CHAPTER - VIII

OTHER MARKET SEGMENTS UNDER REGULATION OF SEBI
CHAPTER - VIII
OTHER MARKET SEGMENTS UNDER REGULATION OF SEBI

I. INTRODUCTION:

There are several other components of the capital market which are also supervised by SEBI which may be summed up as follows:

II. THE DEPOSITORY SYSTEM:

To obviate the hassles and problems associated with the physical handling of securities, the government introduced the depository system under the Depositories Act, 1996, to enable holding and dealing of shares and securities in electronic form. In fact, the depository system was a long-felt need of the investing public for reliable and efficient dealings in the securities market.

The depository system was introduced in India under the 1995 Depository Ordinance, which subsequently became the Depositories Act in 1996. The act primarily provides for:

i. A multi-depository system

ii. Dematerialization of securities

iii. Appointment of depository participants

The Depositories Act, 1996, enables the setting up of multiple depositories in the country and all the operations of the depositories are governed by regulations as framed from time to time with reference to the provisions of the Depositories Act. The act envisages the transfer of ownership of securities electronically by book-entry without making the securities move from person to person. The act has made industrial securities
freely transferable by restricting the issuer's right to use discretion in effecting the transfer of securities. The transfer deed and other procedural requirements under the Companies Act, 1956, are also dispensed with. The stamp duty on transfer of dematerialization (demat) securities is also waived.

**Constituents of the depository system:**

The depository system has the following main constituents.

i. The depository  
ii. The depository participant (DP)  
iii. The issuer/its registrar and transfer agent (RTA) and  
iv. The clearing house or clearing corporation

**The depository:**

In the words of the Bank for International Settlements, "a depository is a facility for holding securities, which enables securities transaction to be processed by book entry. Physical securities may be immobilized by the depository or securities may be dematerialized so that they exist only as electronic records". According to the Depositories Act, 1996, a depository is a company formed and registered under the Companies Act, 1956, and one that has been granted a certificate of registration under the SEBI Act, 1992. The basic functions of the depository are dematerialization and rematerialization of certificates of securities such as shares, bonds, debentures, government securities, commercial paper, certificates of deposits, units of mutual funds and warehouse receipts. According to the Depositories Act, the depository is responsible to every individual investor holding an account with the depository. The depository operates on a two-tier structure, where it maintains the accounts of the DPs, who in turn maintain the investors' or clients' accounts. The online software provided by the depository to the DPS gives it access to each account maintained by the DPS so that their functioning can be monitored and controlled. The depository also maintains online connectivity
with the registrars and transfer agents and performs a daily reconciliation of all the account balances to ensure that the number of securities issued and dematerialized in the depository tallies. The first depository in India was the National Securities Depository Limited (NSDL). It was established in November 1996 by the NSE along with IDBI and UTI. The NSDL facilitates trading and settlement of securities in dematerialized form, which normally obviates all the risks and hassles associated with transacting in physical certificates. India's second depository, the Central Depository Services Limited (CDSL), was established in February 1999 by BSE jointly with some leading commercial banks in the country to provide a system for efficient and instantaneous transfer of securities.

**The Depository Participant (DP):**

The depository participant (DP) is an intermediary created under the provisions of the Depositories Act to interact with investors directly. The DP is the first point of contact in the depository system. A broker, a bank, a financial institution or a company can register with SEBI as a depository participant. Every depository shall have to prescribe by-laws, which inter alia provide for the eligibility criteria for the admission and removal of securities in the depository system, the eligibility criteria for admission of any person/body as a depository participant and the manner and procedure of dematerialization of securities. As the depository system is always operated electronically, the DP should always have adequate infrastructure including automatic data processing systems, adequate and competent staff, effective procedures and risk management systems.

**Registrar and Transfer Agent (RTA):**

Registrar and transfer agents (RTAs) provide services such as maintaining ledger records of all the security holders of a company. They
affect the real transfer of ownership of securities arising on trades made by the sellers and buyers of the securities of the company. The RTAs can also undertake the processing of interest and dividend warrants, processing of rights and bonus issues and despatch of notices and annual reports among other functions. As the services provided by RTAS are specialized, companies often go in for outsourcing. The business of RTAS is governed by the regulations and guidelines issued by SEBI from time to time.

The clearing corporation/clearing house:

The Clearing corporation or clearing house of a stock exchange coordinates between the exchange (for executed trades), the clearing members and custodians (for bringing in necessary funds and securities to be settled), the clearing banks (for funds settlement) and the depository (for securities settlement). The clearing corporation of the stock exchange ascertains the pay-in or pay-out of brokers who have traded the securities on the stock exchange. In the depository system, the actual delivery of securities to the clearing corporation by the selling broker and the actual delivery of securities by the clearing corporation to the buying broker are done by the depository through its electronic linkage with the clearing corporation.

Functions of depository:

The depository has many functions since it provides several services not only for the investors but also for many others who are concerned with securities trading and settlement. The key functions are described briefly as follows:

1. Dematerialization and Rematerialisation:

Dematerialization is the process by which an investor can get his securities, which are actual certificates, converted into electronic form. An investor who wants to get his securities converted into electronic form should
open an account with a depository participant. The investor should surrender the securities he wants to get dematerialized to the depository participant along with the completed dematerialization request form (DRF). Before submission of the certificates, the investor has to write 'Surrendered for Dematerialization' on the form. The DP verifies the form and the certificates of the securities. If they are found to be in order, the DP issues an acknowledgement slip to the investor. The details of the certificates are then entered into the software, which then forwards the details to the depository. Further, the DP despatches the defaced certificates along with the request form to the issuer of the certificates or to the registrar and transfer agent. If no objection is received from the issuer or its RTA, the software at the depository level creates the appropriate credit balance in the investor's account. No credit of any securities to the accounts of any investor shall be made unless the depository receives intimation from the issuer or its RTA.

Rematerialization is the process by which an investor can get his electronically held securities converted into physical certificates. In case the investor wants to rematerialize his securities, he will have to submit a rematerialization request to the DP with which he has an account. If there is sufficient balance in the investor's account, the DP enters the request in its computer system, which blocks the investor's holdings to that extent. The DP then forwards the same to the depository and simultaneously sends the request form to the issuer of the certificates or the RTA. The issuer/RTA prints the certificates and despatches them to the investor. Simultaneously, the depository is informed so that the investor's demat account is debited by the number of securities that are rematerialized.

2. Transfer of Securities:

The depository causes the transfer of securities resulting from the settlement of trades between beneficial owners of securities by recording
entries in the respective accounts of the beneficial owners. It may be noted that the transfer of beneficial ownership of securities occurs merely by making book entries in the electronic records of the depository. As the ownership of securities is registered in the name of the depository, the transfer of ownership becomes a smooth affair at the level of the company that has issued the securities.

3. Pledge and Hypothecation:

Securities held in demat form can be used as collateral to secure loans and other credit by the investors. If the client of the depository wishes to create a pledge on the securities owned by him, he can do so by making an application in the specified form. The pledger and the pledgee must have an account in the depository to create a pledge. However, the pledger and the pledgee may hold an account with two different depository participants. The DP, after being satisfied that the securities are eligible for the pledge, shall make a note in its records and forward the application to the depository. The depository shall create and record the pledge and send this information to the DPS of the pledger and pledgee within 15 days. If the depository does not create the pledge, it shall send this information to the DPS along with the reasons. The pledger or pledgee may cancel the pledge by requesting a cancellation to the depository through the DP. The pledgee may invoke the pledge subject to the provisions of the pledge document. If the client intends to create a hypothecation on the securities owned by him, he may do so in accordance with the rules. No transfer of security with respect to which a notice or entry of a pledge or hypothecation is in force shall be caused by the depository participant without the prior concurrence of the pledgee or the hypothecatee as the case may be.

4. Transmission of Securities:

The depository shall make the transmission of demat balances of any client due to death, lunacy, bankruptcy and insolvency. In the case where the
deceased was one of joint holders of a demat account, the surviving client(s) shall be the person(s) recognized by the depository as the one(s) with any title to the demat balances in the joint account. In the case where the deceased was the sole holder of the client demat account, his legal heir(s) or the legal representative(s) shall be the only person(s) recognized by the depository as possessing the title to the demat balances in that sole account. The client may nominate any person to whom his securities shall vest in the event of his death in the manner prescribed. The securities held in such a demat account will automatically be transferred in the name of the nominee upon the death of the nominating person. The client may substitute or cancel a nomination at any time.

5. Freezing of Account:

The depository system has a provision according to which a DP can freeze the demat account maintained with the DP. The DP shall freeze the demat account of the investor on the written instructions received from the depository pursuant to the orders of the government, SEBI or a court, tribunal or any other statutory authority. Similarly, the depository shall freeze the account of a DP to the extent of the securities held in the DP's name on the orders of the government, SEBI or any court, tribunal or other statutory authority. The frozen account shall be released on instructions from the relevant authority. The DP's account shall also be frozen on disciplinary grounds or if the DP becomes insolvent, bankrupt or a body corporate is being wound up. If the DP goes bankrupt, the creditors of the DP shall have no access to the holdings in the name of the clients of the DP because the depository holds the investors' accounts on trust. The clients of the DP that is bankrupt or facing liquidation can then either rematerialize their holdings or transfer them to a different demat account with another DP.
Opening and closing of the demat account:

In the depository system, securities are held in depository accounts, which is more or less similar to holding funds in a bank account. The investor who wishes to avail himself the services of a depository shall open an account, popularly known as a demat account, with the depository through a depository participant by applying in the format specified for this purpose. The investor is also required to enter into an agreement with the depository participant. Once the application has been accepted by the depository participant, the investor will be issued a client account number. The client wanting to close his account shall apply in the specified format. A client may close his account if no balances are standing to his credit in the account. In case any balance exists, the account may be closed by the rematerialization of the existing balances in its account and/or by transferring his balances to his other accounts either with the same depository participant or with a different participant. It may be observed that the buyer and seller of the securities are free from all the risks and hassles associated with dealing of securities in material form. The buyer gets instant credit for the relevant number of securities in his depository account from his broker and the seller gets instant credit in his bank account for the money he has to receive from his broker on the sale of his securities.

Advantages of the depository system:

There are several benefits of the depository system. The key ones are as follows.

- Bad deliveries are common when securities in physical form are being processed for transfer of ownership. This may result in high trading and settlement costs and waste of time. The question of bad delivery does not arise in the depository environment.
• No stamp duty on transfer of shares is payable on transactions through the depository. This saves a large amount of money, particularly for big investors and institutional investors.

• The depository system facilitates faster settlement and greater liquidity in the market, which enhances the marketability of securities.

• The depository system facilitates the trading of even a single share. Therefore, it eliminates the concept of odd lots and the hassles associated with odd lots.

• If an investor wants to pledge or hypothecate the securities, it is easy to do so in the demat mode.

• Trading in dematerialized securities may involve less margin payments by the investors as they may be able to deliver securities well before the pay-in day.

• In the depository system, there is easy trading and instantaneous settlement of trades. The investors can enter and exit from the trade easily and quickly.

• Brokerage charges for the investors are less when the securities are dematerialized because dealings in dematerialized securities reduces the back office cost of handling paper certificates to a great extent.

• There is a wide network of DPs operating across the country, which makes "the depository services available at the doorsteps of investors. This fosters an equity cult among the investing public, which is essential for faster development of the economy.

• The depository system offers an insurance cover to the investors in the event of a loss suffered by the investor due to negligence at the depository level.
Attempts of SEBI to regulate the working:

SEBI (Depositories and Participants) Regulations, 1996:

In accordance with the Depositories Act, 1996, there are certain regulations governing the registration of a depository, the certificate of commencement of business, registration of a participant, rights and obligations of various constituents of the depository system and inspection. The salient features of these regulations are as follows:

Registration of depository:

Every depository needs to obtain a certificate of registration as well as a certificate of commencement of business from SEBI by fulfilling certain conditions. SEBI shall not consider an application for registration unless the sponsor belongs to one of the following categories.

- A public financial institution
- A scheduled bank
- A foreign bank operating in India with the approval of the RBI
- A recognized stock exchange
- A body corporate engaged in providing financial services where not less than 75 percent of the equity capital is held by any of the institutions mentioned earlier, jointly or severally
- A body corporate constituted or recognized under any law in force in a foreign country at that time for providing custodial, clearing or settlement services in the securities market and approved by the Government of India
- An institution engaged in providing financial services established outside India and approved by the Government of India
An applicant is a fit and proper person:

The sponsor shall, at all times, hold at least 51 per cent of the equity capital of the depository and the balance of the equity capital of the depository shall be held by its participants. No participant shall at any time hold more than 5 per cent of the equity capital of the depository. However, no foreign entity individually or collectively, either as a sponsor or as a participant or as both sponsor and participant, shall hold more than 20 per cent of the equity capital of a depository. A foreign entity shall mean a body corporate or an entity where more than 51 per cent of its equity is held by persons who are not citizens of India.

Conditions for registration:

A depository shall have a net worth of not less than INR 1,000 million and it shall get its by-laws approved by the depository. It shall have automatic data processing systems, which are protected against unauthorized access, alteration, destruction, disclosure or dissemination of records and data. The network through which continuous electronic means of communications is established between the depository, participants, issuers and issuers' agents must be secure against unauthorized entry or access. The depository shall make adequate arrangements, including insurance, for indemnifying the beneficial owners for any loss that may be caused to such owners by a wrongful act, negligence or default of the depository or its participants or of any employee of the depository or participant.

Registration of the DP:

As per the SEBI regulations, the registration of a depository participant with SEBI is also required. An application for the grant of a certificate of registration as a participant shall be made to SEBI in the prescribed form.
through each depository in which the applicant proposes to act as a participant. The applicant shall belong to one of the following categories.

- A public financial institution
- A scheduled commercial bank
- A foreign bank operating in India with the approval of the RBI
- A state financial corporation
- An institution engaged in providing financial services, promoted by any of the institutions mentioned above as sponsors, jointly or severally
- A custodian of securities who has been granted a certificate of registration by SEBI
- A clearing corporation or a clearing house of a stock exchange
- A stockbroker who has been granted a certificate of registration by SEBI, provided that the stockbroker has a minimum net worth of INR 5 million and the aggregate value of the portfolio of securities of the beneficial owners held in dematerialized form in a depository through him does not exceed 100 times the net worth of the stockbroker. If the stockbroker seeks to act as a participant in more than one depository, he shall comply with the specified criteria separately for each such depository. Further, when the stockbroker has a minimum net worth of INR 100 million, the limits on the aggregate value of the portfolio of securities of the beneficial owners held in dematerialized form in a depository through him shall not be applicable
- A non-banking finance company with net worth of not less than INR 5 million, provided that such a company shall act as a
participant only on behalf of itself and not on behalf of any other person. Further, a non-banking finance company may act as a participant on behalf of any other person if it has a net worth of JNR 500 million in addition to the net worth specified by any other authority

- A registrar to an issue or share transfer agent who has a minimum net worth of INR 100 million and who has been granted a certificate of registration by SEBI.

**Eligible securities for dematerialization:**

The following securities shall be eligible for being held in dematerialized form in a depository

- Shares, scripts, stocks, bonds, debentures, debenture stock or other marketable securities of similar nature in or of any incorporated company or other body corporate.
- Units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificates of deposit, securitized debt, money market instruments, government securities and unlisted securities.
- Any other security as may be specified by SEBI from time to time.

**Other conditions:**

Separate accounts shall be opened by every participant in the name of each of the beneficial owners and the securities of each beneficial owner shall be segregated and shall not be mixed up with the securities of other beneficial owners or with the participant's own securities. A participant shall register the transfer of securities to or from a beneficial owner's account only on receipt of instructions from the beneficial owner and thereafter confirm this to the beneficial owner in a manner specified by the depository in its by-laws. Every entry in the beneficial owner's account shall be supported by electronic
instructions or any other mode of instruction received from the beneficial owner in accordance with the agreement with the beneficial owner. Every issuer whose securities have been declared eligible for dematerialization in a depository shall give information to the depository about book closures, record dates, dates for the payment of interest or dividend, dates for annual general meetings and other meetings, dates for redemption of debentures, dates for conversion of debentures and warrants, call money dates and other such information at the time and in the manner specified by the depository in its by-laws or agreement. However, no such information would be required to be given to the depository where the state or the central government is the issuer of government securities. SEBI has made it mandatory for all newly issued securities to be compulsorily traded in dematerialized form. The admission to a depository for dematerialization of securities has been made a prerequisite for making a public or rights issue or an offer for sale. It has also been made compulsory for public limited companies going for an IPO of any security for INR 100 million or more only in dematerialized form.

III. INSIDER TRADING

Introduction

Insider trading can be considered as a lawful activity when insiders—those privileged with price-sensitive information, such as directors, executives or employees—buy or sell securities of their own companies within the confines of company policy and the regulations governing this trade. But insider trading becomes unlawful when the insider, who is supposed to maintain the confidentiality of the information, uses such price-sensitive information to his or her personal advantage (making profits or avoiding losses on securities trading) to the detriment of other investors who buy or sell their securities without the advantage of such information.
Implications of insider trading:

Insider trading vitiates the market environment and causes distortion in pricing of securities. The insiders may buy or sell the securities of their own companies in breach of a fiduciary duty or other relationship of trust and confidence while in possession of material and unpublished information about the company.

The impact of insider trading on stock markets is negative. As insider trading is not fair play, the other investors may suffer heavy losses in their trade. Besides losing money because of insider trading, the investors, particularly small investors, may also lose their confidence in the stock markets. Thus, insider trading is extremely detrimental to the growth of a healthy capital market where all participants, big and small, can step in with confidence of fair play.

Attempts of SEBI to control Insider Trading:

SEBI (Prohibition of Insider Trading) Regulations, 1992:

SEBI has issued certain regulations for prohibition of insider trading. Originally issued in 1992, the regulations have been updated from time to time. According to SEBI, an insider is a person who is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access to unpublished price-sensitive information with respect to the securities of a company, or who has received or has had access to such unpublished price-sensitive information. The connected person may be a director of the company or a person who occupies a position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company and who may reasonably be expected to have access to unpublished price-sensitive information in relation to that company.
Salient features of SEBI regulations on insider trading:

1. (a) No insider shall (i) either on his own behalf or on behalf of any other person deal in securities of a company listed on any stock exchange when in possession of any unpublished price-sensitive information; or (ii) communicate, counsel or procure directly or indirectly any unpublished price-sensitive information to any person who while in possession of such unpublished price-sensitive information shall not deal in securities.

(b) No company shall deal in the securities of another company or associate of that other company while in possession of any unpublished price-sensitive information.

2. Any insider who deals in securities in contravention of the provisions of the regulations shall be guilty of insider trading.

3. If SEBI suspects that any person has violated any provision of these regulations, it may make inquiries with such persons, or any other person as deemed fit, to form a prima facie opinion as to whether there is any violation of the regulations. Before undertaking any investigation, SEBI shall give a reasonable notice to the insider for that purpose. It shall be the duty of every insider, who is being investigated, or any other person to produce to the investigating authority such books, accounts and other documents in his custody or control and furnish the authority with the statements and information relating to the transactions in the securities market within such time as the said authority may require.

4. SEBI may without prejudice to its right to initiate criminal prosecution to protect the interests of investor and in the interests of the securities market and for due compliance with the
provisions of the SEBI Act and regulations made thereunder, issue any or all of the following orders.

- Direct the insider or such person not to deal in securities in any particular manner
- Prohibit the insider or such person from disposing of any of the securities acquired in violation of these regulations
- Restrain the insider from communicating or counselling any person to deal in securities
- Declare the transaction(s) in securities as null and void
- Direct the person who acquired the securities in violation of these regulations to deliver the securities back to the seller. In case the buyer is not in a position to deliver such securities, the market price prevailing at the time of issuing of such directions or at the time of the transactions, whichever is higher, shall be paid to the seller.
- Direct the person who has dealt in securities in violation of these regulations to transfer an amount or proceeds equivalent to the cost price or market price of securities, whichever is higher, to the investor protection fund of a recognized stock exchange.
- All listed companies and organizations associated with securities markets shall frame a code of internal procedures and conduct as near thereto the Model Code specified in these regulations.

6 (a) Any person who holds more than 5 per cent shares or voting rights in any listed company shall disclose to the company the number of shares or voting rights held by such a person, on becoming such a holder, within four working days of the receipt of intimation of allotment of shares, or the acquisition of shares or voting rights, as the case may be.
6 (b) Any person who is a director or officer of a listed company shall disclose to the company the number of shares or voting rights held by such a person within four working days of becoming a director or officer of the company.

6 (c) Any person who holds more than 5 per cent shares or voting rights in any listed company shall disclose to the company the number of shares or voting rights held and change in shareholding or voting rights, even if such change results in shareholding falling below 5 per cent, if there has been a change in such holdings from the last disclosure made and such change exceeds 2 per cent of the total shareholding or voting rights in the company.

6 (d) Any person who is a director or officer of a listed company shall disclose to the company the total number of shares or voting rights held and the change in shareholding or voting rights if there has been a change in such holdings from the last disclosure made and the change exceeds INR 5 lakh in value or 25,000 shares or 1 per cent of the total shareholding or voting rights, whichever is lower.

Model code of conduct for prevention of insider trading for listed companies:

The following are the main points that constitute the model code of conduct for listed companies.

1. The compliance officer, who is appointed by the listed company, shall be responsible for setting forth policies, procedures, monitoring adherence to the rules for the preservation of price-sensitive information, pre-clearing of designated employees' and their dependents' trades (directly or through respective department heads as decided by the company), monitoring of trades and the
implementation of the code of conduct under the overall supervision of the board of directors of the listed company.

2. Employees/directors shall maintain confidentiality of all price-sensitive information. Employees/directors shall not pass on such information to any person directly or indirectly by way of making a recommendation for the purchase or sale of securities. Price-sensitive information is to be handled on a "need-to-know" basis. That is, the price-sensitive information should be disclosed only to those within the company who need the information to discharge their duty.

3. All directors/officers and designated employees of the company shall be subject to trading restrictions as stated below.
   - The company shall specify a trading period, to be called "trading window", for trading in the company's securities.
   - When the trading window is closed, the employees/directors shall not trade in the company's securities in such a period. The trading window shall be closed at the time of declaration of financial results, declaration of dividend, issue of securities, any major expansion plans or execution of new projects, amalgamation, mergers, takeovers and buy-back, disposal of the whole or a substantial whole of the undertaking and any changes in policies, plans or operations of the company. The time for commencement of closing of the trading window shall be decided by the company.
   - The trading window shall be opened 24 hours after the information stated in the previous point is made public. All directors/officers/designated employees of the company shall conduct all their dealings in the securities of the company only in a valid trading window and shall not deal in any transaction
involving the purchase or sale of the company's securities during
periods when the trading window is closed or during any other
period as may be specified by the company. From time to time.

4. All directors/officers/designated employees of the company who
intend to deal in the securities of the company (above a minimum
threshold limit to be decided by the company) should pre-clear the
transaction as per the pre-dealing procedure.

5. All directors/officers/designated employees shall hold their
investments in securities for a minimum period of 30 days in order
to be considered as being held for investment purposes. The
holding period shall also apply to subscription in the primary
market. In case the sale of securities is necessitated by personal
emergency, the holding period may be waived by the compliance
officer after recording in writing his/her reasons in this regard.

6. All directors/officers/designated employees of the listed company
shall be required to forward the following details of their securities
transactions, including the statement of dependent family
members, to the compliance officer.

- All holdings in securities by directors/officers/designated
  employees/partners at the time of joining the organization;
- Periodic statement of any transactions in securities; and
- Annual statement of all holdings in securities.

7. Any employee/officer/director who trades in securities or
communicates any information for trading in securities in
contravention of the code of conduct may be penalized and
appropriate action may be
Model code of conduct for prevention of insider trading for other entities:

The following are the main points of the model code of conduct for entities other than listed companies, as set by SEBI.

1. The compliance officer who is appointed by the organization/firm shall be responsible for setting forth policies, procedures, monitoring adherence to the rules for the preservation of price-sensitive information, pre-clearing of designated employees' and their dependents' trades (directly or through respective department heads as decided by the organization/firm), monitoring of trades and the implementation of the code of conduct under the overall supervision of the partners/proprietors.

2. Employees/directors/partners shall maintain the confidentiality of all price-sensitive information. Employees/directors/partners shall not pass on such information to any person directly or indirectly by way of making a recommendation for the purchase or sale of securities. Price-sensitive information is to be handled on a "need-to-know" basis. That is, the price-sensitive information should be disclosed only to those within the organization/firm who need the information to discharge their duty and whose possession of such information will not give rise to a conflict of interest or appearance of misuse of the information.

3. To prevent the misuse of confidential information, the organization/firm shall adopt a "Chinese Wall" policy that separates those areas of the organization/firm which routinely have access to confidential information, considered "inside areas", from those areas which deal with sales/marketing/investment advice or
other departments providing support services, considered "public areas". The employees in the inside area shall not communicate any price-sensitive information to anyone in the public area. The employees in the inside area may be physically segregated from the employees in the public area. In exceptional circumstances, employees from the public areas may be brought "over the wall" and given confidential information on the basis of "need-to-know" criteria under intimation of the compliance officer.

4. Employees/directors/partners shall not use price-sensitive information to buy or sell securities of any sort, whether for their own account, their relative's account or the organization/firm's account or a client's account.

5. All directors/officers/designated employees of the company who intend to deal in the securities of the company (above a minimum threshold limit to be decided by the company) should pre-clear the transaction as per the pre-dealing procedure.

6. In order to monitor Chinese wall procedures and trading in client securities based on inside information, the organization/firm shall restrict trading in certain securities and designate such a list as the restricted grey list. A security of a listed company shall be put on the restricted/grey list if the organization/ firm is handling any assignment for the listed company or preparing an appraisal report or handling a credit rating assignment and is privy to price-sensitive information. Any security which is being purchased or sold or is being considered for purchase or sale by the organization/firm on behalf of its clients or schemes of mutual funds, etc shall be put on the restricted/grey list. As the restricted
list itself is highly confidential information, it shall not be communicated directly or indirectly to anyone outside the organization/firm.

7. All directors/officers/designated employees/partners shall hold their investments in securities for a minimum period of 30 days in order to be considered as being held for investment purposes. The holding period shall also apply to subscription in the primary market. In case the sale of securities is necessitated by personal emergency, the holding period may be waived by the compliance officer after recording in writing his/her reasons in this regard. Analysts, if any, employed with the organization/firm while preparing research reports of a client company shall disclose their shareholdings/interest in such a company to the compliance officer.

8. All directors/designated employees/partners of the organization/firm shall be required to forward the following details of their securities transactions, including the statement of dependent family members, to the compliance officer.

- All holdings in securities by directors/officers/designated employees/partners at the time of joining the organization;
- Periodic statement of any transactions in securities; and
- Annual statement of all holdings in securities.

9. Any employee/officer/director/partner who trades in securities or communicates any information for trading in securities in contravention of the code of conduct may be penalized and appropriate action may be taken by the company.

**Code of corporate disclosure practices for prevention of insider trading:**
To ensure timely and adequate disclosure of price-sensitive information, the following SEBI norms shall be followed by listed companies.

1. Price-sensitive information shall be given by listed companies to stock exchanges and disseminated on a continuous and immediate basis. Listed companies may also consider ways of supplementing the information released to stock exchanges by improving investor access to their public announcements. A senior official, designated as compliance officer by the company, shall be responsible for ensuring that the company complies with continuous disclosure requirements. Disclosure of shareholdings/ownership by major shareholders and disclosure of changes in ownership and the listing agreement shall be made in a timely and adequate manner.

2. Listed companies should follow the guidelines given below while dealing with analysts and institutional investors.

   - Listed companies shall provide only public information to the analyst/research persons/large investors like institutions. Alternatively, the information given to the analyst should be simultaneously made public at the earliest.

   - In order to avoid misquoting or misrepresentation, it is desirable that at least two company representatives be present at meetings with analysts, brokers or institutional investors, and the discussion should preferably be recorded.

   - A listed company should be careful when dealing with analysts' questions that raise issues outside the intended scope of discussion. Unanticipated questions may be taken on notice and a considered response given later. If the answer includes price-sensitive information, a public announcement should be made before responding.
• When a company organizes meetings with analysts, the company shall make a press release or post relevant information on its website after every such meet. The company may also consider live webcasting of analyst meets.

3. Disclosure/dissemination of information may be done through various media so as to achieve maximum reach and quick dissemination.

4. The disclosures made to stock exchanges may be disseminated by the exchanges to investors in a quick and efficient manner through the stock exchange network as well as through stock exchange websites.

IV. CREDIT RATING SERVICES

Introduction:

Credit rating provides investors with information that helps them in making investment decisions. The rating indicates whether the issuer of securities will be able to meet their obligations with respect to those securities, that is, payment of interest and principal as per the terms and conditions stated in the certificates of the securities. Credit rating involves analysis and assessment of companies and governments that issue the financial securities. The rating agencies evaluate the issuer and the securities and assign a rating or grade according to the degree of relative creditworthiness of the issuer. The rating of debt securities ranges from "AAA" to "D" with some variation in notation by each agency.

The concept of credit rating:

Credit rating represents the current opinion of a rating agency on the ability and willingness of an issuer of a particular financial instrument or borrower of funds to honour on schedule the obligations attached to that
financial instrument or borrowing. The opinion is formed on the basis of a thorough analysis and assessment of the present and prospective factors that may affect credit risk. The credit rating agency employs both qualitative and quantitative criteria for assessing the creditworthiness of the issuer and assigns a rating symbol. The main thrust of credit rating of a structured obligation is to ensure that the cash flows from the assets and the envisaged structure are capable of meeting the committed payments to the investors. A credit rating of a particular capital issue relates to the assessment of that particular financial instrument and is not a rating for the issuer (company) as a whole in as much as it takes into account the specific terms of the capital issue.

The scope of credit rating:

Conventionally, credit rating is done for the following securities.

- Bonds
- Commercial paper
- Fixed deposits/certificates of deposit/inter-corporate deposits/term deposits
- Fully convertible debentures to be converted before 18 months of the issue
- Partly convertible debentures maturing before the 18th month of the issue
- Preference shares
- Structured obligation

However, of late, the scope of credit rating has increased tremendously. Credit rating is being undertaken for a variety of purposes. The rating of IPOs is a new phenomenon. In addition, credit rating agencies have expanded their
business by undertaking the rating of real estate developers/projects, collective investment scheme rating, grading for healthcare institutions, corporate governance rating, claims paying ability rating, line of credit rating, rating of Indian states and rating of LPG/kerosene dealers/firms. Sovereign ratings (rating of countries), which enable governments to raise commercial loans or attract foreign investment, have also become common. Thus, credit rating is not just confined to rating capital issues but is applicable in a much broader sense.

**The process of credit rating:**

Different credit rating agencies adopt different rating processes depending on the nature of the instrument, the credit rating agency itself and the methodology used. Some credit rating agencies emphasize qualitative judgements in addition to quantitative models. But all credit rating agencies rely heavily on professional analysts to assess the degree of credit risk associated with a particular security or issuer. The rating process begins at the request of a company. Rating agencies generally do not undertake unsolicited rating. On receipt of the request from the company, the credit rating agency constitutes different teams to carry out the assignment. The teams obtain the required data from the company and make suitable analyses in order to draw meaningful conclusions. The rating process may also include visits to factories and warehouses to get first-hand information about the company being rated. It may be noted that in certain situations, the credit rating agencies may conduct unsolicited ratings. Unsolicited ratings are ratings that the agencies may undertake without being formally engaged to do so by the issuer. A rating agency generally assesses business risk as well as financial risk after taking into consideration several factors that could affect the creditworthiness of the issuer of securities. Various factors are analysed in order to determine the long-term fundamentals and probabilities of change in
the fundamentals, which could affect the creditworthiness of the issuer. Besides quantitative factors, qualitative aspects like management capabilities and integrity play a very important role in determining the rating of a particular issue. The relative importance of qualitative and quantitative components of the analysis varies with the type of issuer. Thus, different credit rating agencies follow different criteria for assessing different kinds of capital issues or entities. However, the following are the broad and basic aspects that are covered in any evaluation process.

1. Background and History
2. Management
3. Business Analysis
4. Financial Analysis

**Communicating the rating:**

The rating assigned to a particular issue is communicated to the client along with a detailed rationale. The rating agencies may discuss with the management of a company any factors that the latter feels have not been considered. The rating agency may share with the company management the broad reasons for the rating it has assigned. Only ratings accepted by the clients are published and then monitored on a continuous basis over the life of the instrument. The client has the option of not accepting the final rating, in which case the rating arrived at by the rating agency will neither be published nor monitored. Although the rating process is transparent, any information provided by the company to the rating agency is kept confidential. Once a rating is assigned and published, the rating agency keeps the rating under surveillance until the security is fully repaid. The surveillance process may result in rating changes from time to time.
Advantages and limitations of credit rating:

Credit ratings are used by different groups of people and organizations. The specific advantages of credit rating are as follows:

- Credit rating provides investors with convenient and readily identifiable symbols to make finer distinctions of risk.
- Credit rating sets a different corporate culture. A company whose securities are rated by an independent agency will have a wider participation of investors.
- Credit rating also signifies the emergence of a certain sophistication in the capital market by supplanting the importance of the name or reputation of a company with an abstract rating or grading.
- In the globalized financial market, the advice of brokers/underwriters cannot be a sufficient guide for investors in choosing the right kind of capital issues for investment. Credit rating can provide the investor with information that will help determine if he is getting adequate return for the risk he will take in investing in a particular capital issue.
- Credit rating shifts the primary responsibility of establishing corporate credit quality from the broker/underwriter to the rating agency, thereby avoiding potential conflict of interest between brokers/underwriters and investors.
- As the cost of borrowing is inversely related to the ratings received, companies with high growth potential will have greater advantage with credit rating.
- Credit rating plays an important role in protection of investors' interests without putting the burden of that responsibility on SEBI and other agencies.
• Credit rating may also help in benchmarking companies with respect to each other. A higher credit rating may mean that the company has implemented the best practices.

• The eligibility of some securities for portfolios of certain institutional investors is determined based on credit rating.

There are certain bottlenecks in the effective use of the rating system. Some of them are as follows:

• The average investor in India is not able to understand the significance of rating because of lack of awareness.

• Sometimes, ratings may create confusion in the minds of investors when different credit rating agencies give different ratings for the same instrument.

• There is no standardized fee structure. Therefore, different marketing endeavours are being carried out by credit rating agencies for developing their business.

• Rating agencies assign the rating based on information obtained from the issuer and other reliable sources, which are deemed to be accurate. Any distortion in the data may lead to wrong grading of the security.

• Although credit rating agencies are supposed to maintain appropriate independence from the issuer of securities, this is generally does not happen in practice.

• Credit rating agencies fail to adjust the ratings promptly as the performance of the issuer deteriorates.
Credit rating agencies in India:

Credit rating agencies are firms that analyse and evaluate a debtor or a debt instrument and assign a rate or grade according to its degree of credit risk or creditworthiness. Presently, there are seven credit rating agencies in India. They are:

1. Credit Rating Information Services of India Limited (CRISIL)
2. Investment Information and Credit Rating Agency of India Limited (ICRA)
3. Credit Analysis and Research Limited (CARE)
4. Fitch India Limited
5. Onicra Credit Rating Agency of India Limited
6. Brickwork Ratings India Pvt. limited.
7. SME Rating Agency of India Limited

SEBI (Credit Rating Agencies) Regulations, 1999:

Government regulations for credit rating were introduced in January 1990 when the RBI issued guidelines for the issue of commercial paper (CP). The Controller of Capital Issues (CCI) had also insisted that all debentures and bonds be rated by a credit rating agency. With the Controller of Capital Issues (Repealed) Act, SEBI became the regulator of capital issues. In order to regulate the functioning of credit rating agencies and protect the interests of investors, SEBI issued comprehensive guidelines. According to these guidelines, any organization proposing to commence any activity as a credit rating agency shall register with SEBI. The organization shall make an application to SEBI for the grant of a certificate of registration for the purpose. SEBI shall not consider an application unless the applicant is promoted by any one of the following organizations:
• A public financial institution

• A scheduled commercial bank

• A foreign bank operating in India with the approval of the RBI

• A foreign credit rating agency recognized by or under any law for the time being in force in the country of its incorporation, having at least five years' experience in rating securities

• Any company or a body corporate with continuous net worth of a minimum of INR 100 crore as per its audited annual accounts for the five years prior to the filing of the application with SEBI for the grant of the certificate under these regulations.

The applicant shall also fulfill certain eligibility conditions. The important ones are mentioned below:

• The applicant is set up and registered as a company under the Companies Act, 1956.

• The applicant has a minimum net worth of INR 5 crore, provided that a credit rating agency existing at the commencement of these regulations, with a net worth of less INR 5 crore, shall be deemed to have satisfied this condition if it increases its net worth to the said minimum within a period of three years of such commencement.

• The applicant has adequate infrastructure to enable it to provide rating services in accordance with the provisions of the SEBI Act and the relevant regulations.

• The applicant and the promoters of the applicant have professional competence, financial soundness and a general reputation of fairness and integrity in business transactions to the satisfaction of SEBI.
SEBI, on being satisfied that the applicant is eligible for the grant of a certificate of registration, shall grant the certificate subject to the condition that the credit rating agency shall comply with the provisions of the SEBI Act and the regulations made thereunder and the guidelines, directives, circulars and instructions issued by SEBI from time to time on the subject of credit rating. The period of validity of the certificate of registration shall be three years. A credit rating agency, if it desires renewal of the certificate granted to it, shall make an application for the renewal of the certificate of registration. Every credit rating agency shall enter into a written agreement with each client whose securities it proposes to rate. The agreement shall contain, among other things, the rights and obligations of each party with respect to rating of securities. Further, every credit rating agency shall, during the lifetime of the securities rated by it, continuously monitor and review the rating of such securities. If the client does not cooperate with the credit rating agency so as to enable the agency to comply with its obligations, the credit rating agency shall carry out the review on the basis of the best available information. A credit rating agency shall not withdraw a rating as long as the obligations under the security rated by it are outstanding, except where the company whose security is rated is wound up or merged or amalgamated with another company. Every credit rating agency shall make public the definitions of the concerned rating, along with the symbol, and state that the ratings do not constitute recommendations to buy, hold or sell any security. Every credit rating agency shall make available to the general public information relating to the rationale of the ratings, which shall cover an analysis of the various factors justifying a favourable assessment as well as the factors constituting a risk. Every credit rating agency shall specify the rating process and file a copy of the same with SEBI for record. Every credit rating agency shall, in all cases, follow a proper rating process and while rating a security, exercise due
diligence in order to ensure that the rating given by the credit rating agency is fair and appropriate. Every rating agency shall have professional rating committees comprising members who are adequately qualified and knowledgeable to assign a rating. SEBI may appoint one or more persons as inspecting officers to undertake inspection or investigation of the books of account, records and documents of the credit rating agencies. A credit rating agency that fails to comply with any condition subject to which a certificate has been granted, or contravenes any of the provisions of the SEBI Act or the regulations made under the act, shall be dealt with in the manner provided under the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002. As far as the code of conduct is concerned, a credit rating agency shall make all efforts to protect the interests of investors and observe high standards of integrity, dignity and fairness in the conduct of its business. A credit rating agency shall fulfill its obligations in a prompt, ethical and professional manner. It shall not make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports, papers or information furnished to SEBI, a stock exchange or the public at large. A credit rating agency shall ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes. It shall not offer fee-based services to the rated entities, beyond credit ratings and research, and maintain an arm's-length relationship between its credit rating activity and any other activity. A credit rating agency shall not be party to or instrumental in the creation of a false market, price rigging or manipulation or dissemination of any unpublished price-sensitive information with respect to securities that are listed and proposed to be listed in any stock exchange, unless required, as part of the rationale for the rating accorded.
Restriction on rating of securities issued by promoters or by certain other persons: SEBI has also laid down restrictions on the rating of securities issued by promoters or by certain other persons. A promoter is defined as a person who holds 10 per cent or more of the shares of the credit rating agency. An associate in relation to a promoter includes a body corporate in which the promoter holds 10 per cent or more of the share capital. No credit rating agency shall rate a security issued by its promoter. In case the promoter is a lending institution, its chairman, director or employee shall not be a chairman, director or employee of the credit rating agency or its rating committee. No credit agency shall rate a security issued by an entity which is:

- A borrower of its promoter, or
- A subsidiary of its promoter, or
- An associate of its promoter, if there are common chairmen, directors between credit rating agency and these entities, if there are common employees or if there are common chairmen, directors or employees on the rating committee.

No credit rating agency shall rate a security issued by its associate or subsidiary if the credit rating agency or its rating committee has a chairman, director or employee who is also a chairman, director or employee of any such entity.

V. Mutual funds

Introduction:

A collective investment vehicle is an entity that pools the money of investors and invests the pooled money. Collective investment vehicles are classified as mutual funds, exchange traded funds, collective investment schemes and venture capital funds. A mutual fund is an entity that pools money from several investors and invests the pooled money in different kinds
of securities or assets. An exchange traded fund is an investment company whose investment objective is to achieve similar returns as in the case of a particular market index. The International Organization of Securities Commission has defined the collective investment scheme (CIS) as an open-ended collective investment scheme that issues redeemable units and invests primarily in transferable securities or money market instruments. As a mutual fund, a collective investment management company that sponsors or launches a CIS shall seek registration with SEBI by fulfilling certain conditions. No entity can launch a CIS without obtaining a certificate of registration from SEBI. As per SEBI regulations, an entity proposing to operate as a collective investment management company (CIMC) shall register as a public limited company under the provisions of the Companies Act, 1956. The company shall have a minimum net worth of INR 50 million. Each CIS has to be rated by a recognized rating agency and the projects to be undertaken appraised by an appraising agency. The units of every CIS shall be listed on the stock exchange(s) immediately after allotment. A venture capital fund is an entity with a dedicated pool of capital to be invested in venture capital undertakings.

**Mutual Fund Regulations**

**The Structure of Mutual Funds:**

A mutual fund in India has the following constituents:

- Fund sponsor
- Trustees
- Asset management company
- Custodians
- Registrar and transfer agent
- Distributors/agents
A fund sponsor is a person or entity that establishes a mutual fund. A mutual fund can either be managed by a board of trustees, which is a body of individuals, or by a trust company, which is a corporate entity. An asset management company is a company constituted by the sponsor of a mutual fund or the trustees that acts like the investment manager of the trust. A custodian is an organization established for safekeeping of securities and other assets of a mutual fund. The registrar and transfer agent maintains records of unit holders. A mutual fund may choose to hire an independent party registered with SEBI to provide such services or carry out these activities in-house. Communication between a mutual fund and its unit holders takes place through the registrar and transfer agent. Distributors/agents are banks, non-banking companies and other organizations that undertake to distribute the products of a mutual fund.

**Classification of mutual funds:**

A typical small investor saves a part of his income to meet future expenses such as education, marriage, medical purposes and purchase of products. There may be some expenses that are unforeseen. These diverse needs are expressed in terms of investment objectives as safety, liquidity and high return. In order to meet the diverse needs of a multitude of investors, mutual funds have designed and offered a wide variety of mutual fund schemes. On the basis of their structure and objectives, mutual fund schemes are classified as the following:

- Closed-end funds
- Open-end funds
- Income funds
- Growth funds
Balanced funds
• Money market funds
• Sector funds
• Index funds
• Fund of funds
• Value funds
• Offshore funds
• Load funds and no-load funds
• Mid-cap funds
• Large-cap funds
• Equity mutual funds

Advantages and Limitations of Mutual Funds:

There are many advantages of mutual funds, particularly for naive and small investors. The advantages are as follows.

1. **Professional management**: Mutual funds are professional fund managers, managing funds of individuals and institutions that may not have the time, knowledge and skills to cope with the complexities of buying and selling of securities and tax laws.

2. **Diversification**: Diversification refers to combining securities in a way that will reduce risk. Mutual funds can minimize risk by investing in a large number of securities across companies and industries.

3. **Lower Transaction costs**: As mutual funds buy and sell securities in large quantities, transaction costs, particularly brokerage fees, and commissions are lower.
4. **Liquidity:** Investment in mutual funds is highly liquid as the funds are listed on stock exchanges and trading of the units/shares of mutual funds takes place regularly. In certain cases, mutual funds also provide repurchase facility to investors.

5. **Flexibility and choice of schemes:** Investments by mutual funds are more flexible, and depending upon changes, if any, in the investment objectives, the mutual funds can change their investment strategies. Investors can choose from a wide variety of mutual fund schemes according to their financial needs.

6. **Good regulation:** The activities of mutual funds are always subject to SEBI/RBI guidelines and regulations. Therefore, the interests of the unit holders or investors are always protected.

7. **High returns:** In view of professional management taking the right investment decisions, economies of scale and efficiency in operations of mutual funds, investors expect superior returns on their investments.

8. **Pooling advantage:** As savings are pooled and invested, even a small investor can reap the benefits of a large-sized investment.

9. **Better administration:** Mutual fluids are better administered compared to unmanaged funds. Investors need not be bothered about paperwork and switching between investments and investment of returns.

10. **Easy access to information:** Mutual funds are well equipped to identify good investment opportunities since they have easy access to information related to companies, industries and the global scenario. Financial experts with the help of advanced financial models process this information and take informed decisions.

**Mutual funds have certain drawbacks:** When investors invest in a mutual fund, they depend on fund managers' capabilities to make the right
investments and thereby earn good returns. If the fund managers fail to perform as well as the investors expected, the investors would not get the desired yield on their investments. Further, mutual funds account for different kinds of charges such as management fee, brokerage and commission, resulting in a lower NAV. In such cases, unmanaged funds may yield better returns than managed funds. When the stock market becomes extremely volatile, it is very difficult for investors to get an idea about the performance of mutual funds. The mutual funds, particularly closed-end funds, may not be the ideal investment vehicle for small retail investors if they trade at a discount to the NAV.

Attempts of SEBI to regulate their working

SEBI (Mutual Funds) Regulations, 1996:

After the setting up of SEBI, the government permitted SEBI to take over the task of regulating mutual funds in India. Accordingly, SEBI issued comprehensive regulations in 1996 and keeps updating the regulations as per changing requirements. The following are the important features of SEBI regulations.

1. Every mutual fund should get a certificate of registration from SEBI by fulfilling certain conditions, including that the sponsor of a mutual fund should have a sound track record and general reputation of fairness and integrity in all his business transactions. The sponsor should contribute at least 40 per cent to the net worth of the asset management company.

2. 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, executed by the sponsor in favour of the trustees named in such an instrument.
3. The sponsor, or the trustee if authorized by the trust deed, shall appoint an asset management company, which has been approved by SEBI.

4. The asset management company has a net worth of not less than INR 10 crore.

5. Any director of the AMC shall not hold the office of director in another asset management company unless such a person is an independent director.

6. The AMC shall not act as a trustee of any mutual fund and not undertake any other business activities except in the nature of portfolio management services, management and advisory services to offshore funds, pension funds, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on a commercial basis if any of these activities is not in conflict with the activities of the mutual fund.

7. The AMC shall exercise due diligence and care in all its investment decisions as would be exercised by other persons engaged in the same business.

8. The AMC shall be responsible for the acts of commission or omission by its employees or the persons whose services have been procured by the AMC.

9. An AMC shall not through any broker associated with the sponsor purchase or sell securities that are on an average 5 per cent or more of the aggregate purchases and sales of securities made by the mutual fund in all its schemes.
10. An AMC shall not purchase or sell securities through any broker, other than a broker referred above, that are an average of 5 per cent or more of the aggregate purchases and sales of securities made by the mutual fund in all its schemes unless the AMC has recorded in writing the justification for exceeding the limit of 5 per cent and reports of all such investments are sent to the trustees on a quarterly basis.

11. An AMC shall not utilize the services of the sponsor or any of its associates, employees or their relatives for the purpose of any securities transaction and distribution and sale of securities. Provided that an AMC may utilize such services if disclosure to that effect is made to the unit holders and the brokerage or commission paid is also disclosed in the half-yearly annual accounts of the mutual fund.

12. In case any company has invested more than 5 per cent of the net asset value of a scheme, the investment made by that scheme or by any other scheme of the same mutual fund in that company or its subsidiaries shall be brought to the notice of the trustees by the AMC and be disclosed in the half-yearly and annual accounts of the respective schemes with justification for such investment, provided the latter investment has been made within one year of the date of the former investment calculated on either side.

13. The mutual fund shall appoint a custodian to carry out custodial services for the schemes of the fund and send an intimation of the same to SEBI within 15 days of the appointment of the custodian.

14. No custodian in which the sponsor or its associates holds 50 per cent or more of the voting rights of the share capital of the
custodian or where 50 per cent or more of the directors of the custodian represent the interest of the sponsor or its associates shall act as custodian for a mutual fund constituted by the same sponsor or any of its associates or subsidiary company.

15. No scheme shall be launched by the AMC unless the scheme is approved by the trustees and a copy of the offer document has been filed with SEBI. The offer document shall contain disclosures that are adequate in order to enable the investors to make informed investment decisions, including the disclosure on maximum investment proposed to be made by the scheme in the listed securities of the group companies of the sponsor.

16. Every closed-end scheme shall be listed in a recognized stock exchange within six months of the closure of the subscription. Provided that the listing of the closed-end scheme shall not be mandatory (i) if the said scheme provides for periodic repurchase facility to all the unit holders with restriction, if any, on the extent of such repurchase, or (ii) if the said scheme provides for monthly income or caters to special classes of persons like senior citizens, women, children, widows, physically challenged or any special class of persons providing for repurchase of units at regular intervals, or (iii) if the details of such repurchase facility are clearly disclosed in the offer document, or (iv) if the said scheme opens for repurchase within a period of six months from the closure of subscription.

17. The AMC may repurchase or reissue the repurchased units of a closed-end scheme at its discretion. The units of closed-end schemes may be open for sale or redemption at fixed
predetermined intervals if the maximum and minimum amounts of sale or redemption of the units and the periodicity of such sale or redemption have been disclosed in the offer document. The units of a closed-end scheme may be converted into an open-end scheme if the offer document of such a scheme discloses the option and the period of such conversion or the unit holders are provided with an option to redeem their units in full and the initial issue expenses of the scheme have been amortized hilly in accordance with the Tenth Schedule.

18. A closed-end scheme shall be fully redeemed at the end of the maturity period. Provided that a closed-end scheme may be allowed to be rolled over if the purpose, period and other terms of the rollover and all other material details of the scheme including the likely composition of assets immediately before the rollover, the net assets and net asset value of the scheme are disclosed to the unit holders and a copy of the same has been filed with SEBI. Provided further that such rollover will be permitted only in the case of those unit holders who express their consent in writing and the unit holders who do not opt for the rollover or have not given written consent shall be allowed to redeem their holdings in hill at a net asset value-based price.

19. No guaranteed return shall be provided in a scheme (i) unless such returns are hilly guaranteed by the sponsor or the AMC, (ii) unless a statement indicating the name of the person who will guarantee the return is made in the offer document, (iii) unless the manner in which the guarantee is to be met has been stated in the offer document.
20. A scheme of a mutual fund may be wound up after repaying the amount due to the unit holders (i) on the occurrence of any event which, in the opinion of the trustees, requires the scheme to be wound up, or (ii) if 75 per cent of the unit holders of a scheme pass a resolution that the scheme be wound up, or (iii) if SEBI so directs in the interests of the unit holders.

21. A mutual fund may invest the money collected under any of its schemes only in securities, money market instruments, privately placed debentures, securitized debt instruments, which are either asset-backed or mortgage-backed securities, or gold or gold-related instruments. The money collected under any money market scheme of a mutual fund shall be invested only in money market instruments. The money collected under any gold exchanged-traded fund scheme shall be invested only in gold or gold-related instruments.

22. Mutual funds shall not borrow except to meet temporary liquidity needs of the mutual funds for the purpose of repurchase, redemption of units or payment of interest or dividend to the unit holders. Provided that the mutual fund shall not borrow more than 20 per cent of the net asset of the scheme and the duration of such a borrowing shall not exceed a period of six months. The mutual fund shall not advance any loans for any purpose.

23. The funds of a scheme shall not in any manner be used in option trading or short selling or carry forward transactions. Provided that a mutual fund may enter into derivatives transactions in a recognized stock exchange, subject to such guidelines as may be specified by SEBI.
24. Every mutual fund shall compute the NAV of each scheme by dividing the net assets of the scheme by the number of units outstanding on the valuation date.

25. The price at which the units may be subscribed to 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 NAV and the sale price is not higher than 107 per cent of the NAV. Provided that the repurchase price of the units of a closed-end scheme shall not be lower than 95 per cent of the NAV. Provided further, the difference between the repurchase price and the sale price of the unit shall not exceed 7 per cent calculated on the sale price.

26. The AMC may charge the mutual fund investment and advisory fees, which are hilly disclosed in the offer document subject to the condition that: (i) one and a quarter of one per cent of the weekly average net assets outstanding in each accounting year for the scheme concerned, as long as the net assets do not exceed INR 100 crore, and (ii) 1 per cent of the excess amount over INR 100 crore, where net assets so calculated exceed INR 100 crore. For schemes launched on a no-load basis, the AMC shall be entitled to collect an additional management fee not exceeding 1 per cent of the weekly average net assets outstanding in each financial year. In addition to the fees mentioned above, the AMC may charge the mutual fund marketing expenses, brokerage and transaction cost, audit fees, custodian fees, insurance premium, costs of statutory advertisements, costs related to investor communication, fees and expenses of trustees and initial expenses of launching closed-end
schemes. The initial expenses of launching a closed-end scheme shall not exceed 6 per cent of initial resources raised.

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

i. On the first INR 100 crore of the average weekly net assets 2.5 per cent.

ii. On the next INR 300 crore of the average weekly net assets 2.25 per cent.

iii. On the next INR 300 crore of the average weekly net assets 2.0 per cent and

iv. On the balance of the assets 1.75 per cent.

Provided that such recurring expenses shall be lesser by at least 0.25 per cent of the weekly average net assets outstanding in each financial year in respect of a scheme investing in bonds. Provided further that in case of a fund of funds scheme, the total expenses of the scheme including the management fees shall not exceed 0.75 per cent of the daily or weekly average net assets, depending on whether the NAV of the scheme is calculated on a daily or weekly basis. Any expenditure in excess of the limits specified above shall be borne by the AMC or by the trustees or sponsors. In a notification issued on November 16, 2007, SEBI put a limit on the annual expense charged by mutual funds for managing index schemes and exchange traded index schemes at 1.5 per cent. This is calculated on a weekly basis. In index schemes, fund managers replicate an index (Sensex or Nifty for example) by choosing stocks in the portfolio in proportion to their weightage in a particular index. As a result, the net asset value of such schemes would largely rise or fall with the movement of the particular index. In the case of
exchange traded index funds, the units are like shares traded on stock exchanges. Since index schemes are managed passively, they should charge a lower fee compared to other schemes where fund managers actively buy and sell stocks to enhance portfolio returns. Thus, index schemes do not require any active fund management by fund managers and, therefore, the step (cap on the fees) is considered to be in the right direction.

28. A mutual fund may declare dividends in accordance with the offer document and subject to the guidelines as may be specified by SEBI.

29. The scheme-wise annual report of a mutual fund or an abridged summary thereof shall be maintained with all unit holders as soon as may be but not later than six months from the date of closure of the relevant accounts year.

30. The trustee shall be bound to make such disclosures to the unit holders as are essential in order to keep them informed about any information that may have an adverse bearing on their investments.

Mutual funds are also strictly advised to desist from unhealthy and unethical practices like promising assured returns to a select group of investors and entering into clandestine deals with promoters and companies. It is stated that unethical practices of mutual funds go against the grain of the basic concept of mutual funds. The regulations of SEBI also include 12 schedules covering various aspects such as trusteeship of the mutual fund, AMC, fees, contents of the investment management agreement, contents of the trust deed, code of conduct, advertisement code, restrictions on investments, investment valuation norms, accounting policies and standards, amortization of initial issue expenses, annual report and half-yearly financial results. As per a SEBI circular issued in April 2006, open-ended schemes of
mutual funds are not permitted to charge initial expenses such as sales and marketing expenses. However, they could levy an entry load on investments. On the other hand, close-ended schemes are allowed to appropriate a maximum of 6 per cent of the corpus of the scheme towards initial expenses. But they should not levy an entry load.

**Valuation norms:**

SEBI has also prescribed investment valuation norms for mutual funds, the salient features of which are presented in the following paragraphs.

1. The traded securities shall be valued at the last quoted closing price on the stock exchange. When the securities are traded on more than one recognized stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is principally traded. There should, however, be no objection for all scrips being valued at the prices quoted on the stock exchange where a majority in value of the investments is principally traded. When a security is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected stock exchange or any other stock exchange, as the case may be, on the earliest previous day may be used, provided the date is not more than 30 days prior to the valuation date. SEBI has also defined thinly traded securities. When trading in an equity/equity-related security (such as convertible debentures, equity, warrants) in a month is less than INR 5 lakh or the total volume is less than 50,000 shares, it shall be considered as a thinly traded security and valued accordingly. A debt security, other than government securities, that has a trading volume of less than INR 5 in the previous calendar month shall be considered as a thinly traded security based on information provided by the
relevant stock exchange on the volume of debt securities traded. A thinly traded debt security would be valued as per the norms set for non-traded debt securities.

2. When a security is not traded on any stock exchange for a period of 30 days prior to the valuation date, the scrip must be treated as a non-traded scrip. Non-traded/thinly traded securities shall be valued "in-good-faith" by the AMC on the basis of appropriate valuation methods based on the principles approved by the board of the AMC. For the purpose of valuation of non-traded/thinly traded securities, the following principles should be adopted.

a. Equity instruments shall generally be valued on the basis of capitalization of earnings solely or in combination with the net asset value, using for the purposes of capitalization the price or earnings ratios of comparable traded securities and with an appropriate discount for lower liquidity.

b. Debt instruments shall generally be valued on a yield-to-maturity basis, the capitalization factor being determined for comparable traded securities and with an appropriate discount for lower liquidity.

c. While investments in call money, bills purchased under rediscounting scheme and short-term deposits with banks shall be valued at cost plus accrual, other money market instruments shall be valued at the yield at which they are currently traded. For this purpose, non-traded instruments (instruments not traded for a period of seven days) will be valued at cost plus interest accrued till the beginning of the day plus the difference between the redemption value and cost spread uniformly over the
remaining maturity period of the instruments. Government securities will be valued at yield-to-maturity based on the prevailing market rate.

d. With respect to convertible debentures and bonds, the non-convertible and convertible components shall be valued separately. The non-convertible component should be valued on the same basis as would be applicable to a debt instrument. The convertible component should be valued on the same basis as would be applicable to an equity instrument. If after conversion the resultant equity instrument would be traded pari passu with an existing instrument that is traded, the value of the latter instrument can be adopted after an appropriate discount of the non-tradability of the instrument during the period preceding the conversion while valuing such instruments, the fact whether the conversion is optional should also be factored in.

e. With respect to warrants to subscribe for shares attached to instruments, the warrants can be valued at the value of the share that would be obtained on exercise of the warrant as reduced by the amount payable on exercise of the warrant. A discount similar to the discount to be determined in respect of convertible debentures must be deducted to account for the period that must elapse before the warrant can be exercised.

f. Where instruments have been bought on "repo" basis, the instrument must be valued at the resale price after deduction of applicable interest up to the date of resale. Where an instrument has been sold on a "repo" basis, an adjustment must be made for the difference between the repurchase price (after deduction of applicable interest up to the date of repurchase) and the value of
the instrument. If the repurchase price exceeds the value, depreciation must be provided for, and if the repurchase price is lower than the value, credit must be taken for the appreciation.

3. All expenses and income accrued up to the valuation date shall be considered for computation of the net asset value. For this purpose, while major expenses like management fees and other periodic expenses should be accrued on a day-to-day basis, other minor expenses and income need not be so accrued, provided the non-accrual does not affect the NAV calculation by more than 1 per cent.

**Investment in unlisted equity shares:**

SEBI has also issued guidelines for investment in unlisted equity shares, the highlights of which are presented as follows.

Unlisted equity shares of a company shall be valued "in good faith" on the basis of the following valuation principles.

Based on the latest available audited balance sheet, net worth shall be calculated as the lower of (i) and (ii):

i. Net worth per share (share capital plus free reserves, excluding revaluation reserves) minus (miscellaneous expenditure not written off or deferred revenue expenditure, intangible assets and accumulated losses) divided by the number of paid-up shares.

ii. After taking into account the outstanding warrants and options, net worth per share shall again be calculated as (share capital plus consideration on exercise of option/warrants received/receivable by the company plus free reserves, excluding revaluation reserves) minus (miscellaneous expenditure not written off or deferred revenue expenditure, intangible assets and accumulated losses) divided by the number of paid-up shares plus the number of shares
that would be obtained on conversion/exercise of outstanding warrants and options.

Average capitalization rate (PIE ratio) for the industry based on either BSE or NSE data shall be taken and discounted by 75 per cent, i.e., only 25 per cent of the industry average PIE shall be taken as capitalization rate (PIE ratio). The EPS of the latest audited annual accounts will be considered for this purpose. The value as per the net worth value per share and the capital earning value calculated as above shall be averaged and further discounted by 15 per cent for illiquidity so as to arrive at the fair value per share. Mutual funds shall not make investment in unlisted equity shares at a price higher than that obtained by using the aforesaid methodology. However, this will not be applicable for investment made in initial public offers of companies or firm allotment in public issues where all the regulatory requirements and formalities pertaining to public issues have been complied with by the companies and where the mutual funds are required to pay just before the date of public issue.

Guidelines for participation of mutual funds in derivatives trading:

In view of several changes taking place in the structure of the cash market and a significant increase in retail participation in the derivatives market, SEBI has permitted mutual funds to participate in the derivatives market for the purpose of hedging and rebalancing their portfolio (SEBI circular dated December 31, 2002). Mutual funds are permitted to participate in the derivatives market on par with foreign institutional investors (FIIs). Accordingly, the mutual funds shall be treated on par with a registered FII with respect to position limits in index futures, index options, stock options and stock futures contracts. The mutual funds will be considered as trading members like registered FIIs and the schemes of mutual funds will be treated
as clients like sub-accounts of FIIs. Mutual funds shall be required to fully cover their positions in the derivatives market by holding underlying securities/cash or cash equivalent/option and/or obligation for acquiring underlying assets to honour the obligations contracted in the derivatives market. The securities held shall be marked to market by the AMC to ensure full coverage of investments made in derivative products at all times. The word "cash" shall include cash, money market instruments, deposits with scheduled commercial banks and net current assets. The term "hedging" covers derivative market positions that are designed to offset potential losses from existing cash market positions. The use of derivatives for portfolio rebalancing covers situations where a particular desired portfolio position can be achieved more efficiently or at a lower cost using derivatives rather than cash market transactions. The intention to trade in derivative products shall be disclosed in the offer document. The offer document of a scheme envisaging derivative trading shall state unambiguously and clearly the losses that may be suffered by the investors as a consequence of such investments. Mutual funds shall disclose as to how trading in derivatives will help in the furtherance of the investment objective of the scheme. They shall also lay down exposure limits for themselves and disclose the same in the scheme offer document. In case the offer document of an existing scheme does not provide for trading in derivatives, the mutual fund, if it so desires, may trade in derivatives in accordance with these guidelines, provided it obtains approval from the trustees and informs the unit holders of its intention to trade in derivatives and making all disclosures. The participation of existing schemes of the mutual funds in the derivatives market shall be subject to the following conditions:

a. The extent and the manner of the proposed participation in derivatives shall be disclosed to the unit holders.
b. The risks associated with such participation shall be disclosed and explained by suitable numerical examples.

c. Positive consent shall be obtained from the majority of the unit holders.

d. An exit option shall be provided to the dissenting unit holders. This option shall be kept open for a period of one month prior to the scheme commencing trading in derivatives.

e. No exit load shall be charged to the unit holders exercising such exit options.

The position limits for mutual funds and its schemes shall be as follows:

1. Position limits for mutual funds in index option contracts
   a. INR 250 crore or 15 per cent of the total open interest of the market in index options, whichever is higher per stock exchange
   b. This limit would be applicable on open positions in all option contracts on a particular underlying index

2. Position limits for mutual funds in index futures contracts
   a. INR 250 crore or 15 per cent of the total open interest of the market in index futures, whichever is higher per stock exchange
   b. This limit would be applicable on open positions in all option contracts on a particular underlying index

3. In addition to the position limits stated above, mutual funds may take exposure in equity index derivatives subject to the following limits
a. Short positions in index derivatives (short futures, short calls and long puts) shall not exceed (in notional value) the mutual fund's holding of stocks.

b. Long positions in index derivatives (long futures, long calls and short puts) shall not exceed (in notional value) the mutual fund's holding of cash, government securities, T-bills and similar instruments.

c. Position limit for mutual funds for stock-based derivative contracts a. For stocks in which the market-wise position limit is less than or equal to INR 250 crore, the mutual fund position limit in such stock shall be 20 per cent of the market-wise position limit.

d. For stocks in which the market-wise position limit is greater than INR 250 crore, the mutual fund position limit in such stock shall be INR 50 crore

4. Position limit for each scheme of a mutual fund a. For stock option and stock futures contracts, the gross open position across all derivatives contracts on a particular underlying stock of a scheme of a mutual fund shall not exceed the higher of: i. 1 per cent of the free float market capitalization (in terms of number of shares), or ii. 5 per cent of the open interest in the derivative contracts on a particular underlying stock (in terms of number of contracts)

These position limits shall be applicable to the combined position in all derivative contracts on an underlying stock at a stock exchange.

For index based contracts, mutual funds shall disclose the total open interest held by its scheme or all schemes put together in a particular
underlying index, if such open interest equals or exceeds 15 per cent of the open interests of all derivative contracts on that underlying index.

**Benchmarks:**

According to SEBI guidelines, mutual funds are required to disclose their performance periodically (last six months, one year, three years, five years and since the date of launch of the mutual fund) while publishing half-yearly results in the prescribed format. In order to provide investors with an analysis of the performance of mutual funds in association with the rise or fall in the markets, SEBI has prescribed that the mutual funds should disclose the performance of benchmark indices also. Mutual funds are also required to disclose the performance of benchmarks in case of various types of debt-oriented fluids and balanced funds while publishing half-yearly results. These benchmarks shall be developed by research and rating agencies recommended by AMFI on a regular basis.