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Financial Reporting for Financial Institutions

Unit 1: Mutual Funds

1.1 Introduction

The definition of a mutual fund is a form of collective investment that pools money from many investors and invests their money in stocks, bonds, short-term money market instruments, and/or other securities. In a mutual fund, the fund manager trades the fund's underlying securities, realizing capital gains or losses, and collects the dividend or interest income. The income from investments, less specified expenses for managing the funds, are distributed among unit holders in proportion of number of units held. The investments are made under expert guidance to allow unit holders to earn highest possible return for lowest possible risk. Risk reduction is achieved through planned diversification of investment portfolio and also by judicious use of various hedging techniques. The selection of investments for a scheme should be within the investment objectives and other parameters set for the scheme. The value of a share of the mutual fund, known as the net asset value per share (NAV), is calculated daily, based on the total value of the fund divided by the number of shares issued and outstanding.

1.2 Organisation of Mutual Funds

In India, mutual funds are regulated by SEBI (Mutual Funds) Regulations, 1996. According to the SEBI (Mutual Funds) Regulations, 1996, a 'mutual fund' means a fund established in the form of a trust to raise monies through the sale of units to the public under one or more schemes for investing in securities including money market instruments.

The management of mutual fund comprises of a sponsor, trustee company and an Asset Management Company (AMC). Typically, a mutual fund is promoted by a sponsor who appoints trustee, asset management company and custodian. A mutual fund should be registered with SEBI.

"Asset management company" means a company formed and registered under the Companies Act, 1956 and approved as such by the Securities and Exchange Board of India to manage the funds of a mutual fund.

"Unit" means the interest of the unitholders in a scheme, which consists of each unit representing one undivided share in the assets of a scheme;

Money market instruments provide for borrowers' short-term needs and gives needed liquidity to lenders. The types of money market instruments are treasury bills, repurchase agreements,

commercial papers, certificate of deposit, and banker's acceptance.

The money market is a monetary system of lending and borrowing of short-term funds.

A mutual fund invests the money received from investors in instruments which are in line with the objectives of the respective schemes. Regular expenses like custodial fee, cost of dividend warrants, registrar's fee, asset management fee, etc., are borne by the respective schemes. Balance everything is given back to the investors in full.

In a mutual fund, the resources of many investors are pooled to create a diversified portfolio of securities. After collecting the funds from investors, daily operations are managed by experts and professional fund managers. They take investment decisions regarding what, how much, when and where to invest and disinvest so as to get maximum return as well as higher capital appreciation. The purchase and repurchase price of mutual funds are generally fixed and also vary in stock exchanges if the security is quoted on the basis of its net asset value (NAV). The investment pattern of mutual funds is governed partly by Government guidelines and partly by nature and objective of mutual fund.

A mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908), executed by the sponsor in favour of the trustees named in such an instrument.

Under regulation 50, every asset management company for each scheme shall keep and maintain proper books of account, records and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund and intimate to the Board the place where such books of account, records and documents are maintained. Every asset management company shall maintain and preserve for a period of eight years its books of accounts, records and the mutual funds are set up as registered trusts. Any body-corporate, if approved by SEBI can sponsor such trusts. The sponsor appoints the trustees. The trustees hold assets of the trust for the benefit of unit holders. The sponsor, or if the trust deed permits, the trustees, appoint an Asset Management Company (AMC) for creation and maintenance of investment portfolios under different schemes. The AMC is a company formed and registered under the Companies Act 1956. It must obtain approval from the SEBI to act as AMC.

The AMC acts under broad superintendence of the board of trustees. The trustees have the duty to monitor actions of the AMC to ensure compliance with the SEBI regulations. The AMC may charge the mutual fund with Investment Management and Advisory Fees subject to prescribed ceiling. The fees to be paid to the AMC must be disclosed fully in the offer document. In addition to the fees, the AMC may recover prescribed expenses from the Mutual Fund.

1.3 Mutual Fund Schemes

Types of Mutual Funds Schemes in India

Wide variety of Mutual Fund Schemes exists to cater to the various needs such as financial position, risk tolerance and return expectations etc. There are over hundreds of mutual funds

scheme to choose from. However, It is easier to think of mutual funds in categories, mentioned below.

By Structure

1. Open - Ended Schemes: An open-end fund is one that is available for subscription all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices. The key feature of open-end schemes is liquidity.

2. Close - Ended Schemes: These schemes have a pre-specified maturity period. One can invest directly in the scheme at the time of the initial issue. Depending on the structure of the scheme there are two exit options available to an investor after the initial offer period closes. Investors can transact (buy or sell) the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchanges could vary from the net asset value (NAV) of the scheme on account of demand and supply situation, expectations of unit holder and other market factors. Alternatively some close-ended schemes provide an additional option of selling the units directly to the Mutual Fund through periodic repurchase at the schemes NAV; however one cannot buy units and can only sell units during the liquidity window. SEBI Regulations ensure that at least one of the two exit routes is provided to the investor.

3. Interval Schemes: Interval Schemes are that scheme, which combines the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

By Nature

1. Equity fund: These funds invest a maximum part of their corpus into equities holdings. The structure of the fund may vary different for different schemes and the fund manager's outlook on different stocks. The Equity Funds are sub-classified depending upon their investment objective, as follows:

- Diversified Equity Funds
- Mid-Cap Funds
- Sector Specific Funds
- Tax Savings Funds (ELSS)

Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix.

2. Debt funds: The objective of these Funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. Debt funds are further classified as:

- Gilt Funds: Invest their corpus in securities issued by Government, popularly known as Government of India debt papers. These Funds carry zero Default risk but are associated with Interest Rate risk. These schemes are safer as they invest in papers backed by Government.

- Income Funds: Invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities.
- MIPs: Invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt market. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes.
- Short Term Plans (STPs): Meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.
- Liquid Funds: Also known as Money Market Schemes, These funds provides easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1 day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds.

3. Balanced funds: As the name suggest they, are a mix of both equity and debt funds. They invest in both equities and fixed income securities, which are in line with pre-defined investment objective of the scheme. These schemes aim to provide investors with the best of both the worlds. Equity part provides growth and the debt part provides stability in returns.

Further the mutual funds can be broadly classified on the basis of investment parameter viz,

Each category of funds is backed by an investment philosophy, which is pre-defined in the objectives of the fund. The investor can align his own investment needs with the funds objective and invest accordingly.

By investment objective:

- Growth Schemes: Growth Schemes are also known as equity schemes. The aim of these schemes is to provide capital appreciation over medium to long term. These schemes normally invest a major part of their fund in equities and are willing to bear short-term decline in value for possible future appreciation.
- Income Schemes: Income Schemes are also known as debt schemes. The aim of these schemes is to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures. Capital appreciation in such schemes may be limited.
- Balanced Schemes: Balanced Schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. These schemes invest in both shares and fixed income securities, in the proportion indicated in their offer documents (normally 50:50).
- Money Market Schemes: Money Market Schemes aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer,

short-term instruments, such as treasury bills, certificates of deposit, commercial paper and inter-bank call money.

Other schemes

- Tax Saving Schemes: Tax-saving schemes offer tax rebates to the investors under tax laws prescribed from time to time. Under Sec.80C(2) of the Income Tax Act, contributions made to any notified Equity Linked Savings Scheme (ELSS) are eligible for rebate.
- Index Schemes: Index schemes attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50. The portfolio of these schemes will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weightage. And hence, the returns from such schemes would be more or less equivalent to those of the Index.
- Sector Specific Schemes: These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are more risky compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time.

1.4 Evaluation of Mutual Funds

Mutual funds sell their shares to public and redeem them at current Net Assets Value (NAV) which is calculated as under –

$$\frac{\text{Total market value of all MF holdings - All MF liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. To illustrate this better, a simple example will help.

Scheme name	:	XYZ
Scheme size	:	₹ 50,00,00,000 (Rupees Fifty crores)
Face value of units	:	₹ 10
No. of units	:	5,00,00,000
		$\frac{\text{Scheme size}}{\text{Face value of units}}$
Investments	:	In shares
Market value of shares	:	₹ 75,00,00,000 (Rupees seventy five crores)

$$= \frac{\text{Market value of investments}}{\text{No. of units}} = \frac{₹\ 75,00,00,000}{5,00,00,000} = ₹\ 15$$

Thus, each unit of ₹ 10 is worth ₹ 15.

Simply stated, NAV is the value of the assets of each unit of the scheme, or even simpler

value of one unit of the scheme. Thus, if the NAV is more than the face value (₹ 10), it means your money has appreciated and *vice versa*.

NAV also includes dividends, interest accruals and reduction of liabilities and expenses, besides market value of investments. The Net Asset Value (NAV) is the value of net assets under a mutual fund scheme. The NAV per unit is NAV of the scheme divided by number of units outstanding. NAV of a scheme keep on changing with change in market value of portfolio under the scheme. The day of valuation of NAV is called the valuation day.

As per SEBI (Mutual Funds) (Second Amendment) Regulations, 2012, Regulation 48(2) states that the Net Asset Value of the scheme shall be calculated on daily basis.

1.5 Valuation of Portfolio

Every mutual fund shall ensure the asset management company computes and carries out valuation of its investments made by its schemes in accordance with the investment valuation norms specified in the Eight Schedule of SEBI (Mutual fund's) Regulation, 1996. Market value of portfolio has a direct bearing on the NAV and consequently on portfolio performance. The market value of portfolio is the aggregate market value of different investments. Market value of a traded security is the last closing price quoted in a stock exchange immediately before the valuation day. In case, a security is traded in more than one stock exchange, the price quoted in an exchange where the security is mostly traded is taken as market value of the security.

Non-traded securities, i.e. securities not traded in a period of 30 days prior to the valuation day, should be valued in the spirit of good faith subject to SEBI regulations. **For example, non traded debt and money market securities of short term maturities, as may be specified by the Board from time to time, may be valued on amortization basis provided that such valuation shall be reflective of the fair value of the securities and all investors are treated fairly.*

1.6 Pricing of Units

As per Regulation 49, the price at which the units may be subscribed or sold and the price at which such units may at any time be repurchased by the mutual fund shall be made available to the investors. While determining the prices of the units, the mutual fund shall ensure that the repurchase price is not lower than 93 per cent of the Net Asset Value and the sale price is not higher than 107 per cent of the Net Asset Value.

Provided further that the difference between the repurchase price and the sale price of the unit shall not exceed 7 per cent calculated on the sale price. The price of units shall be determined with reference to the last determined Net Asset. The scheme announces the Net Asset Value on a daily basis; and the sale price is determined with or without a fixed premium added to the future net asset value which is declared in advance.

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* Inserted by the SEBI (Mutual Funds) (Amendment) Regulations, 2012, w.e.f. 21-2-2012.

1.7 Annual Reporting

Every mutual fund or the asset management company is required to prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.

As per Regulation 51 the financial year, for all the schemes, shall end as of March 31st of each year.

The scheme wise Annual Report of a mutual fund or an abridged summary thereof shall be mailed to all the unit holders as soon as may be but not later than four[1] months from the date of closure of the relevant accounts year.

According to Eleventh Schedule, the annual report shall contain –

(i) Report of the board of Trustees on the operations of the various schemes of the fund and the fund as a whole during the year and the future outlook of the fund;

(ii) Balance Sheet and Revenue Account in accordance with paras 2, 3 and 4, respectively of this Schedule;

(iii) Auditor's Report in accordance with paragraph 5 of this Schedule;

(iv) Brief statement of the Board of Trustees on the following aspects, namely:-

  (a) Liabilities and responsibilities of the Trustees and the Settlor;

  (b) Investment objective of each scheme;

  (c) Basis and policy of investment underlying the scheme;

  (d) If the scheme permits investment partly or wholly in shares, bonds, debentures and other Scrips or securities whose value can fluctuate, a statement on the following lines :

  "The price and redemption value of the units, and income from them, can go up as well as down with the fluctuations in the market value of its underlying investments;"

  (e) Comments of the Trustees on the performance of the scheme, with full justification.

(v) Statement giving relevant perspective historical 'per unit' statistics in accordance with paragraph 6 of this Schedule;

(vi) Statement on the following lines :

  "On written request, present and prospective unitholder/investors can obtain copy of the trust deed, the annual report [at a price] and the text of the relevant scheme."

1.8 Accounting Policies

As per regulation 50(3) of SEBI (Mutual Funds) Regulations, 1996, the Asset Management Companies are required to follow the accounting policies and standards specified in the Ninth Schedule of the Regulations. Following accounting policies shall be followed by Mutual Funds for the preparation of accounts:

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[1] *Substituted for 'Six months' by SEBI (Mutual Funds) (Third Amendment) Regulations, 2008 w.e.f 29.9.2008.*

Accounting Policies and Standards

a. For the purposes of the financial statements, mutual fund shall mark all investments to 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, provision has to be made for exclusion of this item when arriving at distributable income.

b. Dividend income earned by a scheme should be recognised, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments which 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 up to the date of sale must not be treated as an addition to sale value but must be credited to Interest Recoverable Account.

d. In determining the holding cost of investments and the gains or loss on sale of investments, the "average cost" method must be followed.

e. Transactions for purchase or sale of investments should be recognised as of the trade date and 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 transaction should be recorded, in the event of a purchase, as of the date on which the scheme obtains in enforceable obligation to pay the price or, in the event of a 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 right entitlement accrues are traded on the stock exchange on an ex-rights basis.

g. Where income receivable on investments has accrued but has not been received for the period specified in the guidelines issued by the Board, provision shall be made by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by the Board.

h. When in the case of an open-ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative is debited to reserve, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased the difference between the purchase price and face

value of the unit, if positive should be debited to reserves 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 Equalization Account and when units are repurchased an appropriate amount should be debited to Equalization Account. The net balance on this account should be credited or debited to the Revenue Account. The balance on the Equalization Account debited or credited to the Revenue Account should not decrease or increase the net income of the 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 fund is determined.

j. In a close-ended scheme which provide to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortized 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 revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.

1.9 Contents of Balance Sheet and Revenue Account

The annual report of a mutual fund consists of (a) Balance Sheet (b) Revenue Account (c) Report of the Board of Trustees (d) Auditor's Report and (e) Statement of the Board of Trustees on specified matters.

Contents of Balance Sheet

(i) The Balance Sheet shall give scheme wise particulars of its assets and liabilities. It shall also disclose, *inter alia*, accounting policies relating to valuation of investments and other important areas.

(ii) If investments are carried at costs or written down cost, their aggregate market value shall be stated separately in respect of each type of investment, such as equity shares, preference shares, convertible debentures listed on recognized stock exchange, non-convertible debentures or bonds further differentiating between those listed on recognised stock exchange and those privately placed.

(iii) The Balance Sheet shall disclose under each type of investment the aggregate carrying

value and market value of non-performing investments. An investment shall be regarded as non-performing if it has provided no returns in the form of dividend or interest for a period specified in the Guidelines issued by the Board.

(iv) The Balance Sheet shall indicate the extent of provision made in the Revenue Account for the depreciation/loss in the value of non-performing investments. However, if the investments are valued at marked to market, provisions for depreciation shall not be necessary.

(v) The Balance Sheet shall disclose the per-unit net asset value (NAV) as at the end of the accounting year.

(vi) As in case of companies, the Balance Sheet shall give against each item, the corresponding figures as at the end of the preceding accounting year.

(vii) The notes to the balance sheet should disclose the following information regarding investments:-

(a) all investments shall be grouped under the major classification given in the balance sheet;

(b) under each major classification, the total value of investments falling under each major industry group (which constitutes not less than 5% of the total investment in the major classification) shall be disclosed together with the percentage thereof in relation to the total investment within the classification;

(c) a full list of investments of the scheme shall be made available for inspection with the Asset Management Company;

(d) the basis on which management fees have been paid to the Asset Management Company and the computation thereof;

(e) if brokerage, custodial fees or any other payment for services are paid to or payable to any entity in which the Asset Management Company or its major shareholders have a substantial interest (being not less than 10% of the equity capital), the amounts debited to the revenue account or amounts treated as cost of investments in respect of such services shall be separately disclosed together with details of the interest of the Asset Management Company or its major shareholders;

(f) aggregate value of purchases and sales of investments during the year and expressed as a percentage of average weekly net asset value;

(g) where the non-traded investments which have been valued “in good faith” exceed 5% of the NAV at the end of the year, the aggregate value of such investments; and

(h) movement in unit capital should be stated.

An example of the manner in which the movement in unit capital may be disclosed is given below :

	No. of units	(₹ in lakhs)
Balance as on 1st April, 2012	1250,00,000	12,500.00
Units sold during the year	127,50,000	1,275.00
Units repurchased during the year	(15,40,000)	(154.00)
	1362,10,000	13,621.00

(i) the name of the company including the amount of investment made in each company of the group by each scheme and the aggregate investments made by all schemes in the group companies of the sponsor;

(j) if the investments are marked to market, the total income of the scheme shall include unrealised depreciation or appreciation on investment. There should be disclosure and unrealised appreciation deducted before arriving at the distributable income in the following manner, e.g.

	₹ in lakh	*₹ in lakh*
Net income as per Revenue Account	100	
Add: Balance of undistributed income as at 1st April, 2012 brought forward	20	120
Less: Unrealised appreciation on investments		
As on 31st March, 2013	30	
As on 1st April, 2012	15	(15)
		105
Less: Distributed to unitholders	80	
Transfer to reserve	5	(85)
		20

(viii) Provisions for doubtful deposits, doubtful debts and for doubtful outstandings and accrued income shall not be included under provisions on the liability side of the balance sheet, but shall be shown as a deduction from the aggregate value of the relevant asset.

(ix) Disclosure shall be made of all contingent liabilities showing separately underwriting commitments, uncalled liability on partly paid shares and other commitments with specifying details.

Contents of Revenue Account

(i) The Revenue Account shall give schemewise particulars of the income, expenditure and surplus of the mutual fund. These particulars shall contain information enumerated in Annexure 2 of this Schedule.

(ii) If profit on sale of investments shown in the Revenue Account includes profit/loss on inter-scheme transfer of investments within the same mutual fund the aggregate of such profit recognised as realised, shall be disclosed separately without being clubbed with the profit/loss on sale of investments to third parties.

(iii) Unprovided depreciation in value of investments representing the difference between their aggregate market value and their carrying cost shall be disclosed by way of a note

forming part of the Revenue Account. Conversely, unrealised profit on investment representing the difference between their aggregate market value and carrying cost, shall be disclosed by way of note to accounts. The Revenue Account shall indicate the appropriation of surplus by way of transfer to reserves and dividend distributed. However, if investments are marked to market, depreciation may not be provided.

(iv) The Revenue Account shall indicate the appropriation of surplus by way of transfer to reserves and dividend distributed.

(v) The following disclosures shall also be made in the revenue accounts:

(a) provision for aggregate value of doubtful deposits, debts and outstanding and accrued income;

(b) profit or loss in sale and redemption of investment may be shown on a net basis;

(c) custodian and registrar fees;

(d) total income and expenditure expressed as a percentage of average net assets, calculated on a weekly basis.

1.10 Cost of Investments

According to Ninth Schedule of SEBI (Mutual Fund) Regulations, 1996, 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 deducted from the cost of the investment.

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 upto 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 sale value but must be credited to Interest Recoverable Account.

In determining the holding cost of investments and the gains or loss on sale of investments, the "average cost" method must be followed.

As per Regulation 51A, the exit load charged, if any, after the commencement of the SEBI (Mutual Funds) (Second Amendment) Regulations, 2012, shall be credited to the scheme.

1.11 Limitation on Fees and Expenses on Issue of Schemes

As per Regulation 52, all expenses should be clearly identified and appropriated in the individual schemes. The asset management company may charge the scheme with investment and advisory fees which shall be fully disclosed in the offer document. However, in case of an index fund scheme, the investment and advisory fees shall not exceed three fourths of one percent (0.75%) of the weekly average net assets.

In addition to the above, the asset management company may charge the scheme with recurring expenses as mention in sub regulation 4. Any other expense shall be borne by the asset management company or trustee or sponsors.

The total expenses of the scheme excluding issue or redemption expenses, whether initially borne by the mutual fund or by the asset management company, but including the investment management and advisory fee shall be subject to the following limits:—

(a) in case of a fund of funds scheme, the total expenses of the scheme including weighted average of charges levied by the underlying schemes shall not exceed 2.50 per cent of the daily net assets of the scheme.

(b) in case of an index fund scheme or exchange traded fund, the total expenses of the scheme including the investment and advisory fees shall not exceed one and one half percent (1.5%) of the daily net assets;

(c) in case of any other scheme-

(i) on the first Rs.100 crores of the daily net assets 2.5%;

(ii) on the next Rs.300 crores of the daily net assets 2.25%;

(iii) on the next Rs.300 crores of the daily net assets 2.0%;

(iv) on the balance of the assets 1.75%:

In addition to the limits specified above, the following costs or expenses may be charged to the scheme, namely-

(a) brokerage and transaction costs which are incurred for the purpose of execution of trade and is included in the cost of investment, not exceeding 0.12 per cent in case of cash market transactions and 0.05 per cent in case of derivatives transactions;

(b) expenses not exceeding of 0.30 per cent of daily net assets, if the new inflows from such cities as specified by the Board from time to time are at least -

(i) 30 per cent of gross new inflows in the scheme, or;

(ii) 15 per cent of the average assets under management (year to date) of the scheme,

whichever is higher:

(c) additional expenses, incurred towards different heads mentioned under sub regulations (2) and (4), not exceeding 0.20 per cent of daily net assets of the scheme

Any expenditure in excess of the limits specified shall be borne by the asset management company or by the trustee or sponsors.

Illustration 1

Sparrow Holdings is a SEBI Registered Mutual Fund which made its maiden N.F.O (New Fund Offer) on 10th April, 2012 ₹ 10 face value per unit. Subscription was received for 90 lakhs units. An underwriting arrangement was also entered into with Affinity Capital Markets Ltd., that agreed to underwrite the entire NFO of 100 lakh units on a commission of 1.5%.

Out of the monies received ₹ 892.50 lakhs was invested in various capital market instruments. The marketing expenses for the N.F.O amounted to ₹ 11.25 lakhs. During the financial year ended March 2013 the Fund sold securities having cost of ₹127.25 lakh (FV ₹ 54.36 lakhs) for ₹ 141.25 lakhs. The fund in turn purchased securities for ₹ 130 lakhs. The management expenses of the fund are regulated by SEBI stipulations which state that the same shall not exceed 0.25% of the average funds invested during the year. The actual amount spent towards management expenses was ₹ 2.47 lakhs of which ₹ 47,000 was in arrear. The dividends earned on the investments held amounted to ₹ 2.51 lakhs of which a sum of ₹ 25,000 is yet to be collected. The fund distributed 80% of realized earnings. The closing market value of the portfolio was ₹ 1120.23 lakhs.

You are required to determine the closing per unit NAV of the fund.

Solution

Calculation of Closing per unit of NAV of the fund

	₹ in lakhs
Net Assets of Sparrow holding	
Closing cash balance (W.N.2)	79.99
Closing Market Value of Investments	1,120.23
Accrued Dividends (collectable)	0.25
	1,200.47
Less: Current Liabilities	
Outstanding Management Fee (payable)	(0.47)
Closing Net Assets (A)	1,200.00
Units outstanding (in lakhs) (B)	100.00
NAV per unit (A/B)	12.00

Working Notes:

		₹ in lakhs
1. Computation of opening cash balance		
Proceeds of NFO in full including underwriters commitment		1000.00
Less: Initial Purchase of Securities		(892.50)
		107.50

	Less: Underwriting Commission	15.00	
	Marketing Expenses	11.25	(26.25)
	Opening Cash Balance		81.25
2.	Computation of Closing cash balance		
	Opening bank balance (W.N.1)		81.25
	Add: Proceeds from sale of securities	141.25	
	Dividends received on investment	2.26	143.51
			224.76
	Less: Cost of Securities purchased	130.00	
	Management Expenses (W.N.3)	1.76	
	Capital Gains Distributed ₹ (141.25 - 127.25 x 80%)	11.20	
	Dividends Distributed ₹ (2.26 x 80%)	1.81	(144.77)
	Closing cash balance		79.99
3.	Computation of Management Expenses Chargeable		
	Actual Expense Incurred [A]		2.47
	Opening Investment Made	892.50	
	Closing Funds Invested (892.50 - 127.25 + 130)	895.25	
	Total	1,787.75	
	Average Funds Invested (1,787.75/2)	893.875	
	0.25% of Average Funds Invested [B]		2.23
	Lower of A or B		2.23
	Less: Amount unpaid		(0.47)
	Management expenses paid		1.76

1.12 Marking Investments to Market

For the purposes of the financial statements, mutual funds shall mark all investments to market and carry investments in the balance sheet at market value. However, since the unrealized gain arising out of appreciation on investments cannot be distributed, provision has to be made for exclusion of this item when arriving at distributable income. Clause 2(i) of Eleventh Schedule of the regulations provides that in carrying investments at market values, the asset management companies should follow the Guidance Note issued by the Institute of Chartered Accountants of India.

1.13 Restriction on Investments

As per Seventh Schedule, a mutual fund scheme shall not invest more than 15% of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by a credit rating agency authorised to carry out such activity under the Act. Such investment limit may be extended to 20% of the NAV of the scheme with the prior approval of the Board of

Trustees and the Board of asset management company. Provided that such limit shall not be applicable for investments in government securities and money market instruments.

1. A mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of asset management company.
2. No mutual fund under all its schemes should own more than ten per cent of any company's paid up capital carrying voting rights.
3. Transfers of investments from one scheme to another scheme in the same mutual fund shall be allowed only if, -
   (a) such transfers are done at the prevailing market price for quoted instruments on spot basis.
   [Explanation - "spot basis" shall have same meaning as specified by stock exchange for spot transactions.]
   (b) the securities so transferred shall 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 asset management company or any other mutual fund without charging any fees, provided that aggregate interscheme investment made by all schemes under the same management or in schemes under the management of any other asset management company shall not exceed 5% of the net asset value of the mutual fund.
5. The initial issue expenses in respect of any scheme may not exceed six per cent of the funds raised under that scheme.
6. Every mutual fund shall buy and sell securities on the basis of deliveries and shall in all cases of purchases, take delivery of relative securities and in all cases of sale, deliver the securities and shall in no case put itself in a position whereby it has to make short sale or carry forward transaction or engage in badla finance.
7. Every mutual fund shall, 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.
8. Pending deployment of funds of a scheme in securities in terms of investment objectives of the scheme a mutual fund can invest the funds of the scheme in short term deposits of scheduled commercial banks.
9. No mutual fund [scheme] shall make any investment in;
   (a) any unlisted security of an associate or group company of the sponsor; or
   (b) any security issued by way of private placement by an associate or group company of the sponsor; or
   (c) the listed securities of group companies of the sponsor which is in excess of 25% of the net assets.

10. No mutual fund scheme shall invest more than 10 per cent of its NAV in the equity shares or equity related instruments of any company.

    Provided that, the limit of 10 per cent shall not be applicable for investments [in case of] index fund or sector or industry specific scheme.

11. A mutual fund scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and 10% of its NAV in case of close ended scheme.

12. A fund of funds scheme shall be subject to the following investment restrictions:

    a. A fund of funds scheme shall not invest in any other fund or funds scheme;

    b. A fund of funds scheme shall 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 or redemptions, as disclosed in the offer document of fund of funds scheme.

1.14 Disposal of Investments

The profit/loss arising on the disposal of investment is the difference between the selling price and the cost. The profit arising on disposal of investment is recognised fully in the Revenue Account.

The loss on disposal of investment is recognised fully in the revenue account, if the investments are sold in the same year in which they are purchased. However, if an investment is sold in any year subsequent to year of purchase, loss on disposal is charged first against provision for depreciation to the extent of balance available, and the balance of loss, if any, should be charged directly to the Revenue Account.

Illustration 2

The investment portfolio for a mutual fund scheme includes 10,000 shares of A Ltd. and 8,000 shares of B Ltd. acquired on 30/10/2012. The cost of A Ltd. shares is ₹ 20 while that of B Ltd. shares is ₹ 30. The market values of these shares at the end of 2012-13 were ₹ 19 and ₹ 32 respectively. Show important accounting entries in books of the fund in the accounting year 2012-13.

Solution

		₹ 000	*₹ 000*
Investment in A Ltd. Shares	Dr.	200	
Investment in B Ltd. Shares	Dr.	240	
To Bank			440
Revenue A/c	Dr.	10	
To Provision for Depreciation			10
Investment in B Ltd. Shares	Dr.	16	
To Unrealised Appreciation Reserve			16

Illustration 3

In the previous example, suppose that shares of both of the companies were disposed off on 31/05/12 realizing ₹ 18.50 per A Ltd. shares and ₹ 33.50 per B Ltd. shares. Show important accounting entries in books of the fund in the accounting year 2012-13.

Solution

		₹ 000	₹ 000
Unrealised Appreciation Reserve	Dr.	16	
To Investment in B Ltd. shares			16
Bank	Dr.	185	
Loss on disposal of Investment	Dr.	15	
To Investment in A Ltd. shares			200
Provision for Depreciation	Dr.	10	
Revenue A/c	Dr.	5	
To Loss on disposal of Investment			15
Bank	Dr.	268	
To Investment in B Ltd. shares			240
To Profit on disposal of investments			28
Profit in disposal of Investments	Dr.	28	
To Revenue A/c			28

Illustration 4

A fund purchased 10,000 debentures of a company on June 1, 2012 for 10.7 lakh and further 5,000 debentures on November 1, 2012 for ₹ 5.45 lakh. The debentures carry fixed annual coupon of 12%, payable on every 31 March and 30 September. On February 28, 2013 the fund sold 6,000 of these debentures for ₹ 6.78 lakh. Nominal value per debenture is ₹ 100.

Show Investment in Debentures A/c in books of the fund.

Solution

Investment in Debentures A/c

		₹ Lakh			₹ Lakh
June 1, 2012	To Bank	10.70	June 1, 2012	By Interest Recoverable (Note 1)	0.20
Nov. 1, 2012	To Bank	5.45	Nov. 1, 2012	By Interest Recoverable (Note 2)	0.05
Feb. 28, 2013	To Interest Recoverable (Note 3)	0.30	Feb. 28, 2013	By Bank	6.78
Feb. 28, 2013	To Profit on disposal (Note 4)	0.12	March 31, 2013	By Balance c/d	9.54
		16.57			16.57

Working Notes:

Note 1: 10,000 x 100 x 12/100 x 2/12 = ₹ 0.20 Lakhs

Note 2: 5,000 x 100 x 12/100 x 1/12 = ₹ 0.05 Lakhs

Note 3: 6,000 x 100 x 12/100 x 5/12 = ₹ 0.30 Lakhs

Note 4: Cost of investments (per unit) = [(10,70,000 -20,000)+(5,45,000– 5,000)]/15,000 units
= [10,50,000+ 5,40,000]/15,000 = ₹ 106

Cost of investments sold = ₹ 106 x 6,000 = ₹ 6,36,000

Sale proceeds = ₹ 6,78,000 - ₹ 30,000(interest) = ₹ 6,48,000

Profit = ₹ 6,48,000 - ₹ 6,36,000 = ₹ 12,000

1.15 Recognition of Dividend Income

Dividend income earned by a scheme should be recognized, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments, which are not quoted on the stock exchange, dividend income must be recognized on the date of declaration.

Where income receivable on investments has accrued but has not been received for the period specified in the SEBI guidelines, the income accrued should be debited to Revenue A/c as provision.

Bonus shares to which the scheme becomes entitled should be recognized only when the original shares on which the bonus the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognized only when the original shares on which the right entitlement accrues are traded on the stock exchange on an ex-rights basis.

1.16 Date of Recognition of Transactions

Transaction for purchase or sale of investments should be recognized as of the trade date and 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 transaction should be recorded in the event of a purchase, as of the date on which the scheme obtains in enforceable obligation to pay the price or, in the event of a sale, when the scheme obtains an enforceable right to collect the proceeds of sale or an enforceable obligation to deliver the instruments sold.

(a) When in the case of an open – ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative be debited to reserves, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased, the difference between the purchase price and face value of the unit, if positive should be debited to reserves and, if negative, should be credited to reserves, the face value being debited to the capital account.

(b) 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 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 decease or increase the net income of the 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 fund is determined.

(c) In a close – ended scheme which provide to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortized 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.

(d) Underwriting commission should be recognized as revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.

1.17 Dividend Equalisation

New investors are not entitled to any share of the income of a mutual fund scheme which arose before they bought their units. However, at the end of each distribution period the fund management allocates the same amount from the income of the fund to each unit. To compensate for this an equalisation payment is added to the cost of new units. This is the amount of income that has arisen up to the date of purchase of the unit. Because these payments are included in the amount available for distribution they are effectively repaid to the purchaser. The purchaser's dividend voucher at the end of the first distribution period should show the amount of the returned equalisation payment. This payment is not income. It should not be treated as capital distribution. It is a return of the initial price paid and it should therefore be deducted from the price paid when computing the chargeable gain on eventual disposal.

Illustration 5

On April 1, 2012 a mutual fund scheme had 9 lakh units of face value ₹ 10 outstanding. The scheme earned ₹ ₹ 81 lakh in 2012-13, out of which ₹ 45 lakh was earned in first half-year. 1 lakh units were sold on 30.09.12 at NAV ₹ 60. Show important accounting entries for sale of units and distribution of dividend at the end of 2012-13.

Solution

Allocation of earnings

	Old unit holders (9 lakh units) (₹ Lakh)	*New unit holders (1 lakh units) (₹ lakh)*	*Total earning (₹ Lakh)*
First half-year (₹ 5.00 per unit)	45.0	Nil	45

Second half-year (₹ 3.60 per unit)	32.4	3.6	36
	77.4	3.6	81.0
Add: Equalisation payment recovered			5.0
Total available for distribution			86.0

Note: Equalisation payment = ₹ 45 lakh / 9 lakh = ₹ 5 per unit.

Distribution of earning per unit

	Old unit holders ₹	*New unit holders* ₹
Dividend distributed	8.60	8.60
Less: Equalisation payment		(5.00)
Net distributed income	8.60	3.60

Journal Entries

Date			*₹ lakh*	*₹ lakh*	
30/09/12	Bank	Dr.	65		1 lakh x ₹ 65
	To Unit Capital			10	1 lakh x ₹ 10
	To Reserves			50	1 lakh x ₹ 50
	To Dividend Equalisation			5	1 lakh x ₹ 5
31/03/13	Dividend Equalisation	Dr.	5		
	To Revenue A/c			5	
31/03/13	Revenue A/c	Dr.	86		
	To Bank			86	10 lakh x ₹ 8.60

Unit 2: Non-Banking Finance Company

2.1 Introduction

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (Residuary non-banking company).

NBFCs perform functions similar to that of banks. However there are a few differences. First an NBFC cannot accept demand deposits; second an NBFC is not a part of the payment and settlement system and as such, third an NBFC cannot issue cheques drawn on itself; and last deposit insurance facility of the Deposit Insurance and Credit Guarantee Corporation is not available for NBFC depositors, unlike banks.

Non Banking Financial Companies (NBFC) play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. They are increasingly being recognised as complementary to the banking system, capable of absorbing shocks and spreading risks at times of financial distress. Simplified sanction procedures, orientation towards customers, attractive rates of return on deposits and flexibility and timeliness in meeting the credit needs of specified sectors (like equipment leasing and hire purchase), are some of the factors that enhanced the attractiveness of NBFCs.

2.2 Definition of NBFC

Section 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

(i) A financial institution which is a company;

(ii) A non banking institution which is a company with principal business of receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) Such other non-banking institution or class of such institutions, as the Reserve Bank with the previous approval of the Central Government may specify by notification in the Official Gazette.

For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a –¨Loan company, ¨Investment company, Hire purchase finance company, Equipment leasing company and Mutual benefit financial company".

2.3 Registration and Regulation of NBFC

Under Section 45–IA of the Reserve Bank of India (Amendment) Act, 1997, no non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration issued by the Reserve Bank of India.

A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

The Reserve Bank of India has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs. Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders.

2.4 Minimum Net Owned Fund

The minimum net owned fund of a registered NBFC is Rs 200 lakhs. The term net owned fund (NOF) is given in the explanation to Section 45-IA of the Reserve Bank of India Act, 1934. As per the definition:

Owned Fund = Aggregate of the paid-up equity capital + Free reserves as disclosed in the latest balance sheet of the company – Accumulated balance of loss – Deferred revenue expenditure – Other intangible assets.

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC. – Book value of debentures, bonds, outstanding loans and advances made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund)

In terms of Section 45-IC of the RBI Act, NBFCs are required to create a reserve fund and transfer therein a sum not less than twenty per cent of its net profit every year.

2.5 Classification of NBFC

Originally, NBFCs registered with RBI were classified as:

(i) equipment leasing company;

(ii) hire-purchase company;

(iii) loan company;

(iv) investment company.

However, with effect from December 02, 2011 NBFCs registered with RBI have would be classified under following categories:

(i) Asset Finance Company (AFC)

(ii) Investment Company (IC)

(iii) Loan Company (LC)

(iv) Infrastructure Finance Company (IFC)

(v) Core Investment Company (CIC)

(vi) Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC)

(vii) Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI).

Specified Criteria:

Asset Finance Company (AFC)

(i) AFC would be defined as 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.

(ii) Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively.

Investment Company (IC)

It means a company which is a financial institution carrying on as its main business of the acquisition of securities.

Loan Company (LC)

It means any company which is a financial institution carrying on as its main business by 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.[4]

The above type of companies may be further classified into those accepting deposits or those not accepting deposits.

Mortgage Guarantee Company to be NBFC

As per RBI Notification dated January 15, 2008, a mortgage guarantee company would be treated as NBFC. The relevant notification is reproduced as below:

"The Reserve Bank of India, on being satisfied that it is necessary so to do, in exercise of the powers conferred on it under section 45-I(f)(iii) of the Reserve Bank of India Act, 1934 (2 of 1934) (the Act), with the prior approval of the Central Government hereby specifies that a Mortgage Guarantee Company, that is, a company registered with the Bank under the scheme for registration of Mortgage Guarantee Companies notified by the Bank in this regard, will be treated as Non-Banking Financial Company under the provisions of the Act."

Infrastructure Finance Company (RBI Notification dated February 12, 2010)

Currently, the Reserve Bank has classified NBFCs under three categories, viz., Asset Finance Companies, Loan companies and Investment Companies. It has now been decided to introduce a fourth category of NBFCs as "Infrastructure Finance Companies"(IFCs).

Accordingly, it is advised that the present classification of NBFCs stands modified to include IFCs. An IFC is defined as non deposit taking NBFC that fulfills the criteria mentioned below:

(i) a minimum of 75 per cent of its total assets should be deployed in infrastructure loans as defined in Para 2(viii) of the Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

(ii) Net owned funds of ₹ 300 crore or above;

(iii) minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA or equivalent rating by any other accrediting rating agencies;

(iv) Capital to Risk Asset Ratio (CRAR) of 15 percent (with a minimum Tier I capital of 10 percent).

Core Investment Companies (RBI Notification August 12, 2010)

Core Investment Company means a NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:

- it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;
- its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;
- it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
- it does not carry on any other financial activity referred to in section 45-I(*c*) and 45-I(*f*) of the RBI Act, 1934 except investment in bank deposits, money market instruments, government securities, loans and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

Core Investment Companies (CIC) with an asset size of less than ₹ 100 crores will not be required to register themselves with RBI.

Core Investment Companies (CIC) with an asset size of ₹ 100 crores or more, will be regarded as Systemically Important Core Investment Companies (CICs-ND-SI). Systemically Important Core Investment Companies will be required to get themselves registered with Reserve Bank of India.

A CIC-ND-SI which fulfills the following conditions, will not be required to meet the requirement for maintaining Net Owned Funds & capital adequacy and exposure norms as required under Non-Banking Financial (Non-Deposit Accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007:

- Maintenance of minimum Capital Ratio where Adjusted Net Worth shall not be less than 30% of its Aggregate Risk Weighted Assets on Balance Sheet and risk adjusted value off-balance sheet items as on the date of the last audited Balance Sheet at the end of the financial year.
- Ensuring that it's outside liabilities at all times doesn't not exceed 2.5 times of the Adjusted Net Worth as on last audited Balance Sheet date.

CICs-ND-SI will be required to submit an Annual Certificate from their statutory auditors regarding compliance with the above guidelines within one month from the date of finalisation of the Balance-Sheet.

The above mentioned categories may further have the following sub-categories depending upon their business functions:

(i) Equipment leasing company engaged in equipment leasing or financing of such activity.

(ii) Hire purchase finance company engaged in hire purchase transaction or financing of such transactions.

(iii) Investment company engaged in acquisition of securities and trading in such securities to earn a profit.

(iv) Loan company engaged in providing finance by making loans or advances, or otherwise for any activity other than its own; excludes EL/HP/Housing finance Companies (HFCs).

(v) Residuary non-banking company (RNBC) which receives deposits under any scheme or arrangement, by whatever name called, in one lump-sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any manner. These companies do not belong to any of the categories as stated above.

Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC) (RBI notification dated November, 21, 2011)

Infrastructure Debt Funds (IDFs), to facilitate the flow of long-term debt into infrastructure projects. IDF- NBFC would raise resources through issue of either Rupee or Dollar denominated bonds of minimum 5 year maturity. The investors would be primarily domestic

and off-shore institutional investors, especially insurance and pension funds which would have long term resources. IDF-NBFC would be regulated by the Reserve Bank.

Besides the above class of NBFCs the Residuary Non-Banking Companies are also registered as NBFC with the Bank.

Non-Banking Financial Company–Micro Finance Institution (NBFC-MFI) (RBI notification dated December 02, 2011)

The Reserve Bank of India having considered it necessary in the public interest and being satisfied that for the purpose of enabling the Bank to regulate the credit system to the advantage of the country, gave the directions for the Non-Banking Financial Company -Micro Finance Institutions (Reserve Bank) Directions, 2011.

An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Indian Companies Act, 1956) that fulfils the following conditions:

i. Minimum Net Owned Funds of ₹ 5 crore. (For NBFC-MFIs registered in the North Eastern Region of the country, the minimum NOF requirement shall stand at ₹ 2 crore).

ii. Not less than 85% of its net assets are in the nature of "qualifying assets."

   For the purpose of ii. above,

   "Net assets" are defined as total assets other than cash and bank balances and money market instruments.

   "Qualifying asset" shall mean a loan which satisfies the following criteria:-

   a. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹ 60,000 or urban and semi-urban household income not exceeding ₹ 1,20,000;

   b. loan amount does not exceed ₹ 35,000 in the first cycle and ₹ 50,000 in subsequent cycles;

   c. total indebtedness of the borrower does not exceed ₹ 50,000;

   d. tenure of the loan not to be less than 24 months for loan amount in excess of ₹ 15,000 with prepayment without penalty;

   e. loan to be extended without collateral;

   f. aggregate amount of loans, given for income generation, is not less than 75 per cent of the total loans given by the MFIs;

   g. loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower

iii. Further the income an NBFC-MFI derives from the remaining 15 percent of assets shall be in accordance with the regulations specified in that behalf.

iv. An NBFC which does not qualify as an NBFC-MFI shall not extend loans to micro finance sector, which in aggregate exceed 10% of its total assets.

2.6 Liquid Asset Requirements

In terms of Section 45-IB of the RBI Act, 1934 the minimum level of liquid asset to be maintained by NBFCs is 15 per cent of public deposits outstanding as on the last working day of the second preceding quarter.

Of the 15%, NBFCs are required to invest not less than 10% in approved securities and the remaining 5% can be in unencumbered term deposits with any scheduled commercial bank. Thus, the liquid assets may consist of government securities, government guaranteed bonds and term deposits with any scheduled commercial bank.

The investment in government securities should be in dematerialised form which can be maintained in Constituents' Subsidiary General Ledger (CSGL) Account with a scheduled commercial bank (SCB) / Stock Holding Corporation of India Limited (SHICL). In case of Government guaranteed bonds the same may be kept in dematerialised form with SCB/SHCIL or in a dematerialised account with depositories [National Securities Depository Ltd. (NSDL)/Central Depository Services (India) Ltd. (CDSL)] through a depository participant registered with Securities & Exchange Board of India (SEBI). However in case there are Government bonds which are in physical form the same may be kept in safe custody of SCB/SHCIL.

NBFCs have been directed to maintain the mandated liquid asset securities in a dematerialised form with the entities stated above at a place where the registered office of the company is situated. However, if a NBFC intends to entrust the securities at a place other than the place at which its registered office is located, it may do so after obtaining in writing the permission of RBI. It may be noted that the liquid assets in approved securities will have to be maintained in dematerialised form only.

The liquid assets maintained as above are to be utilised for payment of claims of depositors. However, deposit being unsecured in nature depositors do not have direct claim on liquid assets.

2.7 Prudential Accounting Norms

In order to ensure that NBFCs function on sound and healthy lines, the Reserve Bank issued its Non-banking Financial Companies Prudential Norms Directions in January 1998. All NBFCs, accepting public deposits and residuary non-banking companies are required to follow the norms. They are also to comply with the Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India, so far as these are not inconsistent with the prudential norms directions of the Reserve Bank of India.

The provisions of the prudential norm directions regarding capital adequacy and credit concentration does not apply to (i) a loan company; (ii) an investment company; (iii) a hire purchase finance company; and (iv) an equipment leasing company, unless they accept/hold public deposit.

An investment company not accepting public deposits need not comply with the prudential

norms, provided it holds investments in the securities of its group/holding/subsidiary companies and book value of such holding is not less than 90% of its total assets and if it does not trade in such securities.

Prudential norms directions prescribe principles of income recognition, asset classification, provisioning, capital adequacy and disclosures.

2.8 Income Recognition

(a) The income recognition shall be based on recognised accounting principles.

(b) Income on non-performing assets (NPA) shall be recognised only when it is actually realised.

(c) Income relating to hire purchase asset, where instalments are overdue for more than 12 months, shall be recognised only when the hire charge is actually received.

(d) Income relating to leased asset, where lease rentals are overdue for more than 12 months, shall be recognised only when the lease rental is actually received.

(e) Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis. However, income from dividend on shares of corporate bodies may be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the NBFC's right to receive payment is established.

(f) Income from bonds and debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis:, provided that the interest rate on these instruments is pre-determined and that interest is serviced regularly and is not in arrears.

(g) Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

2.9 Accounting for Investments

1. (a) The Board of Directors of every non-banking financial company shall frame investment policy for the company and implement the same;

   (b) The criteria to classify the investments into current and long term investments shall be spelt out by the Board of the company in the investment policy;

   (c) Investments in securities shall be classified into current and long term, at the time of making each investment;

   (d) (i) There shall be no inter-class transfer on ad-hoc basis;

   (ii) The inter-class transfer, if warranted, shall be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board;

(iii) The investments shall be transferred scrip-wise, from current to long-term or vice-versa, at book value or market value, whichever is lower;

(iv) The depreciation, if any, in each scrip shall be fully providedfor and appreciation, if any, shall be ignored;

(v) The depreciation in one scrip shall not be set off against appreciation in another scrip, at the time of such inter-class transfer, even in respect of the scrips of the same category.

2. Quoted current investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

   (a) equity shares,

   (b) preference shares,

   (c) debentures and bonds,

   (d) Government securities including treasury bills,

   (e) units of mutual fund, and

   (f) others.

   Quoted current investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each category shall 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 for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

3. Unquoted equity shares in the nature of current investments shall be valued at cost or break up value, whichever is lower. However, non-banking financial companies may substitute fair value for the break up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at one Rupee only.

4. Unquoted preference shares in the nature of current investments shall be valued at cost or face value, whichever is lower.

5. Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.

6. Unquoted investments in the units of mutual funds in the nature of current investments shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme.

7. Commercial papers shall be valued at carrying cost.

8. A long term investment shall be valued in accordance with the Accounting Standard issued by ICAI.

Note: Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

2.10 Asset Classification

Every NBFC shall, 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 namely, -

(a) Standard assets;
(b) Sub-standard assets;
(c) Doubtful assets; and
(d) Loss assets.

Standard asset means an 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.

Sub-standard asset means (a) an asset which has been classified as non-performing asset for a period not exceeding 18 months; (b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or 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, or (b) a lease asset, or (c) a hire purchase asset, or (d) any other asset, which remains a sub-standard asset for a period exceeding 18 months;

Loss asset means (i) an asset which has been identified as loss asset by the NBFC or its internal or external auditor or by the Reserve Bank during the inspection of the NBFC, to the extent it is not written off by the NBFC; and (ii) an asset which 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.

The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the up gradation.

2.11 Non-Performing Asset (NPA)

'Non-performing asset' means:

(a) an asset, in respect of which, interest has remained overdue for a period of six months or more;

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;

(c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;

(d) a bill which remains overdue for a period of six months or more;

(e) the interest in respect of a debt or the income on receivables under the head other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

(g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

(h) in respect of 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 non-performing asset:

Provided that in the case of lease and hire purchase transactions, a non-banking financial company may classify each such account on the basis of its record of recovery;

2.12 Provisioning Requirements

Every NBFC shall, after 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, make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder :-

Loans, advances and other credit facilities including bills purchased and discounted

The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under :

Loss Assets

The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for.

Doubtful Assets

(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the NBFC has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis.

(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis : -

Period for which the asset has been considered as doubtful	% of provision
Upto one year	20
One to three years	30
More than three years	50

Sub-standard asset

A general provision of 10% of total outstanding shall be made.

Standard asset

A general provision at 0.25* per cent of the outstanding standard assets shall be made. The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' in the balance sheet. Also, NBFCs are allowed to include the 'General Provisions on Standard Assets' in Tier II capital which together with other 'general provisions/ loss reserves' will be admitted as Tier II capital only up to a maximum of 1.25 per cent of the total risk-weighted assets.

Lease and hire purchase assets

The provisioning requirements in respect of hire purchase and leased assets shall be as under:

Hire purchase assets

(i) In respect of hire purchase assets, 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 charges; and

(b) the depreciated value of the underlying asset,

shall be provided for.

Explanation :

For the purpose of this paragraph,

(1) the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method; and

* RBI vide notification no. DNBS.PD.CC.No.207/03.02.002/2010-11 dated January 17, 2011.

(2) in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset.

Additional provision for hire purchase and leased assets

(ii) In respect of hire purchase and leased assets, additional provision shall be made as under:

(a) Where hire charges or lease rentals are overdue upto 12 months	Nil
(b) where hire charges or lease rentals are overdue for more than12 months but upto 24 months	10% of the net book value
(c) where hire charges or lease rentals are overdue for more than 24 months but upto 36 months	40 percent of the net book value
(d) where hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value
(e) where hire charges or lease rentals are overdue for more than 48 months	100 percent of the net book value

(iii) On expiry of a period of 12 months after the due date of the last instalment of hire purchase/leased asset, the entire net book value shall be fully provided for.

Illustration 1

Samvedan Limited is a non-banking finance company. It accepts public deposit and also deals in hire purchase business. It provides you with the following information regarding major hire purchase deals as on 31-03-2011. Few machines were sold on hire purchase basis. The hire purchase price was set as ₹ 100 lakhs as against the cash price of ₹ 80 lakhs. The amount was payable as ₹ 20 lakhs down payment and balance in 5 equal instalments. The hire vendor collected first instalment as on 31-03-2012, but could not collect the second instalment which was due on 31-03-2013. The company was finalising accounts for the year ending 31-03-2013. Till 15-05-2013, the date 'on which the' Board of Directors signed the accounts, the second instalment was not collected. Presume IRR to be 10.42%.

Required:-

(i) What should be the principal outstanding on 1-4-2012? Should the company recognize finance charge for the year 2012-13 as income?

(ii) What should be the net book value of assets as on 31-03-13 so far Samvedan Ltd. is concerned as per NBFC prudential norms requirement for provisioning?

(iii) What should be the amount of provision to be made as per prudential norms for NBFC laid down by RBI?

Solution

(i) Since, the hire-purchaser paid the first instalment due on 31.3.2012, the notional principal outstanding on 1-4-2012 was ₹ 50.25 lakhs. In the year ended 31.03.2013, the instalment due of ₹ 16 lakhs has not been received. Therefore, Samvedan Ltd. should not recognise ₹ 5.24 lakhs as interest income included in that due instalment as this should be treated as finance charge (not collected). (Refer W.N.1)

(ii) The net book value of the assets as on 31-3-2013

	₹ in lakhs
Overdue instalment	16.00
Instalments not due (₹ 16 lakhs x 3)	48.00
	64.00
Less: Finance charge (not collected)	(5.24)
	58.76
Less: Depreciated value (cash price less depreciation for two years on SLM @ 20%*)	(48.00)
Net book value of assets for Samvedan Ltd.	10.76

(iii) Provision of 0.25% will be made on net book value of assets as on 31.3.2013 as the asset is a standard asset and not termed as a non-performing asset. For an asset being in the nature of lease rental & hire purchase instalment, classification as a non performing asset will be done only if it is overdue for a period of 12 months or more. However, in the given question it is overdue only for 1.5 months. Therefore, it will be classified as standard asset only.

Provision of ₹ 0.0269 lakhs (10.76 lakhs x 0.25%) will be made at the year ended 31.3.2013, as per NBFC prudential norms laid down by the RBI.

Working Note:

It is necessary to segregate the instalments into principal outstanding and interest components by using I.R.R. @ 10.42%.

* As per NBFC prudential norms laid down by the RBI.

(₹ in lakhs)

Time	Opening outstanding amount (a)	Cash flow (b)	Interest @ 10.42% (c) = (a x 10.42%)	Principal repayment (d) = (b – c)	Closing outstanding (e) = (a – d)
31-3-2011		(-) 60	-----	---	60.00
31-3-2012	60.00	16	6.25	9.75	50.25
31-3-2013	50.25	16	5.24	10.76	39.49
31-3-2014	39.49	16	4.11	11.88	27.60
31-3-2015	27.60	16	2.88	13.12	14.48
31-3-2016	14.48	16	1.52	14.48	0.00

2.13 Disclosure in the Balance Sheet

Every non-banking financial company shall finalise its balance sheet within a period of 3 months from the date to which it pertains.

(a) Every NBFC shall, separately disclose in its balance sheet the provisions made as per requirements without netting them from the income or against the value of assets.

(b) The provisions shall be distinctly indicated under separate heads of accounts as provisions for bad and doubtful debts and provisions for depreciation in investments.

(c) Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the NBFC.

(d) Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general Provisions and loss reserves may be written back without making adjustment against them.

2.14 Requirement as to Capital Adequacy

Every non-banking financial company shall maintain a minimum capital adequacy ratio of Tier I and Tier II capital which should not be less than 12% of its aggregate risk weighted assets on balance sheet date and of risk adjusted value of off-balance sheet items.

The total of Tier II capital, at any point of time, shall not exceed one hundred percent of Tier I capital. Capital Adequacy ratio shall be maintained at a percentage prescribed by RBI from time to time, (presently, it should not be less than 15% by 31st March, 2012).

"*Tier I Capital*" means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;

"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 fifty five percent;

(c) general provisions and loss reserves to the extent these are 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 one and one fourth percent of risk weighted assets;

(d) hybrid debt capital instruments; and

(e) subordinated debt to the extent the aggregate does not exceed Tier I capital.

"*Subordinated debt"* means an instrument, which is fully paid up and is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of non-banking financial company. The book value of such instrument shall be subjected to discounting as provided hereunder:

	Remaining Maturity of the instruments	Rate of discount
(a)	Upto one year	100%
(b)	More than one year but upto two years	80%
(c)	More than two years but upto three years	60%
(d)	More than three years but upto four years	40%
(e)	More than four years but upto five years	20%

to the extent such discounted value does not exceed fifty per cent of Tier I capital;

2.15 Asset-Liability Management (ALM)

ALM is a risk management tool that helps a bank/NBFC to manage its liquidity risk and interest rate risk. This is a powerful tool that helps banks/NBFCs plan long term financial, funding, and capital strategy using present value analysis. With ALM, a bank/NBFC can model interest income and expenses for analysis and re-price assets and liabilities. Based on ALM position, banks/NBFCs can also model effect of competitive pricing to create innovative and imaginative new banking products. ALM also helps regulatory compliance for banks/NBFCs by through appropriate investment / disinvestment decisions to maintain the required statutory liquidity ratio (SLR), credit reserve ratio (CRR) and other ratios as per Reserve Bank of India (RBI) guidelines. ALM involves the analysis of Structural Liquidity Gap Analysis, Interest Rate Gap Analysis, Net Interest Income (NII) Analysis, Net Interest Margin (NIM) Analysis, Tolerance Analysis, Cost to Close Analysis, Duration Gap Analysis, Trend Analysis, Comparative Analysis, Present Value Analysis, Forward Analysis and Scenario Analysis The Reserve Bank of India has announced its ALM guidelines for NBFCs for effective risk management. The NBFCs covered under the system are required to submit ALM returns comprising of statements on structural liquidity, short-term dynamic liquidity and interest rate sensitivity, to the Reserve Bank of India.

Unit 3: Merchant Bankers

3.1 Introduction

In banking a **merchant bank** is a financial institution primarily engaged in offering financial services and advice to corporations and wealthy individuals on how to use their money. The term can also be used to describe the private equity activities of banking.

According to **Cox, D.** merchant banking is defined as, "merchant banks are the financial institutions providing specialist services which generally include the acceptance of bills of exchange, corporate finance, portfolio management and other banking services".

The Notification of the Ministry of Finance defines a merchant banker as, **"any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management".**

A merchant banker is an organization that acts as an intermediary between the issuers and the ultimate purchasers of securities in the primary security market. In addition to managing an issue for a client, the services offered by a merchant banker includes underwriting and providing advice on complex financings arrangements, mergers and acquisitions, and at times direct equity investments in corporations.

In exercise of the powers conferred vide Section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Board, with the previous approval of the Central Government made the SEBI (Merchant Bankers) Regulations, 1992 which specify various requirements. Further, the SEBI has amended SEBI (Merchant Bankers) Regulations, 1992 in various years i.e. 2006, 2007, 2010 and 2011. These regulations specify the norms which SEBI takes into account for considering the grant of a certificate of registration and its renewal. The code of conduct has been given in schedule III and Chapter III of these regulations contain general obligations and responsibilities of merchant bankers.

3.2 Registration of Merchant Banker

Under Regulation 3, a person can apply for grant of certificate as merchant banker under any one of the following categories:

(i) Merchant bankers who carry on activity of the issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of subscriptions; and act as advisor, consultant, manager, underwriter, portfolio manager;

(ii) Merchant bankers who act as advisor, consultant, co-manager, underwriter, portfolio manager;

(iii) Merchant bankers who act as underwriter, advisor, consultant to an issue

(iv) Merchant bankers who act only as advisor or consultant to an issue

3.3 Capital Adequacy Requirement

Capital adequacy requirements have been specified by SEBI under the SEBI (Merchant Bankers) Regulations, 1992. Regulation 7 specifies that the requirement of capital adequacy shall be a net worth of not less than five crore rupees.

For the purpose of this regulation, 'Net worth' means the sum of paid-up capital and free reserves of the applicant at the time of making application under sub-regulation (1) of regulation 3.

3.4 Maintenance of Books of Account, Records etc.

Every merchant banker shall keep and maintain the following books of account, records and documents as per regulation 14:

(*a*) a copy of balance sheet as at the end of the each accounting period;

(*b*) a copy of profit and loss account for that period;

(*c*) a copy of the auditor's report on the accounts for that period;

(*d*) a statement of financial position;

(e) Records and documents pertaining to due diligence exercised in pre-issue and post issue activities of issue management and in case of takeover, buy-back and delisting of securities*.

Every merchant banker shall intimate to the SEBI the place where the books of account, records and documents are maintained. Every merchant banker shall, after the end of each accounting period furnish to the Board copies of the balance sheet, profit and loss account and such other documents for any other preceding five accounting years when required by the SEBI. The merchant banker shall preserve the books of account and other records and documents maintained under regulation 14 for a minimum period of five years.

As per Regulation 28 of the SEBI (Merchant Banker) Regulations 1992, a merchant banker shall disclose to the Board, as and when required, the following information, namely :–

(i) his responsibilities with regard to the management of the issue;

(ii) any change in the information or particulars previously furnished, which have a bearing on the certificate granted to it.

(iii) the names of the body corporate whose issue he has managed or has been associated with;

(iv) the particulars relating to the breach of the capital adequacy requirements as specified in regulation 7;

**SEBI notification no. LAD-NRO/GN/2011-12/17/26149 dated 16th August, 2011.*

(v) relating to the activities as manager, underwriter, consultant or advisor to an issue, as the case may be.

Under Regulation 29, the merchant banker shall submit a half yearly report for the period ending up to 31st March and 30th September of every year in the format specified in Schedule IV, within three months from the close of the period to which it corresponds.* The merchant banker shall SEBI has the right to appoint one or more persons as inspecting authority to undertake inspection of the books of account, records and documents of the merchant banker for any of the following purposes :

(i) to ensure that the books of account are being maintained in the required manner;

(ii) that the provisions of the Act, rules, regulations are complied with;

(iii) to investigate into the complaints received from investors, other merchant bankers or any other person on any matter having a bearing on the activities of the merchant banker; and

(iv) to investigate suo motu in the interest of securities business or investors' interest into the affairs of the merchant banker.

As per Regulation 31, it shall be the duty of the merchant banker to allow the inspecting authority to have reasonable access to the premises occupied by such merchant banker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the merchant banker or any such other person and also provide copies of documents or other materials which, in the opinion of the inspecting authority, are relevant for the purposes of the inspection.

The SEBI may also appoint a qualified auditor to investigate into the books of account or the affairs of the merchant bankers.

SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 has specified a format for half yearly report to be submitted by merchant bankers.

3.5 Underwriting Obligations

As per Regulation 22, in respect of every issue to be managed, the lead merchant banker holding a certificate under Category I shall accept a minimum underwriting obligation of five per cent of the total underwriting commitment or rupees twenty-five lacs, whichever is less.

Further, in any issue made in accordance with Chapter XA of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 the merchant banker shall, itself or jointly with other merchant bankers associated with the issue, underwrite at least fifteen per cent of the issue size.

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* *Inserted by SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.*

Unit 4: Stock and Commodity Market Intermediaries

4.1 Introduction

A **stock market** or **equity market** is a public entity (a loose network of economic transactions, not a physical facility or discrete entity) for the trading of company stock (shares) and derivatives at an agreed price. These are securities listed on a stock exchange as well as those only traded privately.

Commodity markets are markets where raw or primary products are exchanged. These raw commodities are traded on regulated commodities exchanges, in which they are bought and sold in standardized contracts.

Intermediary is a firm or person (such as a broker or consultant) who acts as a mediator on a link between parties to a business deal, investment decision, negotiation, etc. In money markets, for example, banks act as intermediaries between depositors seeking interest income and borrowers seeking debt capital. Intermediaries usually specialize in specific areas, and serve as a conduit for market and other types of information.

With the removal of the ban on forward trading in all commodities, the Indian commodities futures market has been totally liberalised. Participants in the securities and other financial markets can now think of exploring the opportunities offered by the emerging commodities market. There are, however, some basic issues relating to the securities and commodity derivative markets and the likely impact of any moves for unifying the two on participant institutions, players and regulatory bodies. Neither convergence nor divergence may necessarily mean a win-win situation for the existing stock and commodity exchanges in the present situation. Even though there are differences between commodity and financial derivatives markets, they also have some close link in so far as trading practices and mechanisms are concerned. The reforms in the securities market over the past two decades were carried out both in the primary and secondary markets. The Securities and Exchange Board of India has introduced in the past decade a number of measures to streamline the capital market, professionalize trading and protect the interests of the small investor. There is complete automation of trading in the securities market. Proper risk management, governance principles and regulatory measures are in place.

In the commodities markets too the situation is changing. Some commodity exchanges are specializing in specific areas with varying degrees of success. The task force has stressed the need to have at least a third of each exchange board manned by independent directors. Licenses have been given for a multiple commodities exchange and single commodity exchanges and for conducting trading on-line. Even a single commodity exchange can trade in multiple commodities after obtaining permission from the Forward Markets Commission (FMC). FMC has issued various guidelines to control the operations of stock and commodity market intermediaries.

Commodity exchanges are promoted by institutions and associations. With convergence, there will be an opportunity to speed up the development of the commodity markets. Because of the economies of scale in operations there will be scope for further improvement However, there are certain differences. Financial futures generally draw their strength from actively traded cash markets. The exchanges oversee the operations. While organised trading in commodities may closely resemble financials (as in bullion), one area of concern in the former case is the impact of price volatility on the market; also, commodities markets require specialised knowledge that is different from securities trading.

The task force has identified many legal and regulatory hurdles in the way of convergence of securities and commodities markets. The securities market is governed by the Securities Contracts Regulation Act, 1956 whereas the forward market is regulated by the Forward Contracts Regulation Act 1952. Another basic consideration is that stock exchanges and futures markets for financials are Central subjects whereas agriculture is under the jurisdiction of States and futures trading in commodities are with the Union Government. In reality, policies for the securities market and development of the commodities market are of different nature. Even though the volume of trading in commodities is much higher than in securities, it is better to keep them apart in the initial stages. Clearing members of a stock exchange would like to trade in a commodity exchange as it provides them another avenue for making money. The Securities Contracts Regulation Act has therefore been amended whereby members of a stock exchange can be members of a commodity exchange by forming a separate company. This is essential because at present there are two regulators and each one will exercise his supervisory powers as provided under the rules in the respective market. The net worth for becoming a clearing member can be fixed separately for the two exchanges and this will play an important role in risk management. Even if there is a risk in one market, no cascading effect will be felt in the other. There is also the fact that net worth from one market cannot be moved to another. This will provide the necessary firewall between the two markets and will benefit all the participants.

4.2 Stock Brokers

A stock broker is a member of a recognised stock exchange(s) and is engaged in buying, selling and dealing in securities. A stock broker can deal in securities only after getting registration with SEBI. A stock broker can function as a proprietorship firm, partnership firm or a corporate. Brokers are subject to capital adequacy requirements comprising of a basic minimum capital and additional volume related capital. Stock brokers are also eligible to act as underwriters without obtaining a separate registration as an underwriter. He may or may not appoint sub-brokers. A sub-broker is subordinate to main stock broker and acts on behalf of a stock broker as an agent or otherwise, for assisting the investors in buying, selling or dealing in securities through such stock brokers. The stock broker as a principal, is responsible to the investor for his sub-brokers' conduct and acts.

In exercise of the powers conferred by section 30 of the Securities and Exchange Board of India Act ,1992 the SEBI Board made the SEBI (Stock-Brokers and Sub-Brokers) Regulations,

1992 to exercise the control on the activities of stock brokers and their sub-brokers. In a contract for buying and selling securities, stock brokers act as agents for investors. In return for this service they charge commission or brokerage at a specified percentage on contract value. In addition to acting as agents for others, a stockbroker may also trade directly by buying and selling securities as principals. If a stockbroker enters into a contract to buy or sale securities as principal with any person other than another stockbroker, he must secure the consent or authorization from the other party and must disclose in the agreement for buying or selling of securities that he is acting as a principal.

A sub-broker is any person not being a member of a recognised stock exchange who acts on behalf of a stock-broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stockbroker.

The Securities and Exchange Board of India (Stockbrokers and sub-brokers) Rules, 1992 provides that no stockbroker or sub-broker can buy, sell or deal in securities, unless he holds a certificate of registration granted by the Securities and Exchange Board of India (SEBI). The certification of registration is granted by SEBI on an application made to it in prescribed form, subject to fulfillment of conditions specified in the Securities and Exchange Board of India (Stockbrokers and sub-brokers) Rules, 1992.

The Securities and Exchange Board of India (Stockbrokers and sub-brokers) Regulations, 1992 provides inter-alia, for the obligations and responsibilities of stock brokers regarding maintenance of proper books of accounts, records and documents and other allied matters. In the regulations, board means, the Securities and Exchange Board of India (SEBI).

4.3 Maintenance of Proper Books of Account, Records etc. (Regulation 17)

Every stock boker is required to maintain the following books of account and records as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992 :

(a) Register of transactions (Sauda Book);

(b) Clients 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 participants in respect of dematerialized securities;

(h) 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 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 authority, and responsibilities of the Stock Broker and such Sub-broker;

*(n) Client account opening form in the format as may be specified by the Board.

In addition to the above statutory requirements, they are also required to maintain the following records/documents:

(a) Scripwise clientwise list in respect of scrips of specified group, i.e., 'A' Group (inclusive of brought forward positions);

(b) Client upla statement (i.e. carry forward position of all clients);

(c) Duplicate copies of self-certificates submitted on monthly basis (i.e., that the daily and badla break-up have been reported correctly without netting positions of two different clients in the same scrip);

(d) Copies of all margin statements downloaded by the Stock Exchange;

(e) Copies of Valan Balance Sheet (Form 31) along with all relevant assets;

(f) Details of spot delivery transactions entered into (including securities delivered and payments made to the members);

(g) Client database and broker client agreement;

(h) Copy of registration certificate of each sub-broker issued by SEBI;

(i) Copy of approval for each remisier given by the exchange;

(j) Copy of the power of attorney/board resolution authoritizing directors, employees to sign the contract note;

(k) Copies of pool account statements.

Every stock broker shall intimate to the SEBI the place where the books of account, records and documents are maintained. Every stock broker shall, after the close of each accounting period furnish to the SEBI if so required as soon as possible but not later than six months from the close of the said period a copy of the audited balance sheet and profit and loss account as at the end of the said accounting period; provided that if, it is not possible to furnish the above documents within the time specified, the stock broker shal keep the SEBI informed of the

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* *Inserted by the SEBI vide notification no.* LAD-NRO/GN/2011-12/19/26273 dated 17th August, 2011.

same together with the reasons for delay and the period of time by which such documents would be furnished. Every stock broker is required to preserve the books of account and other records maintained under regulation 17 for a minimum period of five years.

SEBI may appoint one or more persons as inspecting authority to undertake inspection of the books of account, other records and documents of the stock brokers for any of the following purposes:

(a) to ensure that the books of the account and other books are being maintained in the manner required;

(b) that the provisions of the Act, rules, regulations and the provisions of the Securities Contract (Regulation) Act, and the rules made there under are being complied with;

(c) to investigate into the complaints received from investors, other stock brokers, sub-brokers or any other person on any matter having a bearing on the activities of the stock brokers; and

(d) to investigate suo motu, in the interest of securities business or investors' interest into the affaris of the stock-brokers.

The SEBI may appoint a qualified auditor to investigate into the books of account or the affairs of the stock-broker.

As per Regulation 25, a stock broker or a sub-broker who contravenes any of the provisions of the Act, rules or regulations framed there under shall be liable for any one or more of the following actions—

(i) Monetary penalty under Chapter VIA of the Act.

(ii) Penalties as specified under* [Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008] including suspension or cancellation of certificate of registration as a stock broker or a sub-broker,

(iii) Prosecution under section 24 of the Act.

4.4 Preservation of Books of Accounts and Records (Regulation 18)

Every stockbroker shall preserve the books of account and other records maintained under regulation 17 for a minimum period of five years.

4.5 Obligations of Stockbroker on Inspection by the Board (Regulation 21)

It shall be the duty of broker on inspection by the Board every director, proprietor, partner, officer and employee of the stock-broker, who is being inspected, to produce to the inspecting authority such books, accounts and other documents in his custody or control and furnish him

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* *Subsituted by SEBI (Intermediaries) Regulations, 2008 w.e.f 26.5.2008.*

with the statements and information relating to the transactions in securities market within such time as the said officer may require.

The stock-broker shall allow the inspecting authority to have reasonable access to the premises occupied by such stock- broker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the stock- broker or any other person and also provide copies of documents or other materials which, in the opinion of the inspecting authority are relevant.

The inspecting authority, in the course of inspection, shall be entitled to examine or record statements of any member, director, partner, proprietor and employee of the stock- broker.

It shall be the duty of every director proprietor, partner, officer and employee of the stock broker to give to the inspecting authority all assistance in connection with the inspection, which the stock broker may be reasonably expected to give.

4.6 Regulation of Transactions between Clients and Brokers

It shall be compulsory for all member brokers to keep the money of the clients in a separate account and their own money in a separate account. No payment for transactions in which the member broker is taking a position as a principal will be allowed to be made from the client's account.

4.7 Member Broker to Keep Accounts

Every member broker shall keep such books of accounts, as will be necessary, to show and distinguish in connection with his business as a member –

(a) Moneys received from or on account of each of his clients and,

(b) The moneys received and the moneys paid on Member's own account.

4.8 Obligation to Pay Money into "Clients Accounts"

Every member broker who holds or receives money on account of a client shall forthwith pay such money to current or deposit account at bank to be kept in the name of the member in the title of which the word "clients" shall appear (hereinafter referred to as "clients account").

Member broker may keep one consolidated clients account for all the clients or accounts in the name of each client, as he thinks fit. If a Member broker receives a cheque or draft representing in part money belonging to the client and in part money due to the Member, he shall pay the whole of such cheque or draft into the clients account and effect subsequent transfer.

Nothing in the above paragraph shall deprive a Member broker of any recourse or right, whether by way of lien, set-off, counter-claim charge or otherwise against moneys standing to the credit of clients account.

Moneys to be paid into "clients account"

No money shall be paid into clients account other than –

(a) Money held or received on account of clients;

(b) Such money belonging to the Member as may be necessary for the purpose of opening or maintaining the account;

(c) Money for replacement of any sum, which may by mistake or accident have been drawn from the account.

(d) A cheque or draft received by the Member representing in part money belonging to the client and in part money due to the Member.

Moneys to be withdrawn from "clients account"

No money shall be drawn from clients account other than -

(a) Money properly required for payment to or on behalf of clients or for or towards payment of a debt due to the Member from clients or money drawn on client's authority, or money in respect of which there is a liability of clients to the Member, provided that money so drawn shall not in any case exceed the total of the money so held for the time being for such each client;

(b) Such money belonging to the Member as may have been paid into the client account;

(c) Money, which may by mistake or accident have been paid into such account.

4.9 Accounts for Client's Securities

It shall be compulsory for all Member brokers to keep separate accounts for client's securities and to keep such books of accounts, as may be necessary, to distinguish such securities from his/their own securities. Such accounts for client's securities shall, inter-alia provide for the following:

(a) Securities received for sale or kept pending delivery in the market;

(b) Securities fully paid for, pending delivery to clients;

(c) Securities received for transfer or sent for transfer by the Member, in the name of client or his nominees;

(d) Securities that are fully paid for and are held in custody by the Member as security/margin etc. Proper authorization from client for the same shall be obtained by Member;

(e) Fully paid for client's securities registered in the name of Member, if any, towards margin requirements etc.;

(f) Securities given on Vyaj-badla. Member shall obtain authorization from clients for the same.

4.10 Payment and Delivery of Securities

Member Brokers shall make payment to their clients or deliver the securities purchased within two working days of payout unless the client has requested otherwise. Stock Exchange shall issue a Press Release immediately after the payout.

Member brokers shall issue the contract note for purchase/sale of securities to a client within 24 hours of the execution of the contract.

4.11 Margin

Member Brokers shall buy securities on behalf of client only on receipt of specified margin money on the price of the securities proposed to be purchased, unless the client already has an equivalent credit with the broker. Member may not, if they so desire, collect such a margin from Financial Institutions, Mutual Funds and FII's.

Member brokers shall sell securities on behalf of client only on receipt of a margin money on the price of securities proposed to be sold, unless the member has received the securities to be sold with valid transfer documents to his satisfaction prior to such sale.

4.12 Closing Out

In case of purchases on behalf of clients, Member brokers shall be a liberty to close out the transactions by selling the securities, in case the client fails to make the full payment to the Member Broker for the execution of the contract within two days of contract note having been delivered for cash shares and seven days for specified shares or before pay-in day (as fixed by Stock Exchange for the concerned settlement period), whichever is earlier; unless the client already has an equivalent credit with the Member. The loss incurred in this regard, if any, will be met from the margin money of that client.

In case of sales on behalf of clients, Member broker shall be at liberty to close out the contract by effecting purchases if the client fails to deliver the securities sold with valid transfer documents within 48 hours of the contract note having been delivered or before delivery day (as fixed by Stock Exchange authorities for the concerned settlement period), whichever is earlier. Loss on the transaction, if any, will be deductible from the margin money of that client.