB, would be applicable in the matter of taxation of income from dividends from underlying shares and interest on FCCBs. During the period, if any, when the redeemed underlying shares are held by the non-resident investor on transfer from the fiduciary ownership of the ODB, before they are sold to resident purchasers, the Avoidance of Double Taxation Agreement entered into by the Government of India with the coun-try of residence of the non-resident investor would be applicable in the matter of taxation of income from the dividends of the said underlying shares, or interest on FCCBs, or any capital gain arising out of transfer of underlying shares.

Gift Tax and Wealth Tax

Holding of GDRs/ADRs in the hands of non-resident investors and holding of the underlying shares by the ODB in a fiduciary capac-ity and the transfer of the GDRs/ADRs between non-resident inves-tors and the ODB would be exempt from wealth tax under the Wealth tax Act, 1957, and from gift tax under the Gift Tax Act, 1958.

Operational Guidelines

These relate to **(i)** automatic route of the RBI to issue GDRs/ADRs to foreign investors, **(ii)** two-way fungibility of ADRs/GDRs, **(iii)** disinvestment of shares by Indian companies **(iv)** automatic route for issue of FCCBs **(v)** issue of ADRs/GDRs through automatic route, **(vi)** issue of ADR/GDR linked employee stock options by Indian software/IT companies, and **(vii)** norms of overseas business acquisition through ADRs/GDRs. **The detailed guidelines are given in Appendix 19-B on the website. The website address is http://www.mhhe.com/khanifs10e.**

FOREIGN CURRENCY EXCHANGEABLE BONDS

A foreign currency exchangeable bond (FCEB) means a bond expressed in foreign currency, the principal and interest in respect of which is payable in foreign currency, issued by an Indian (issuing) company and subscribed to by a person who is a resident outside India in foreign currency and exchangeable into equity shares of another company (i.e. an **offered company** whose equity shares would be offered in exchange of the FCEB) in any manner either wholly or partly or on the basis of an equity related warrants attached to debt instruments. The main elements of the FCEB scheme, 2008 are discussed in this Section.

Eligibility Conditions

The issuing company should be part of the promoter group of the offered company and hold the equity shares being offered at the time of issuance of the FCEBs. The offered company should be a listed company engaged in a sector eligible **(i)** for FDI and **(ii)** to issue/avail of FCCBs/ECBs. An Indian company which is not eligible to raise funds from the Indian securities marke/ has been restrained from accessing the securities market by the SEBI cannot issue the FCEBs. The subscribers to the FCEBs should comply with the FDI policy and adhere to the sectoral caps at the time of issuance of the FCEBs. Prior approval of the FIPB, if required under the FDI policy, should be obtained. **Entities** prohibited to buy/sell/deal in securities by the SEBI are not eligible to subscribe to the FCEBs.

End-Use Requirements

The proceeds of the FCEBs may be invested by the issuing company in the promoter group companies who can use the proceeds in accordance with the end-user prescribed under the ECBs policy. (**These are discussed in another Section of this Chapter**). The investee promoter group company would not be able to utilise the proceeds/funds for investment in **(i)** the capital, market, **(ii)** real estate in India.

The issuing company may invest the proceeds of the FCEBs overseas by way of direct investment including in joint ventures/wholly owned subsidiaries subject to the guidelines in force in this respect (**These are discussed in another Section of this Chapter**).

Operational Procedure

The issuance of the FCEBs, which may be denominated in any freely convertible currency, would require the prior approval of the RBI.

All-in-Cost, Pricing and Maturity

The rate of interest payable on the FCEBs and the issue expenses incurred in foreign currency should be within the all-in-cost ceiling specified by the RBI under the ECBs policy. At the time of issuance of the FCEBs, the exchange price of the offered listed equity shares should not be less than the higher of the average of the weekly high and low of the closing prices of the shares of the offered company quoted on the stock exchange during the **(i)** six months, **(ii)** two weeks preceding in the relevant date, that is, the date on which the Board of Directors of the issuing company passes the resolution authorising the issue of the FCEBs.

The minimum maturity of the FCEBs should be 5 years for redemption purposes. The exchange option can be exercised at any time before redemption. While exercising the option, the holders of the FCEBs should take delivery of the offered shares. Cash (net) settlement would not be permissible.

Mandatory Requirements

The issuing company should comply with the provisions of the Companies Act and obtain necessary approvals of its Board of Directors/shareholders, if necessary. Similarly, the offered company should also obtain the approval of its Board of Directors in favour of the FCEBs proposal of the issuing company. The issuing company should comply with all the applicable provisions of the SEBI Act/Rules/Regulations/Guidelines with respect to disclosures of their shareholding in the offered company. It should **(i)** not transfer/mortgage/offer as collateral/trade in the offered shares, **(ii)** keep the offered shares free from all encumbrances from the date of issuance of the FCEBs till the date of exchange/redemption.

Retention/Deployment of Proceeds

The proceeds of the FCEBs should be retained and/or deployed overseas by the issuing/promoter group companies in accordance with the policy for the proceeds of the ECBs. The issuing company should ensure that the FCEB proceeds are used by the promoter group company(ies) only for the permitted end-uses prescribed under the ECB policy. It should also submit audit trail of end-uses of the proceeds to the RBI duly certified by the designated AD bank.

Taxation

The interest payments on the FCEBs, until the exchange option is exercised, would be subject to deduction of tax at source under the provisions of Section 115-AC (1) of the Income Tax Act. The tax on dividend on the exchange portion of the FCEBs would be in accordance with the provisions of Section 115-AC (1) of the Income Tax. The exchange of the FCEBs into shares would not give rise to any capital gains liable to tax in India. The transfer of the FCEBs made outside between investors resident outside India would also not give rise to any capital gains liable to tax in India.

FOREIGN PORTFOLIO INVESTORS (FPI) INVESTMENTS

While presenting the Budget for 1992-93, the Finance Minister had announced a policy decision to allow reputed foreign institutional investors (FIIs) such as pension funds, mutual funds, investment trusts, asset management companies, institutional portfolio managers, to invest in the Indian capital market. To operationalise this policy statement, Government guidelines were formulated for investments by the FIIs. The SEBI had issued the FII Regulations to provide the framework for their investments. These have now been replaced by the foreign portfolio investors (FPI) regulation. This is discussed in this Section.

A **FPI** means a person who is registered with, and satisfies the SEBI-prescribed, eligibility criteria (**discussed below**), and is deemed to an intermediary under the provisions of the SEBI Act. The main elements of the SEBI framework of their regulations are: **(i)** registration, **(ii)** approval of designated depository participant, **(iii)** investment conditions and restrictions, **(iv)** general obligations and responsibilities of foreign portfolio investors/designated depository participants, **(v)** inspection and **(vi)** action in case of default.

Registration of Foreign Portfolio Investors

To buy, sell or otherwise deal in securities as a foreign portfolio investor requires a certificate granted by the SEBI-approved designated depository participant (DDP) on behalf of the SEBI. However, an existing foreign institutional investor or sub-account may, subject to payment of the specified conversion fees, continue to buy, sell or otherwise deal in securities, till the expiry of its registration obtains a certificate of registration a **FPI**, whichever is earlier. A **qualified foreign investor** (i.e. a person who has a demat account with a qualified SEBI-approved qualified depository participant as a foreign investor) may also continue to buy, sell or otherwise deal in securities for a period of one or until he obtains a certificate of registration as FPI, whichever is earlier.

The application for the grant of certificate for **category II and III** FPI should be made to the DDP in the prescribed format accompanied by the specified fee: **(a)** Conversion fee by FIIs/sub-account, US $1,000; **(b)** Registration fee by **category II and III** FPIs, US$3,000 and $300 respectively for every block of three years till the validity of registration. No fee is required from **category I** FPIs.

Eligibility Criteria The applicant should satisfy the following conditions:

1. The applicant is as a **(a)** person not resident in India; **(b)** resident of a country whose securities market regulator is a signatory to **(i)** International Organisation of Securities Commission's Multilateral Memorandum of Understanding, **(ii)** bilateral Memorandum of Understanding with the SEBI, that, ***inter-alia***, provides for information sharing arrangement; **(c)** a bank which is a resident of a country whose central bank is a member of Bank for International Settlements; **(d)** not resident in a country identified in the public statement of financial action task force as a jurisdiction **(i)** having a strategic anti-money laundering or combating the financing of terrorism deficiencies to which counter measures apply; or **(ii)** that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the financial action task force to address the deficiencies; **(e)** not a non-resident Indian; **(f)** legally permitted to invest in securities outside the country of its incorporation/establishment/place of business; **(g)** authorised by its memorandum and articles of association/equivalent document(s)/the agreement to

invest on its own behalf or on behalf of its client; **(h)** has sufficient experience, good track record, is professionally competent, financially sound and has a generally good reputation of fairness and integrity.

2. The grant of certificate to the applicant is in the interest of the development of the securities market.
3. The applicant is a fit and proper person based on the criteria specified in the SEBI **Intermediaries Regulation**.
4. Any other criteria specified by the SEBI from time to time.

Categories of Foreign Portfolio Investors The applicant should seek registration in one of the categories mentioned below:

(a) Category I Foreign Portfolio Investor which would include Government and Government-related investors such as central banks, Governmental agencies, sovereign wealth funds and international/multilateral organisations/agencies;

(b) Category II Foreign Portfolio Investors which would include: **(i) appropriately regulated (1)** broad-based funds such as mutual funds, investment trusts, insurance/reinsurance companies, **(2)** persons such as banks, asset management companies, investment managers/advisors, portfolio managers; **(ii)** broad-based funds that are not **appropriately regulated** but whose investment manager is appropriately regulated provided he is itself registered as Category II foreign portfolio investor. The investment manager should undertake that he would be responsible/liable for all acts of commission/omission of all its underlying broad-based funds and other deeds and things done by them; **(iii)** University and pension funds; and **(iv)** University-related endowments already registered with the SEBI as FIIs/or sub-accounts.

The applicant would be considered to be **appropriately regulated** if regulated/supervised by the securities market/banking regulator of the concerned foreign jurisdiction, in the same capacity in which it proposes to make investments in India. The **broad-based fund** means a fund, established/incorporated outside India, which as at least 20 investors, with no investor holding more than 49 per cent of its shares/units. An institutional investor holding more than 49 per cent of the shares/units in the fund must itself be a broad-based fund. For ascertaining the number of investors in a fund, direct as well as underlying investors would be considered. Only investors of entities which have been set up for the sole purpose of pooling funds and making investments, would be considered for the purpose of determining underlying investors.

Category III Foreign Portfolio Investor would include all non-eligible Category I and II FPIs such as endowments, charitable societies/trusts, foundations, corporate bodies, trusts, individuals and family offices.

The SEBI/the designated depository participant may require the applicant to furnish further necessary information/clarification. The applicant/his authorised representative would, if required, appear before them for personal representation. The designated depository participant would grant registration in the prescribed format if satisfied that the applicant is eligible and fulfils the specified requirements. It should endeavour to dispose of the application as soon as possible but not later than 30 days. Upon grant of certificate of registration, the designated depository participant should forthwith collect the specified fees and remit it to the SEBI. Subject to compliance with the provisions of the SEBI Act/regulations/circulars, the registration would be permanent unless suspended/cancelled/surrendered by the foreign portfolio investor. Suspension and cancellation of registration would be dealt with in the manner as provided in SEBI **Intermediaries Regulations**.

Approval of Designated Depository Participant

To act as designated depository participant (DDP), a person has to obtain the approval of the SBEI. However, a SEBI-registered custodian of securities would deemed to have been granted approval as designated depository participant subject to the payment of the specified fees: ₹10,000 (application fee) and ₹5,00,000 (approval fee). The application by the DDP should be made to the SEBI through the concerned depository accompanied by the application fee. The depository should forward to the SEBI the application, as early as possible, but not later than 30 days from the date of its receipt, along with its recommendations and certifying that the participant complies with the eligibility criteria (**discussed below**).

Eligibility Criteria The applicant should satisfy the following conditions: **(a)** The applicant is **(1)** a participant/SEBI-registered custodian; **(2)** an authorised dealer category-I bank authorised by the RBI; **(3)** has multinational presence through its branches/agency relationships with intermediaries regulated in their respective home jurisdiction; **(4)** has systems and procedures to comply with the requirements of financial action task force standards, prevention of money—laundering Act/rules/circulars; **(5)** a fit and proper person based on the criteria specified in SEBI **Intermediaries Regulations**; **(b)** Any other criteria specified by the SEBI from time to time. However, the SEBI may consider an application from a global bank, regulated in its home jurisdiction, for grant of approval to act as designated depository participant, if it is satisfied that it has sufficient experience in providing custodial services and the grant of such approval is in the interest of the development of the securities market. It should be registered with the SEBI as a participant, custodian of securities, and should have tie-up with authorised dealer category-I bank.

On being satisfied that the applicant is eligible and fulfils the specified requirements including payment of specified fees, the SEBI would approve the application. It would dispose of the application as soon as possible but not later than one month. The approval granted by the SEBI would be permanent unless suspended/withdrawn/surrendered by the DDP.

Suspension or Withdrawal of Approval Where any DDP **(a)** fails to comply with any conditions subject to which an approval has been granted, **(b)** contravenes any of the provisions of the securities laws/directions/instructions/circulars, the SEBI may, without prejudice to any other action under any other law, suspend/withdraw the approval after providing the DDP a reasonable opportunity of being heard.

Any designated depository participant may surrender the approval to the SEBI. While accepting the surrender, it may impose conditions as it deems fit for protection of investors/the clients of DDP/securities market.

Investment Conditions and Restrictions

The investments by the FPIs would be subject to the following conditions/restrictions.

- A foreign portfolio investor (FPI) can invest only in the following securities: **(a)** securities in the primary/secondary markets including shares/debentures/warrants of listed/to be listed companies, in India, **(b)** units of schemes of domestic mutual funds, **(c)** units of scheme of a collective investment scheme, **(d)** derivatives traded on a recognised stock exchange, **(e)** treasury bills and dated Government securities, **(f)** commercial papers issued by an Indian company, **(g)** rupee denominated credit enhanced bonds, **(h)** security receipts issued by asset reconstruction companies, **(i)** RBI-specified perpetual debt/debt capital instruments, **(j)** listed/unlisted non-convertible debentures/bonds of an Indian company in the infrastructure sector, **(k)** non-convertible debentures/bonds issued by NBFCs categorised as `Infrastructure Finance Corporation' (IFCs) by the RBI, **(l)** rupee denominated bonds/units issued by infrastructure debt funds, **(m)** Indian depository receipts, and **(n)** other SEBI-specified instruments.

- The following additional conditions would apply in respect of investments in the secondary market: **(a)** Transactions in the securities in India should be only on the basis of taking/giving delivery of securities purchased/sold, excepting the following: **(i)** any transactions in derivatives on a recognised stock exchange, **(ii)** short selling transactions in accordance with the SEBI-specified framework, **(iii)** any transaction pursuant to an agreement with the merchant banker in the process of market making/subscribing to/unsubscribed portion of the issue in accordance with the SEBI Issue of Capital and Disclosure Requirements Regulations; **(iv)** any other SEBI-specified transaction; **(b)** Transaction on the stock exchange should not be carried forward; **(c)** It should be only through SEBI-registered stock brokers, with the following exceptions/exemptions: **(i)** transactions in Government securities/securities falling under the purview of the RBI, **(ii)** sale of securities in response to **(1)** a letter of offer by an acquirer in accordance with the **SEBI Substantial Acquisition of Shares and Takeover Regulations**, **(2)** an offer by any promoter/acquirer in accordance with the **SEBI Delisting of Equity Shares Regulations/SEBI Buy-back of Securities Regulations**, **(iii)** disinvestment of securities in response to an offer by Indian companies in the overseas market through issue of American/Global depository receipts, **(iv)** any bid for, or acquisition of, securities in response to an offer for disinvestment of shares made b the Central/State Government, **(v)** any transaction pursuant to an agreement entered into with merchant banker in the process of market making/subscribing to unsubscribed portion of the issue in accordance with **SEBI Issue of Capital and Disclosure Requirements Regulation**, **(vi)** any other transaction specified by the SEBI; and **(d)** The securities should be held, delivered/caused to be delivered only in dematerialised form;
- The foreign portfolio investors should also comply with the terms/conditions/directions, specified/issued by the SEBI/RBI in respect of investments in the debt securities. The `**debt securities**' include dated Government securities, commercial paper, treasury bills, listed/to be listed corporate debt, units of debt-oriented mutual funds, unlisted non-convertible debentures/bonds in the infrastructure sector, security receipts issued by assets reconstruction companies/any other SEBI-specified security.
- Unless otherwise approved by the SEBI, securities should be registered in the name of the FPI as a beneficial owner for the purposes of the Depositories Act.
- The purchase of equity shares by a single FPI/an investor group should be below 10 per cent of the total issued capital of the company.
- The investment would also be subject to such other conditions and restrictions as may be specified by the Government of India from time to time.
- In cases where the Government of India enters into agreement/treaties with other sovereign Governments specifically recognising certain entities to be distinct and separate, the SEBI may recognise them subject to the specified conditions.
- The foreign portfolio investor may lend/borrow securities in accordance with the framework specified by the SEBI in this regard.

Conditions for Issuance of Offshore Derivative Instruments A foreign portfolio investor can directly or indirectly issue/subscribe to/otherwise deal in **offshore derivative instruments,** that is, an instrument issued overseas by a FPI against listed/proposed to be listed on a stock exchange in

India securities held by it as its underlying, only if **(a)** issued only to persons who are regulated by an appropriate foreign regulatory authority, **(b)** after compliance with '**know your client**' norms. However, unregulated broad-based funds, which are classified as **Category II** foreign portfolio investor by virtue of their investment manager being appropriately regulated, should not directly or indirectly issue/subscribe/otherwise deal in offshore derivative instruments. No **Category III** foreign portfolio investor should directly or indirectly issue/subscribe to/otherwise deal in offshore derivatives instruments.

A foreign portfolio investor should ensure that any further issue/transfer is made only to persons who are regulated by an appropriate foreign regulatory authority. He should fully disclose to the SEBI any information concerning the terms of, and parties to offshore derivative instruments, such as participatory notes, equity linked notes/any other such instruments, entered into to relating to any securities listed/proposed to be listed in any stock exchange in India, as and when and in such form as the SEBI may specify.

General Obligations and Responsibilities

Every FPI should: **(a)** comply with the provisions of these regulations/circulars/any other terms and SEBI-specified conditions; **(b)** forthwith inform the SEBI and the DDP in writing, if **(i)** any information or particulars previously submitted are found to be false/misleading in any material respect, **(ii)** there is any material change in the information previously furnished; **(c)** as and when required by the SEBI/any other government agency in India, submit any information/record/document in relation to its activities; **(d)** forthwith inform the SEBI/DDP, in case of any penalty, pending litigations or proceedings, findings of inspections or investigations for which action may have been taken or is in the process of being taken by an overseas regulator against it; **(e)** obtain permanent account from the Income-tax Department; **(f)** in relation to its activities, subject itself to the extant Indian laws/rules/regulations/circulars and provide an express undertaking to this effect to the DDP; **(g)** provide declaration/undertakings as required by the DDP; and **(h)** provide any acquired additional information/documents by the DDP to ensure compliance with the Prevention of Money Laundering Act/rules/regulations, financial action task force standards and circulars issued by the SEBI.

In case of jointly held depository accounts, each of the joint holders should meet the specified requirements and each would be deemed to be holding a depository account. In case the same set of ultimate beneficial owner(s) invest through multiple entities, they should be treated as part of same investor group and their investment limits should be clubbed at the investment limit as applicable to a single foreign portfolio investor. In case of any direct or indirect change in structure or beneficial ownership of the foreign portfolio investor, it should bring the same to the notice of its designated depository participant forthwith.

Code of Conduct A foreign portfolio investor should, at all times, abide by the code of conduct as specified below: A foreign portfolio investor (and its key personnel) should **(1)** observe high standards of integrity, fairness and professionalism in all dealings in the Indian securities market with intermediaries, regulatory and other government authorities, **(2)** render high standards of service, exercise due diligence and independent professional judgment, **(3)** ensure and maintain confidentiality in respect of trades done on its own behalf and/or on behalf of its clients, **(4)** ensure: **(a)** clear segregation of its own money/securities an its client's money/securities, **(b)** arms length relationship between its business of fund management/investment and its other business, **(5)** maintain an appropriate level of knowledge and competency and abide by the provisions of the applicable and relevant SEBI Act/regulations/circulars/guidelines, and also comply with award of the Ombudsman and decision of the SEBI under SEBI Ombudsman Regulations, **(6)** not make any untrue statement or suppress any material fact in any documents, reports or information to be furnished to the designated depository participant and/SEBI, **(7)** ensure that good corporate policies and corporate governance are observed by it, **(8)** ensure that it does not engage in fraudulent and manipulative transactions in the listed securities in India, **(9)** not, either through its/his own account or through any associate or family members, relatives or friends indulge in any insider trading, and **(10)** not be a party to or instrumental for **(a)** creation of false market in securities, **(b)** price rigging or manipulation of prices of listed or proposed to be listed securities in any stock exchange in India, **(c)** passing of price sensitive information to any person or intermediary in the securities market.

Engagement of Designated Depository Participant The applicant should engage a DDP to avail its services for obtaining a certificate of registration.

Appointment of Custodian of Securities A foreign portfolio investor or a global custodian acting on his behalf, should enter into an agreement with the DDP to act as a custodian of securities, before making any investment. In addition to the obligation of custodian of securities, the custodian should **(a)** report in the SEBI-prescribed form and manner to the depositories and the SEBI on a daily basis the transactions entered into by the FPI, **(b)** monitor his investment, **(c)** maintain the relevant true and fair records, books of accounts, and documents including the records relating to his transactions, **(d)** report his holdings who form part of investor group to the depositories and they club the investment limits to ensure that their combined investments remains below 10 per cent of the issued capital of the investee company at any time.

Appointment of Designated Bank A FPI should appoint a branch of a bank authorised by the RBI for opening of foreign currency denominated account and special non-resident rupee account before making any investments in India.

Appointment of Compliance Officer Every FPI should appoint a compliance officer responsible for monitoring the compliance of the SEBI Act/rules/regulations/notifications/guidelines/instructions issued by the DDP/SEBI/the Central Government. However, individual FPIs would be responsible for monitoring the compliance(s). The compliance officer should immediately and independently report to the SEBI and the DDP regarding any non-compliance observed by him.

Investment Advice in Publicly Accessible Media The FPI/employees should not directly/indirectly render any real-time or non-real time investment advice about any security in the publicly accessible media, unless a disclosure of his interest including long or short position has been made. An employee of the FPI rendering such advice, should also disclose the interest of his dependent family members and his employer including their long or short position.

Maintenance of Proper Books of Account, Records and Documents Every FPI should keep/maintain the following books of account, records and documents and preserve them for at least 5 years: **(a)** true and fair accounts relating to remittance of initial corpus for buying, selling and realising capital gains of investment made from the corpus; **(b)** accounts of remittances to India for investments in India and realising capital gains on investments made from such remittances; **(c)** banks statement of accounts; **(d)** contract notes relating to purchase and sale of securities; and **(e)** communication from, and to, the DDPs/stock brokers and depository participants regarding investments in securities. He should intimate to its DDP, the location where the books, records and documents will be kept/maintained.

General Obligations and Responsibilities of Designated Depository Participants

All SEBI-approved DDPs should **(a)** comply with the provisions of the SEBI regulations/circulars/ any other terms and specified conditions by the SEBI; **(b)** forthwith inform, if **(i)** any information/particulars previously submitted to the SEBI are found to be false or misleading, in any material respect, **(ii)** there is any material change in the information previously furnished by him; **(c)** furnish the required information/record/documents to the SEBI and the RBI in relation to his activities; **(d)** ensure that **(i)** only registered FPIs are allowed to invest in securities market, **(ii)** FPI does not have **opaque** structure(s) (i.e. any structure such as protected/segregated cell company or equivalent, where the details of the ultimate beneficial owners are not accessible/the beneficial owners are ring fenced from each other/they are ring fenced with regard to enforcement). However, the FPI satisfying the following criteria would not be treated as having opaque structure: **(i)** if regulated in its home jurisdiction, **(ii)** each fund/sub-fund satisfies broad-based criteria, and **(iii)** if gives an undertaking to provide information regarding its beneficial owners as and when SEBI seeks this information; **(e)** have adequate systems to ensure that each of the joint holders meets the requirements specified for FPI and perform KYC due diligence for each of them; **(f)** the designated depository participant should bring information relating to penalty, pending litigations/proceedings, findings of inspections/investigations for which action may have been taken/is in the process of being taken by any regulator against a DDP, forthwith, to the attention of the SEBI/depositories/stock exchanges; **(g)** be guided by the relevant circulars on anti-money laundering or combating the financing of terrorism specified by the SEBI.

- The DDP should **(a)** ascertain, whether the applicant forms part of any investor group, **(b)** open a dematerialised account for the applicant only after ensuring compliance with all the requirements under prevention of money laundering act/rules/regulations, financial action task force standards and circulars issued by the SEBI in this regard and also ensure that FPIs comply with these requirements on an ongoing basis, **(c)** carry out necessary diligence and obtain appropriate declarations and undertakings from applicant to ensure that no other depository account is held by any of them as a FPI/non-resident Indian, before opening a depository account, **(d)** ensure that equity shares held by FPI are free from all encumbrances, **(e)** collect and remit the specified fees to the SEBI, and **(f)** in case of change in structure/constitution/direct/indirect change in beneficial ownership reported by the FPI, re-assess its eligibility.

Maintenance of Proper Books of Accounts, Records and Documents Every DDP **(i)** should keep/ maintain the relevant true and fair records, books of account, and documents including the records relating to registration of FPIs, and **(ii)** intimate to the SEBI in writing the location where such books, records and documents will be kept or maintained.

Appointment of Compliance Officer Every DDP should appoint a compliance officer responsible for monitoring the compliance of the SEBI Act/rules/regulations/notifications/guidelines/instructions issued by the SEBI/Central Government and immediately and independently report to the SEBI any non-compliance observed by him.

Information to SEBI/RBI Every designated depository participant should submit to the SEBI/RBI information/record/documents in relation to activities of FPI.

Investment Advice in Publicly Accessible Media A DDP/employees should not directly/indirectly render any real-time or non-real-time investment advice about any security in the publicly accessible media, unless a disclosure of his interest including long or short position in the said security has been made. The employee should also disclose the interest of his dependent family members and his employer including their long or short position in the said security.

Inspection

The SEBI may ***suo moto*** or upon receipt of information/complaint, appoint one/more person(s) as inspecting authority/auditor to undertake inspection of the books of account, records and documents relating to a DDP for any of the following purposes: **(a)** ensure that the books accounts, records including telephone records and electronic records and documents are being maintained, **(b)** ascertain whether any circumstances exist which would render him unfit or ineligible, **(c)** inquire into the complaints received from investors, clients, other market participants/any other person on any matter having a bearing on his activities, **(d)** ascertain whether the provisions of the securities laws and the directions/circulars are being complied with, **(e)** ascertain whether the systems, procedures and safeguards which have been established/ are being followed are adequate, and **(f)** investigate ***suo moto*** into their affairs in the interest of the securities market/investors.

Obligations of Designated Depository Participants Every DDP/director/officer/ employee would be duty bound to produce to the inspecting officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to its activities, as the inspecting officer may require, within such reasonable period as he may specify. It should allow the inspecting officer to have reasonable access to the premises occupied by him or by any other person on its behalf and also extend reasonable facility for examining any books, records, documents and computer data in its possession or such other person and also provide copies of documents or other materials which in the opinion of the inspecting officer are relevant for the purposes of the inspection. The inspecting officer would be entitled to examine/record the statements of any director/officer/employee of the DDP. It would be the duty of every director/officer/employee to give to the inspecting office all assistance in connection with the inspection, which the inspecting officer may reasonably require.

The inspecting officer would, as soon as possible, on completion of the inspection/investigation submit a report to the SEBI. He may also submit interim report(s). After consideration of inspection report, the SEBI would take such action as deem fit and appropriate including action under the **SEBI Intermediaries Regulations**.

The SEBI would be entitled to recover from the DDP/applicant, expenses including fees paid to the auditors incurred by it for the purposes of inspecting or investigating their books of account, records, documents, infrastructures, systems and procedures/affairs.

Procedure for Action in Case of Default

A FPI/DDP/depository/any other person who contravenes any of the provisions of the SEBI regulations would be liable for action under the **SEBI Intermediaries Regulations/**relevant provisions of the SEBI/Depositories Act.

OFFSHORE (MUTUAL)/COUNTRY FUNDS

These are mutual funds of a given country which collect subscription from the residents abroad. Apart from facilitating transfer of capital of the host country, they widen the choice of investment for the individual and institutional investors abroad.

Salient Features

Tax Exemption This is the main consideration for launching offshore mutual funds which route their investments through tax havens. A tax haven is a country which provides shelter from excessive taxes that may prevail in the investing country. In such tax havens, either no taxes are levied on income, or taxes are levied only on incomes which arise within that country, with foreign income being exempted either in part or in toto. The examples of such countries are Netherlands and Mauritius.

Absence of Exchange Control Another attraction is the absence of exchange control measures and a minimum double-tax avoidance treaty with India.

Concessional Rate of Withholding Tax Dividend income earned by an offshore entity based in Mauritius is subject to withholding tax in India at 5 per cent compared to 15 per cent for FIIs and NRIs.

Confidentiality The information regarding offshore companies are not disclosed to the companies.

Complete Exemption from Stamp Duties There is complete exemption from stamp duties on all document relating to offshore transactions in many tax havens.

Offshore funds provide a vehicle for unregistered FIIs to participate in India without registering with the SEBI as an approved FII. Investors abroad are able to participate in Indian stock markets without its attendant problems of share transfer and other rules. Moreover, they get access to one-stop shop for research base, dealing room and custodial services through the offshore fund. Also, offshore funds are listed in the developed stock markets where liquidity is of a very high order. The offshore funds are exempted from the RBI guidelines pertaining to investments by FIIs according to the holding of a single FII in any company not exceeding 15 per cent of issued capital. Portfolio investments of FIIs, NRIs and OBCs are collectively subject to a ceiling of 40 per cent of issued share capital.

Constitution and Set up

Offshore funds are trust companies that raise funds from investors, both retail and institutional, for investments in Indian securities. An offshore fund can be set up in either of the two ways: **(i)** as a foreign institution (FII) and **(ii)** as a client of a domestic fund.

Offshore Fund as an FII Funds are raised by a trust, an investment company or a fund and invested in India. The investment company could register itself as an FII or become the client of an FII for the purpose of investment. The FII is governed by the SEBI guidelines on investments and has to pay 20 per cent withholding tax on interest and dividend income and long-term capital gains. The fund is free to invest in securities on the Indian stock exchange as well as the GDR stock. In order to reduce the tax-incidence, the fund may decide to invest the money through an investment company based in Mauritius. Due to the Dual Tax Avoidance (DTA) agreement between India and Mauritius, the income and capital gains of such a company are completed exempted from taxes in India. The fund may raise the money for investment after getting approval from the SEBI, which looks for the track-record of the fund raising body, its investment strategy details and fund raising plans, and so on. After closing the subscription list, the fund manager has to send a list of investors and the amounts invested by each. The SEBI reserves the right to reject the list or a part of it, based on its perception of the investors. A revised list has to be submitted to the SEBI, and upon approval, the fund may commence its investment activities.

Offshore Fund as a Client of a Domestic Fund The offshore partner has to tie-up with a domestic mutual fund organisation. The latter floats a scheme and offers the unit(s) of the scheme only to the offshore partner which issues the funds and invests the corpus into the unit(s) issued by the domestic institution. The offshore partner is free to redeem a part/whole of the fund as laid down in the agreement. Short-term capital gain tax is applicable if the units are redeemed before the completion of one year. The withholding tax on interest and dividend is only 10 per cent. The permission for setting up the fund has to be obtained from the Ministry of Finance and SEBI for floating the domestic scheme. The foreign partner(s) or investment manager(s) of their choice may be retained as investment advisor(s) in which case the domestic fund manager would have to invest as per their advice. The domestic fund is not permitted to invest in GDR stock. Such investments may be made out of the funds retained/remitted abroad. Due to the delays involved in this process, most of the funds have chosen the first route since the beginning of the permission to FIIs for portfolio management.

OVERSEAS VENTURE CAPITAL INVESTMENTS

In recognition of the growing importance of venture capital as one of the sources of finances for Indian industry, particularly for the smaller unlisted companies, overseas venture capital investments are allowed with effect from September 1995.

The SEBI Foreign Venture Capital Investors (FVCIs) Regulations, 2000

A foreign venture capital investor (FVCI) is an investor incorporated and established outside India and is registered with the SEBI under these regulations and proposes to make investment in accordance with these regulations. The VCFs refer to funds established in the form of a trust/company, including a body corporate, and registered with the SEBI Venture Capital Fund Regulations, 1996, which have a dedicated pool of capital raised in the manner specified under the regulations and invested in accordance with the regulations. While a VCU is a domestic company **(i)** whose shares are not listed in a recognised stock exchange in India, **(ii)** which is engaged in the business of providing services, production/manufacture of articles/things but does not include such activities/factors as specified in the Government approved negative list of the SEBI—namely, NBFCs, gold financing, excluding companies engaged in gold financing for jewellary, activities not permitted under the industrial policy of the Government and any other activity that may be specified from time to time. The main features of FVCIs are described below.

Registration A FVCI should be registered with the SEBI to carry on business in India. To seek registration with the SEBI, an applicant should apply in the prescribed form, along with an application fee of US$ 1,000. The eligibility criteria for registration of an applicant include the following conditions: **(i)** its track record, professional competence, financial soundness, experience, general reputation of fairness and integrity; **(ii)** the RBI's approval for investing in India; **(iii)** it is an investment company/trust/partnership, pension/mutual/endowment fund, charitable institution or any other entity incorporated outside India; **(iv)** it is an asset/investment management company, investment manager or any other investment vehicle incorporated outside India; **(v)** it is authorised to invest in VCFs/carry on activity as a foreign venture capital investor; **(vi)** it is regulated by an appropriate foreign regulatory authority, or is an income tax payer, or where it is neither a regulated entity nor an income tax payer, it submits a banker's certificate certifying its promoters' track record; **(vii)** it has not been refused a certificate by the SEBI and **(viii)** it is a fit and proper person. **The criteria for fit and proper person would be the provisions of the SEBI Intermediaries Regulation, 2008.** The applicant may be required by the SEBI to furnish such further information as it may consider necessary.

On being satisfied that the applicant is eligible, and on receipt of the registration fee of US$ 10,000, the SEBI would grant it a certificate of registration subject, inter-alia, to the condition that it would **(a)** abide by the SEBI Act and FCVIs regulations, **(b)** appoint a domestic custodian (ie a person registered under the SEBI Custodian of Securities Regulations, 1996) for custody of securities **(c)** enter into an arrangement with a designated bank (ie any bank in India permitted by the RBI to act as a banker to the FVCI) for operating a special non-resident rupee/foreign currency account and **(d)** forthwith inform the SEBI, in writing, if any information/particulars previously submitted to it are found to be false/misleading in any material particular, or if there is any change in information already submitted.

Investment Criteria Investments by FVCIs should conform to the norms prescribed by the SEBI. Firstly, they should disclose their investment strategy to the SEBI. Secondly, they can invest their total funds committed in one VCF. Thirdly, at least 66.67 per cent of their investible funds (ie funds committed for investment in India, net of expenditure, for administration and management of the fund) should be invested in unlisted equity shares/equity linked instruments, that is, convertible securities/share warrants, preference shares, debentures compulsorily/optionally convertible into equity of VCUs. Finally, not more than 33.33 per cent of such funds may be invested by way of **(a)** subscription to initial public offer of a VCU whose shares are proposed to be listed, **(b)** debt or debt instruments of a VCU in which the FVCI has already made an investment by way of equity, **(c)** prefereantial allotment of equity shares of a listed company subject to lock-in of one year. A **financially weak company** means a company which has at the end of the previous financial year accomulated losses resulting in erosion of more than 50 per cent but less than 100 per cent of its networth as at the begenning of the previous financial year, **(d)** it should disclose the duration of the life cycle of the efund and **(e)** special purpose vehicles which are created for the purpose of facilitating, promoting investment in accordance with these regulations.

General Obligations and Responsibilities The FVCIs have to maintain, for a period of eight years, books of accounts/records/documents that would give a true and fair picture of their affairs and intimate to the SEBI the place where they are being maintained. They may be called upon at any time by the SEBI to furnish, within a specified time, any information with respect to any matter relating to their activities. Moreover, they/a global custodian acting on their behalf should enter into an agreement with the domestic custodian to act as a custodian of securities for them. They have to also ensure that the domestic custodian takes steps towards **(i)** monitoring of their investments in India, **(ii)** furnishing of periodic reports to, and such information as may be called for by, the SEBI. A branch of a bank approved by the RBI should be appointed by the FVCIs as the designated bank for opening of foreign currency denominated accounts/special non-resident rupee accounts.

Inspection and Investigation The SEBI has the right to, suo moto, or upon receipt of information/complaint, order an inspection/investigation, by an officer, in respect of conduct and affairs of any FVCI to **(i)** ensure that the books/accounts/documents are being maintained in the specified manner, **(ii)** inspect/investigate into complaints from investors/clients/any other person on any matter having a bearing on its activities, **(iii)** ascertain whether the provisions of the SEBI Act and FVCIs regulations are being complied with and **(iv)** inspect/investigate, *suo moto*, into its affairs in the interest of the securities market/investors. The FVCI/any other associated person, including an asset management company/fund manager, in possession of information relevant to its conduct/affairs must **(1)** produce to the investigating/inspecting officer such books/accounts/other documents in his custody/control and furnish him such statements and information as he may acquire and **(2)** give him all assistance, extend all cooperation and furnish all information sought by him.

He would also have the power **(1)** to examine an oath and record the statement of any person responsible for or connected with the activities of the FVCI and **(2)** to get authenticated copies of documents/books/accounts of the FVCI from any person having control/custody over them. On the basis of the inspection/investigation report, the SEBI has the right to require the FVCI to take such measures or issue such directions as it deems fit in the interest of the capital market and investors, including directions in the nature of **(a)** requiring the disposal of the securities of investment in a specified manner, **(b)** requiring not to further invest for a particular period and **(c)** prohibiting operations in the capital market in India for a specified period.

Procedure for Action in Case of Default In addition to the issue of appropriate directions specified above, the SEBI can also suspend/cancel registration of the FVCI on the basis of the investigation report.

Suspension of Registration The registration of a FVCI can be suspended by the SEBI if it **(1)** contravenes any of the provisions of the SEBI Act or SEBI FVCI Regulations, **(2)** fails to furnish any information relating to its activities as required by the SEBI, **(3)** furnish to it information that is false/misleading in any material particular, **(4)** does not submit periodic returns/reports as required by it and **(5)** does not cooperate in any enquiry/inspection conducted by it.

Cancellation of Registration The SEBI may cancel the registration of a FVCI when he **(1)** is guilty of fraud/has been convicted of an offence involving moral turpitude, **(2)** has been guilty of repeated defaults of the nature resulting in suspension of registration; **(3)** does not meet the eligibility criteria laid down in the SEBI FVCIs Regulations and **(4)** contravenes any of the provision of the SEBI Act/these regulations. The order of penalty/cancellation of certificate would be imposed on a FVCI after enquiring according to the procedure specified in SEBI Intermediaries Regulations, 2008.

The order of suspension/cancellation of registration may be published by the SEBI in two newspapers. Action may also be initiated by the SEBI for suspension/cancellation of registration of an intermediary who fails to exercise due diligence in the performance of its functions/comply with its obligations under these regulations. Any person aggrieved by an order of the SEBI may prefer to appeal to the Securities Appellate Tribunal (SAT).

CONCLUDING OBSERVATIONS

- The major aspects of other forms of foreign investments in India/abroad are: Investment in JVs/WOSs abroad, ECBs, Euro issues, FCEBs, FII investments, Offshore funds and Overseas venture capital investments.
- An Indian party is permitted to invest in JVs and WOSs abroad within the framework of Government/RBI policy. A JV means a foreign concern formed in the host country in which the Indian party makes a direct investment. Direct investment means investment in the equity capital with a view to acquiring a long-term interest in the concern including representation on its Board and so on. A WOS means a foreign concern formed in the host country where entire equity capital is owned by an Indian party. Indian parties are prohibited from making investment in a foreign entity engaged in real estate/banking business without the RBI's prior approval. There are two routes for approval for JVs/WOSs abroad: automatic route and approval route.
- The automatic route facility is not available for investment in Pakistan and such investments in Nepal and Bhutan can be made only in Indian rupees. An Indian party can invest in overseas JV/WOS without RBI's prior approval upto 400 per cent of its networth. The main elements of the automatic approval framework are: **(i)** investment in unincorporated entities overseas in oil sector, **(ii)** methods of funding, **(iii)** caiptalisation of exports, **(iv)** investment in financial services sector, **(v)** investment in equities of companies registered overseas/rated debt instruments.
- In all other cases of direct investment abroad, RBI's prior approval is necessary. The main elements of the framework include the following: **(i)** investment in energy and natural resources sector, **(ii)** overseas investment by proprietorship concerns, **(iii)** overseas investment by registered trust/society, **(iv)** post-investment changes, **(v)** obligations, **(vi)** transfer by way of sale of shares, **(vii)** pledge of shares, **(viii)** hedging of overseas direct investment.
- The ECBs refer to commercial loans [in the form of bank loans, buyer's credit, supplier's credit, securitised instrument (for example, floating rates notes and fixed interest bonds] availed from non-resident lenders. The policy for ECBs is also applicable to FCCBs. They can be accessed through two routes: automatic and approval.
- The ECBs for investments in real sector-industrial and especially infrastructure do not require Government/RBI approval. Only corporates other financial intermediaries and NGOs engaged in micro-finance are eligible borrowers of ECBs/FCCBs. The lenders can be only internationally recognised sources such as international banks/capital markets, multilateral financial institutions, export credit agencies, suppliers of equipment, foreign collaborators and foreign equityholders. Overseas organisation/individuals may provide ECB to NGOs on the basis of a due diligence certificate. The maturity of ECBs may range between 3-7 years. The minimum and maximum amount of ECB for a corporate (NGO) would be US dollars 20 million and 500 million respectively. The ceiling on all-in costs over 6 month LIBOR currently valid are 300 basic point for average maturity period of 3-5 years and 350 basic point for more than 5 years. It is 500 basic points for average maturity of 7 years. The ECBs cannot be used for on-lending/investment in capital market/acquiring a company; in real estate: and for working capital/general corporate purpose/repayment of existing rupee loans. They can be used for investment in industrial and infrastructure sector, overseas direct investment on JVs/WOSs and acquisition of shares in disinvestments process of PSUs. Until their actual requirement in India, ECB proceeds should be parked outside in liquid assets. Refinancing of existing ECBs by fresh ECBs at lower cost is permitted. Prepayment of ECBs upto US dollars 200 million is also permitted.

- The approval route of ECBs is applicable to financial institutions/banks/cases falling outsider the automatic route limits and maturity period/ECBs by NBFCs with minimum average maturity of 5 years/FCCBs by housing finance companies. All the stipulations applicable to ECBs under the automatic route are also applicable to ECBs under the approval route.
- The two long-term primary instruments of Euroissues by Indian corporates are FCCBs and GDRs/ADRs. A FCCB is a bond subscribed by a non-resident in foreign currency and convertible into ordinary shares of the issuing company in India on the basis of any equity-related warrants attached to the debt instruments. A GDR/ADR means an instrument in the form of a depository receipt/certificate created by the overseas depository bank (ODB) outside India and issued to non-resident investors against the issue of ordinary shares/FCCBs of the issuing company. A bank authorised by the issuing company to issue GDRs/ADRs against its FCCBs/ordinary shares is known as the ODB.
- According to Government guidelines, the issue of FCCBs/ordinary shares through GDR/ADR would have to conform to the EDI policy and other mandatory statutory requirements and detailed guidelines. An Indian company which is not eligible to raise funds from the domestic market cannot be issuing FCCBs/ordinary shares through GDRs/ADRs. Unlisted Indian companies issues of FCCBs/shares should be simultaneously listed in the Indian stock exchanges. The OCBs who are not eligible to invest in India through portfolio route and entities prohibited by SEBI to buy/sell/deal in securities are not eligible to subscribe to FCCBs/shares through GDRs/ADRs.
- The FCCBs (bonds) should be denominated in any convertible foreign currency and shares of the issuing company should be denominated in Indian rupees. The shares/bonds should be delivered to a domestic custodian bank (DCB) who would instruct the ODB to issue GDR/ADR certificates/receipts to non-resident investors against the shares/bonds held. A GDR/ADR may be issued in a negotiable form and may be listed on any international stock exchange for trading outside India. A non-resident holder of GDRs/ADRs may transfer them or may ask the ODB to redeem them. The redeemed GDRs/ADRs and underlying shares sold may be re-issued.
- The issuing company would finalise the issue structure with the lead manager of the issue. The aspects to be considered would include public/private placement, number of GDRs/ADRs issued, issue price, interest on FCCBs, conversion price/coupon rate/pricing of the conversion options of the FCCBs. The pricing for listed companies as well as the conversion price of FCCBs should not be less than the higher of the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange(s) during **(i)** 2 weeks or **(ii)** 6 months preceding the relevant date. The RBI regulations would be the basis in case of unlisted companies.
- Indian companies can also access the GDR/ADR market through the automatic route in the following cases: **(i)** through a registered stock exchange, **(ii)** through private placement if lead managed by an overseas investment banker, **(iii)** linked to employee stock options of by software/IT companies, **(iv)** arising out of business reorganisation/merger/demerger. All the mandatory approval requirements under the FDI policy, approvals under the Companies Act, approval for overseas investments and so on should be obtained by the company prior to the GDR/ADR issue.
- A **FPI** means a person who is registered with, and satisfies the SEBI-prescribed eligibility criteria (**discussed below**), and is deemed to an intermediary under the provisions of the SEBI Act. The main elements of the SEBI framework of their regulations are: **(i)** registration, **(ii)** approval of designated depository participant, **(iii)** investment conditions and restrictions, **(iv)** general obligations and responsibilities of foreign portfolio investors/designated depository participants, **(v)** inspection and **(vi)** action in case of default.

- To buy, sell or otherwise deal in securities as a foreign portfolio investor requires a certificate granted by the SEBI-approved designated depository participant (DDP) on behalf of the SEBI.
- The applicant should satisfy the following conditions: **(1)** The applicant is as a **(a)** person not resident in India; **(b)** resident of a country whose securities market regulator is a signatory to **(i)** International Organisation of Securities Commission's Multilateral Memorandum of Understanding, **(ii)** bilateral Memorandum of Understanding with the SEBI, that, ***inter-alia***, provides for information sharing arrangement; **(c)** a bank which is a resident of a country whose central bank is a member of Bank for International Settlements; **(d)** not resident in a country identified in the public statement of financial action task force as: a jurisdiction **(i)** having a strategic anti-money laundering or combating the financing of terrorism deficiencies to which counter measures apply; or **(ii)** that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the financial action task force to address the deficiencies; **(e)** not a non-resident Indian; **(f)** legally permitted to invest in securities outside the country of its incorporation/establishment/place of business; **(g)** authorised by its memorandum and articles of association/equivalent document(s)/the agreement to invest on its own behalf or on behalf of its client; **(h)** has sufficient experience, good track record, is professionally competent, financially sound and has a generally good reputation of fairness and integrity; **(2)** The grant of certificate to the applicant is in the interest of the development of the securities market; **(3)** The applicant is a fit and proper person based on the criteria specified in the SEBI **Intermediaries Regulation**.
- The applicant should seek registration in one of the categories mentioned below: **(a) Category I Foreign Portfolio Investor** which would include Government and Government-related investors such as central banks, Governmental agencies, sovereign wealth funds and international/ multilateral organisations/agencies; **(b) Category II Foreign Portfolio Investors** which would include: **(i)** appropriately regulated **(1)** broad-based funds such as mutual funds, investment trusts, insurance/reinsurance companies, **(2)** persons such as banks, asset management companies, investment managers/advisors, portfolio managers; **(ii)** broad-based funds that are not appropriately regulated but whose investment manager is appropriately regulated provided he is itself registered as Category II foreign portfolio investor. **(c) Category III Foreign Portfolio Investor** would include all non-eligible Category I and II such as endowments, charitable societies/trusts, foundations, corporate bodies, trusts, individuals and family offices.
- To act as designated depository participant (DDP), a person has to obtain the approval of the SEBI.
- The applicant should satisfy the following conditions: **(a)** The applicant is **(1)** a participant/ SEBI-registered custodian; **(2)** an authorised dealer category-I bank authorised by the RBI; **(3)** has multinational presence through its branches/agency relationships with intermediaries regulated in their respective home jurisdiction; **(4)** has systems and procedures to comply with the requirements of financial action task force standards, prevention of money laundering Act/ rules/circulars; **(5)** a fit and proper person based on the criteria specified in SEBI **Intermediaries Regulations**; **(b)** Any other criteria specified by the SEBI from time to time.
- Where any DDP **(a)** fails to comply with any conditions subject to which an approval has been granted, **(b)** contravenes any of the provisions of the securities laws/directions/instructions/ circulars, the SEBI may, without prejudice to any other action under any other law suspend/ withdraw the approval.
- The investments by the FPIs would be subject to the following conditions/restrictions. A foreign portfolio investor (FPI) can invest only in the following securities: **(a)** securities in the primary/ secondary markets including shares/debentures/warrants of listed/to be listed companies,

in India, **(b)** units of schemes of domestic mutual funds, **(c)** units of scheme of a collective investment scheme, **(d)** derivatives traded on a recognised stock exchange, **(e)** treasury bills and dated Government securities, **(f)** commercial papers issued by an Indian company, **(g)** rupee denominated credit enhanced bonds, **(h)** security receipts issued by asset reconstruction companies, **(i)** RBI-specified perpetual debt/debt capital instruments, **(j)** listed/unlisted non-convertible debentures/bonds of an Indian company in the infrastructure sector, **(k)** non-convertible debentures/bonds issued by NBFCs categorised as `Infrastructure Finance Corporation' (IFCs) by the RBI, **(l)** rupee denominated bonds/units issued by infrastructure debt funds, **(m)** Indian depository receipts, and **(n)** other SEBI-specified instruments.

- The following additional conditions would apply in respect of investments in the secondary market: **(a)** Transactions in the securities in India should be only on the basis of taking/giving delivery of securities purchased/sold, excepting the following: **(i)** any transactions in derivatives on a recognised stock exchange, **(ii)** short selling transactions in accordance with the SEBI-specified framework, **(iii)** any transaction pursuant to an agreement with the merchant banker in the process of market making/subscribing to/unsubscribed portion of the issue in accordance with the SEBI Issue of Capital and Disclosure Requirements Regulations; **(iv)** any other SEBI-specified transaction; **(b)** Transaction on the stock exchange should not be carried forward; **(c)** It should be only through SEBI-registered stock brokers, with the following exceptions/exemptions: **(i)** transactions Government securities/securities falling under the purview of the RBI, **(ii)** sale of securities in response to **(1)** a letter of offer by an acquirer in accordance with the **SEBI Substantial Acquisition of Shares and Takeover Regulations**, **(2)** an offer by any promoter/acquirer in accordance with the **SEBI Delisting of Equity Shares Regulations/SEBI Buy-back of Securities Regulations**, **(iii)** disinvestment of securities in response to an offer by Indian companies in the overseas market through issue of American/Global depository receipts, **(iv)** any bid for, or acquisition of, securities in response to an offer for disinvestment of shares made b the Central/State Government; **(v)** any transaction pursuant to an agreement entered into with merchant banker in the process of market making/subscribing to unsubscribed portion of the issue in accordance with **SEBI Issue of Capital and Disclosure Requirements Regulation**. **(vi)** any other transaction specified by the SEBI. **(d)** The securities should be held, delivered/caused to be delivered only in dematerialised form;
- The foreign portfolio investors should also comply with the terms/conditions/directions, specified/issued by the SEBI/RBI in respect of investments in the debt securities.
- Unless otherwise approved by the SEBI, securities should be registered in the name of the FPI as a beneficial owner for the purposes of the Depositories Act. The purchase of equity shares by a single FPI/an investor group should be below 10 per cent of the total issued capital of the company. The investment would also be subject to such other conditions and restrictions as may be specified by the Government of India from time to time. In cases where the Government of India enters into agreement/treaties with other sovereign Governments specifically recognising certain entities to be distinct and separate, the SEBI may recognise them subject to the specified conditions. The foreign portfolio investor may lend/borrow securities in accordance with the framework specified by the SEBI in this regard.
- An Indian company can issue FCEB expressed in foreign currency the principal and interest in respect of which is payable in foreign currency and subscribed by a person who is resident outside India in foreign currency and exchangeable into equity shares of another company (i.e. offered company) in any manner, either wholly/partly or on the basis of any equity related warrants attached to a debt instrument.
- The proceeds of the FCEB may be invested by the issuing company in the promoter group companies which would use the proceeds in accordance with the end-users prescribed under

the ECBs policy. They may also be invested overseas by way of direct investment including in JVs/WOS.

- The interest and the issue expenses should be within the all-in-cost ceiling specified by the RBI under the ECBs policy.
- The exchange price of the offered listed equity shares should not be less than the higher of the average of the weekly high and low of the closing prices quoted on the stock exchange during (i) six months, (ii) two weeks preceding the relevant date. The minimum maturity of the FCEB should be five years for redemption purposes.
- Interest payments on the FCEBs until the exchange option is exercised would be subject to deduction of tax at source. Tax on dividends on the exchanged portion of the FCEB would be in accordance with Section 115-AC(1) of the Income-tax Act. The exchange of the FCEB into shares would not give rise to any capital gains tax.
- The FVCIs are not permitted to invest in NBFCs, gold financing excluding companies engaged in gold financing for jewellery, and activities not permitted under the industrial policy of the Government.
- They can invest their total funds committed in one VCF; atleast 66.67 per cent should be invested in unlisted equity/equity linked instruments; not more than 33.33 per cent of funds can be inverted in IPO/debt instruments/preferential allotment/and SPVs.

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