**BBA THIRD SEMESTER**

**INTRODUCTION TO CAPITAL MARKET**

**Unit -I**

**Markets and Financial Instruments**

## TYPES OF MARKETS

Efficient transfer of resources from those having idle resources to others who have a pressing need for them is achieved through financial markets. Stated formally, financial markets provide channels for allocation of savings to investment. These provide a variety of assets to savers as well as various forms in which the investors can raise funds and thereby decouple the acts of saving and investment. The savers and investors are constrained not by their individual abilities, but by the economy's ability, to invest and save respectively. The financial markets, thus, contribute to economic development to the extent that the latter depends on the rates of savings and investment.

The financial markets have two major components:

* Money market
* Capital market.

The **Money market** refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs. Money market instruments are generally financial claims that have low default risk, maturities under one year and high marketability.

The **Capital market** is a market for financial investments that are direct or indirect claims to capital. It is wider than the Securities Market and embraces all forms of lending and borrowing, whether or not evidenced by the creation of a negotiable financial instrument. The Capital Market comprises the complex of institutions and mechanisms through which intermediate term funds and long-term funds are pooled and made available to business, government and individuals. The Capital Market also encompasses the process by which securities already outstanding are transferred.

The **Securities Market**, however, refers to the markets for those financial instruments/claims/obligations that are commonly and readily transferable by sale.

The Securities Market has two interdependent and inseparable segments, the new issues (*primary*) market and the stock (*secondary*) market.

The *Primary market* provides the channel for sale of new securities. The issuer of securities sells the securities in the primary market to raise funds for investment and/or to discharge some obligation.

The *Secondary market* deals in securities previously issued. The secondary market enables those who hold securities to adjust their holdings in response to charges in their assessment of risk and return. They also sell securities for cash to meet their liquidity needs.

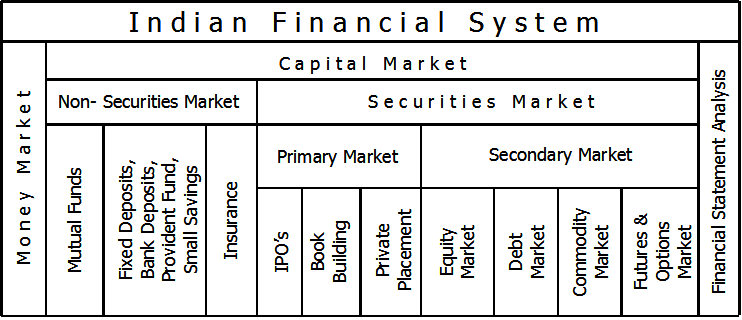
The price signals, which subsume all information about the issuer and his business including associated risk, generated in the secondary market, help the primary market in allocation of funds.

This secondary market has further two components.

First, the spot market where securities are traded for immediate delivery and payment.

The other is forward market where the securities are traded for future delivery and payment. This forward market is further divided into Futures and Options Market (Derivatives Markets).

In futures Market the securities are traded for conditional future delivery whereas in option market, two types of options are traded. A **put option** gives right but not an obligation to the owner to sell a security to the writer of the option at a predetermined price before a certain date, while a **call option** gives right but not an obligation to the buyer to purchase a security from the writer of the option at a particular price before a certain date.



Lets now understand these markets in broader sense.

## EQUITY MARKET

Before discussing the equities market, we should first understand the basic meaning of markets, their functions and classification.

***What is a Market?*** A market is a location where buyers and sellers come into contact to exchange goods or services. Markets can exist in various forms depending on various factors.

***Can Markets Exist in Different Forms?*** Yes, the markets do exist in different forms depending on the nature of location and mode of contact. It can have a physical location where buyers and sellers come in direct contact with each other or a virtual location where the buyers and sellers contact each other employing advance means of communication. There is another form of market where actual buyers and sellers achieve their objectives through intermediaries.

***Securities Markets in India: An Overview:*** The process of economic reforms and liberalization was set in motion in the mid-eighties and its pace was accelerated in 1991 when the economy suffered severely from a precariously low foreign exchange reserve, burgeoning imbalance on the external account, declining industrial production, galloping inflation and a rising fiscal deficit. The economic reforms, being an integrated process, included deregulation of industry, liberalization in foreign investment, regime, restructuring and liberalization of trade, exchange rate, and tax policies, partial disinvestments of government holding in public sector companies and financial sector reforms. The reforms in the real sectors such as trade, industry and fiscal policy were initiated first in order to create the necessary macroeconomic stability for launching financial sector reforms, which sought to improve the functioning of banking and financial institutions (FIs) and strengthen money and capital markets including securities market. The securities market reforms specifically included:

* Repeal of the Capital Issues (Control) Act, 1947 through which Government used to expropriate and allocate resources from capital market for favored uses;
* Enactment of the Securities and Exchange Board of India Act, 1992 to provide for the establishment of the Securities and Exchange Board of India (SEBI) to regulate and promote development of securities market;
* Setting up of NSE in 1993, passing of the Depositories Act, 1996 to provide for the maintenance and transfer of ownership of securities in book entry form;
* Amendments to the Securities Contracts (Regulation) Act, 1956 (SCRA) in 1999 to provide for the introduction of futures and option.
* Other measures included free pricing of securities, investor protection measures, use of information technology, dematerialization of securities, improvement in trading practices, evolution of an efficient and transparent regulatory framework, emergence of several innovative financial products and services and specialized FIs etc.

These reforms are aimed at creating efficient and competitive securities market subject to effective regulation by SEBI, which would ensure investor protection.

***A Profile:*** The corporate securities market in India dates back to the 18th century when the securities of the East India Company were traded in Mumbai and Kolkotta. The brokers used to gather under a Banyan tree in Mumbai and under a Neem tree in Kolkota for the purpose of trading those securities. However the real beginning came in the 1850’s with the introduction of joint stock companies with limited liability. The 1860’s witnessed feverish dealings in securities and reckless speculation. This brought brokers in Bombay together in July 1875 to form the first formally organized stock exchange in the country viz. The Stock Exchange, Mumbai. Ahmedabad stock exchange in 1894 and 22 others followed this in the 20th century. The process of reforms has led to a pace of growth almost unparalleled in the history of any country. Securities market in India has grown exponentially as measured in terms of amount raised from the market, number of stock exchanges and other intermediaries, the number of listed stocks, market capitalization, trading volumes and turnover on stock exchanges, investor population and price indices. Along with this, the profiles of the investors, issuers and intermediaries have changed significantly. The market has witnessed fundamental institutional changes resulting in drastic reduction in transaction costs and significant improvements in efficiency, transparency and safety, thanks to the National Stock Exchange. Indian market is now comparable to many developed markets in terms of a number of parameters.

***Structure and Size of the Markets:*** Today India has two national exchanges, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). Each has fully electronic trading platforms with around 9400 participating broking outfits. Foreign brokers account for 29 of these. There are some 9600 companies listed on the respective exchanges with a combined market capitalization near $125.5bn. Any market that has experienced this sort of growth has an equally substantial demand for highly efficient settlement procedures. In India 99.9% of the trades, according to the National Securities Depository, are settled in dematerialized form in a T+2 rolling settlement The capital market is one environment. In addition, the National Securities Clearing Corporation of India Ltd (NSCCL) and Bank of India Shareholding Ltd (BOISL), Clearing Corporation houses of NSE and BSE, guarantee trades respectively. The main functions of the Clearing Corporation are to work out (a) what counter parties owe and (b) what counter parties are due to receive on the settlement date.

Furthermore, each exchange has a Settlement Guarantee Fund to meet with any unpredictable situation and a negligible trade failure of 0.003%. The Clearing Corporation of the exchanges assumes the counter-party risk of each member and guarantees settlement through a fine-tuned risk management system and an innovative method of online position monitoring. It also ensures the financial settlement of trades on the appointed day and time irrespective of default by members to deliver the required funds and/or securities with the help of a settlement guarantee fund.

***Style of Operating:*** Indian stock markets operated in the age-old conventional style of fact-to-face trading with bids and offers being made by open outcry. At the Bombay Stock Exchange, about 3,000 persons would mill around in the trading ring during the trading period of two hours from 12.00 noon to 2.00 p.m. Indian stock markets basically quote-driven markets with the jobbers standing at specific locations in the trading ring called trading posts and announcing continuously the two-way quotes for the scrips traded at the post. As there is no prohibition on a jobber acting as a broker and vice versa, any member is free to do jobbing on any day. In actual practice, however, a class of jobbers has emerged who generally confine their activities to jobbing only. As there are no serious regulations governing the activities of jobbers, the jobbing system is beset with a number of problems like wide spreads between bid and offer; particularly in thinly traded securities, lack of depth, total absence of jobbers in a large number of securities, etc. In highly volatile scrips, however, the spread is by far the narrowest in the world being just about 0.1 to 0.25 percent as compared to about 1.25 per cent in respect of alpha stocks, i.e. the most highly liquid stocks, at the International Stock Exchange of London. The spreads widen as liquidity decreases, being as much as 25 to 30 per cent or even more while the average touch of gamma stocks, i.e. the least liquid stocks at the International Stock Exchange, London, is just about 6 to 7 per cent. This is basically because of the high velocity of transactions in the active scrips. In fact, shares in the specified group account for over 75 percent of trading in the Indian stock markets while over 25 percent of the securities do not get traded at all in any year. Yet, it is significant to note that out of about 6,000 securities listed on the Bombay Stock Exchange, about 1,200 securities get traded on any given trading day.

The question of automating trading has always been under the active consideration of the Bombay Stock Exchange for quite sometime. It has decided to have trading in all the non-specified stocks numbering about 4,100 totally on the computer on a quote-driven basis with the jobbers, both registered and roving, continuously keying in their bids and offers into the computer with the market orders getting automatically executed at the touch and the limit orders getting executed at exactly the rate specified.

In March 1995, the BSE started the computerized trading system, called BOLT - BSE on-line trading system. Initially only 818 scripts were covered under BOLT. In July 1995, all scripts (more than 5,000) were brought under the computerized trading system. The advantages realized are: (a) improved trading volume; (b) reduced spread between the buy-sell orders; c) better trading in odd lot shares, rights issues etc.

***Highlights of the Highly Attractive Indian Equity Market:*** Two major reasons why Indian securities are now increasingly regarded as attractive to international investors are the relatively high returns compared with more developed global markets as well as the low correlation with world markets.

## DEBT MARKET

The National Stock Exchange started its trading operations in June 1994 by enabling the Wholesale Debt Market (WDM) segment of the Exchange. This segment provides a trading platform for a wide range of fixed income securities that includes central government securities, treasury bills (T-bills), state development loans (SDLs), bonds issued by public sector undertakings (PSUs), floating rate bonds (FRBs), zero coupon bonds (ZCBs), index bonds, commercial papers (CPs), certificates of deposit (CDs), corporate debentures, SLR and non-SLR bonds issued by financial institutions (FIs), bonds issued by foreign institutions and units of mutual funds (MFs).

To further encourage wider participation of all classes of investors, including the retail investors, the Retail Debt Market segment (RDM) was launched on January 16, 2003. This segment provides for a nation wide, anonymous, order driven, screen based trading system in government securities. In the first phase, all outstanding and newly issued central government securities were traded in the retail debt market segment. Other securities like state government securities, T-bills etc. will be added in subsequent phases. The settlement cycle is same as in the case of equity market i.e., T+2 rolling settlement cycle.

## DERIVATIVES MARKET

The emergence of the market for derivative products, most notably forwards, futures and options, can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. By their very nature, the financial markets are marked by a very high degree of volatility. Through the use of derivative products, it is possible to partially or fully transfer price risks by locking–in asset prices. As instruments of risk management, these generally do not influence the fluctuations in the underlying asset prices.

However, by locking-in asset prices, derivative products minimize the impact of fluctuations in asset prices on the profitability and cash flow situation of risk-averse investors.

***Derivatives Defined:*** Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. The underlying asset can be equity, forex, commodity or any other asset. For example, wheat farmers may wish to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such a transaction is an example of a derivative. The price of this derivative is driven by the spot price of wheat which is the “underlying”.

In the Indian context the Securities Contracts (Regulation) Act, 1956 (SC(R)A) defines “derivative” to include –

* A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.
* A contract, which derives its value from the prices, or index of prices, of underlying securities.

Derivatives are securities under the SC(R)A and hence the trading of derivatives is governed by the regulatory framework under the SC(R)A.

***Products, Participants and Functions:*** Derivative contracts have several variants. The most common variants are forwards, futures, options and swaps. The following three broad categories of participants - hedgers, speculators, and arbitrageurs trade in the derivatives market. Hedgers face risk associated with the price of an asset. They use futures or options markets to reduce or eliminate this risk. Speculators wish to bet on future movements in the price of an asset. Futures and options contracts can give them an extra leverage; that is, they can increase both the potential gains and potential losses in a speculative venture. Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

The derivatives market performs a number of economic functions. First, prices in an organized derivatives market reflect the perception of market participants about the future and lead the prices of underlying to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of the derivative contract. Thus derivatives help in discovery of future as well as current prices. Second, the derivatives market helps to transfer risks from those who have them but may not like them to those who have an appetite for them. Third, derivatives, due to their inherent nature, are linked to the underlying cash markets. With the introduction of derivatives, the underlying market witnesses higher trading volumes because of participation by more players who would not otherwise participate for lack of an arrangement to transfer risk. Fourth, speculative trades shift to a more controlled environment of derivatives market. In the absence of an organized derivatives market, speculators trade in the underlying cash markets. Margining, monitoring and surveillance of the activities of various participants become extremely difficult in these kind of mixed markets. Fifth, an important incidental benefit that flows from derivatives trading is that it acts as a catalyst for new entrepreneurial activity. The derivatives have a history of attracting many bright, creative, well-educated people with an entrepreneurial attitude. They often energize others to create new businesses, new products and new employment opportunities, the benefit of which are immense. Finally, derivatives markets help increase savings and investment in the long run. Transfer of risk enables market participants to expand their volume of activity.

***Types of Derivatives:*** The most commonly used derivatives contracts are forwards, futures and options, which we shall discuss these in detail in the FMM-II later. Here we take a brief look at various derivatives contracts that have come to be used.

* *Forwards:* A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today’s pre-agreed price.
* *Futures:* A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts.
* *Options:* Options are of two types - calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date.
* *Warrants:* Options generally have lives of up to one year, the majority of options traded on options exchanges having a maximum maturity of nine months. Longer-dated options are called warrants and are generally traded over-the-counter.
* *LEAPS:* The acronym LEAPS means Long-Term Equity Anticipation Securities. These are options having a maturity of up to three years.
* *Baskets:* Basket options are options on portfolios of underlying assets. The underlying asset is usually a moving average or a basket of assets. Equity index options are a form of basket options.
* *Swaps:* Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. The two commonly used swaps are:

*Interest rate swap*s: These entail swapping only the interest related cash flows between the parties in the same currency and

*Currency swap*s: These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction.

* *Swaptions:* Swaptions are options to buy or sell a swap that will become operative at the expiry of the options. Thus a swaption is an option on a forward swap. Rather than have calls and puts, the swaptions market has receiver swaptions and payer swaptions. A receiver swaption is an option to receive fixed and pay floating. A payer swaption is an option to pay fixed and receive floating.

## TYPES OF INVESTMENT AVENUES

Before starting with the deep discussion on financial markets, we must know in a broad sense about the types of investment avenues available in these markets. In other words knowing the alternative financial instruments that are bought and sold in these markets. When a person has more money than he requires for current consumption, he would be coined as a potential investor. The investor who is having extra cash could invest it in assets like stock or gold or real estate or could simply deposit it in his bank account. All of these activities in a broader sense mean investment. Now, lets define investment.

# HOW DO YOU DEFINE INVESTMENT?

# We can define investment as the process of, “sacrificing something now for the prospect of gaining something later”. So, the definition implies that we have four dimensions to an investment – time, today’s sacrifice and prospective gain. *Can we think of Some Transactions, which will qualify as “Investments” as per Our Definition!*

1. In order to settle down, a young couple buys a house for Rs.3 lakhs in Bangalore.
2. A wealthy farmer pays Rs.1 lakh for a piece of land in his village.
3. A cricket fan bets Rs.100 on the outcome of a test match in England.
4. A government officer buys ‘units’ of Unit Trust of India worth Rs 4,000.
5. A college professor buys, in anticipation of good return, 100 shares of Reliance Industries Ltd.
6. A lady clerk deposits Rs.5, 000 in a Post Office Savings Account.
7. Based on the rumor that it would be a hot issue in the market in no distant future, our friend John invests all his savings in the newly floated share issue of Fraternity Electronics Ltd., a company intending to manufacture audio and video magnetic tapes to start with, and cine sound tapes at a later stage.

***Is there any common feature to all these investments?*** A common feature of all these transactions is that something is sacrificed now for the prospects of gaining something later. For example, the wealthy farmer in transaction 2 sacrifices Rs.1 lakh now for the prospects of crop income later. The lady clerk in transaction 6 sacrifices Rs.5,000 now for the prospect of getting a larger amount later due to interest earned on the savings account. Thus, in a broad sense, all these seven transactions qualify as investment.

Lets now understand the classification of various investment alternatives.

## FIXED DEPOSITS

The term “fixed” in fixed deposits denotes the period of maturity or tenor. Fixed Deposits, therefore, pre-supposes a certain length of time for which the depositor decides to keep the money with the bank and the rate of interest payable to the depositor is decided by this tenor. The rate of interest differs from bank to bank and is generally higher for private sector and foreign banks. This, however, does not mean that the depositor loses all his rights over the money for the duration of the tenor decided. The deposits can be withdrawn before the period is over. However, the amount of interest payable to the depositor, in such cases goes down (usually 1% to 2% less than the original rate). Moreover, as per RBI regulations there will be no interest paid for any premature withdrawals for the period 15 days to 29 or 15 to 45 days as the case may be.

Other than banks, there are non-banking financial companies and companies who float schemes from time to time for garnering deposits from the public. In the recent past, however, many such schemes have gone bust and it is very essential to look out for danger signals before putting all your eggs in one basket.

**THINGS TO LOOK OUT FOR....**

* Credit rating/ reputation of the group
* The rating is possibly the best way to judge the credit worthiness of a company. However, for manufacturing company deposits, it is not mandatory to get a rating. In such cases, it is better to check the size and reputation of the company or the industrial group it belongs to.
* Interest rate
* Within the same safety level (or rating), a higher interest rate is a better option. The difference in some cases can be as high as 1%.
* Diversify
* The portfolio principle applies to company deposits also. It is always better to spread deposits over different companies and industries so as to reduce risk.
* Period of deposit: The ideal period for a company deposit is 6 months to one year as it offers the liquidity option. Also, it gives an opportunity to review the company’s performance.
* Periodic review of the company: As your principal and interest rests in the hand of the company, it is advisable to review the company’s performance periodically.

**Where Not To Invest?**

* Companies that offers very high rates of interest, say 16% or above, when others are offering 12-13%.
* Companies with poor cash flows.
* Avoid unincorporated companies/ private limited companies, as it is difficult to judge their performance in absence of information.
* Companies with accumulated losses on their balance sheets.
* Companies with a poor dividend paying record.

# Company Fixed Deposits

Fixed deposits in companies that earn a fixed rate of return over a period of time are called Company Fixed Deposits. Financial institutions and Non-Banking Finance Companies (NBFCs) also accept such deposits. Deposits thus mobilized are governed by the Companies Act under Section 58A. These deposits are unsecured, i.e., if the company defaults, the investor cannot sell the company to recover his capital, thus making them a risky investment option. NBFCs are small organizations, and have modest fixed and manpower costs. Therefore, they can pass on the benefits to the investor in the form of a higher rate of interest. NBFCs suffer from a credibility crisis. So be absolutely sure to check the credit rating. AAA rating is the safest. According to latest RBI guidelines, NBFCs and companies cannot offer more than 14 per cent interest on public deposits

# INVESTMENT OBJECTIVES

***Are Company Fixed Deposits Suitable for an Increase in Investment?***

A Company/NBFC Fixed Deposit provides for faster appreciation in the principal amount than bank fixed deposits and post-office schemes. However, the increase in the interest rate is essentially due to the fact that it entails more risk as compared to banks and post-office schemes.

***Are Company Fixed Deposits Suitable for Income?***

Yes, Company/NBFC Fixed Deposits are suitable for regular income with the option to receive monthly, quarterly, half-yearly, and annual interest income. Moreover, the interest rates offered are higher than banks.

***To What Extent Does a Company Deposit Protect Against Inflation?***

A Company/NBFC Fixed Deposit provides you with limited protection against inflation, with comparatively higher returns than other assured return options.

***Can I Borrow against a Company Fixed Deposit?***

Whether the loans/credit can be provided against the fixed deposits of the company.

# RISK CONSIDERATIONS

***How Assured Can a person be Of Getting his Full Investment Back?***

Company Fixed Deposits are unsecured instruments, i.e., there are no assets backing them up. Therefore, in case the company/NBFC goes under, chances are that you may not get your principal sum back. It depends on the strength of the company and its ability to pay back your deposit at the time of its maturity. While investing in an NBFC, always remember to first check out its credit rating. Also, beware of NBFCs offering ridiculously high rates of interest.

***How Assured Is the Income?***

Not at all secured. Some NBFCs have known to default on their interest and principal payments. You must check out the liquidity position and its revenue plan before investing in an NBFC.

***Are Their any Risks Unique to Company Fixed Deposits?***

If the Company/NBFC goes under, there is no assurance of your principal amount. Moreover, there is no guarantee of your receiving the regular-interval income from the company. Inflation and interest rate movements are one of the major factors affecting the decision to invest in a Company/NBFC Fixed Deposit. Also, you must keep the safety considerations and the company/NBFC’s credit rating and credibility in mind before investing in one.

***Are Company/NBFC Deposits rated for their credit Quality?***

Yes, Company/NBFC Fixed Deposits are rated by credit rating agencies like CARE, CRISIL and ICRA. A company rated lower by credit rating agency is likely to offer a higher rate of interest and vice-versa. An AAA rating signifies highest safety, and D or FD means the company is in default.

## BANK DEPOSITS

When you deposit a certain sum in a bank with a fixed rate of interest and a specified time period, it is called a bank Fixed Deposit (FD). At maturity, you are entitled to receive the principal amount as well as the interest earned at the pre-specified rate during that period. The rate of interest for Bank Fixed Deposits varies between 4 and 6 per cent, depending on the maturity period of the FD and the amount invested. The interest can be calculated monthly, quarterly, half-yearly, or annually, and varies from bank to bank. They are one the most common savings avenue, and account for a substantial portion of an average investor’s savings. The facilities vary from bank to bank. Some services offered are withdrawal through cheques on maturity; break deposit through premature withdrawal; and overdraft facility etc.

# INVESTMENT OBJECTIVES

***How Suitable are Fixed Deposits for an Increase in Investment?***

While a Bank FD does provide for an increase in your initial investment, it may be at a lower rate than other comparable fixed-return instruments. Since capital appreciation in any investment option depends on the safety of that option, and banks being among the safest avenues, the increase in investment is modest.

***Are Fixed Deposits Suitable For Regular Income?***

A Bank FD does not provide regular interest income, but a lump-sum amount on its maturity. Since the lump-sum amount depends on the rate of interest, currently between 4 and 6 per cent, Bank FDs are not suitable for regular income.

***To What Extent Does a Bank FD Protect the investor against Inflation?***

With a fixed return, which is lower than other assured return options, banks cannot guard against inflation. In fact, this is the main problem with Bank FDs as any return has to be calculated keeping inflation in mind.

***Can the investor Borrow Against Bank FDs?***

Yes, in some cases, loans up to 90 per cent of the deposit amount can be taken from the bank against fixed deposit receipts.

# RISK CONSIDERATIONS

***How assured can the investor be of getting his Full Investment Back?***

Almost 100 per cent. Bank Deposits are the safest investment option after post-office schemes since the banks function according to the parameters set by the Reserve Bank of India (RBI), which frames regulations keeping in mind the interest of the investors.

***How Assured Is his Income?***

There is no regular income in this option as the payment is made in one lump sum after the expiry of the tenure of the Bank Fixed Deposit.

***Are There Any Risks Unique To Bank FDs?***

Not really. Since all the banks operating in the country, irrespective of whether they are nationalized, private, or foreign, are governed by the RBI’s rules and regulations, which give due weight age to the interest of the investor, there is little chance of an investment in a bank deposit going under. In fact, till recently, all bank deposits were insured under the Deposit Insurance & Credit Guarantee Scheme of India, which has now been made optional. Nevertheless, bank deposits are still among the safest modes of investment. The thing to consider before investing in a FD is the rate of interest and the inflation rate. A high inflation rate can simply chip away your real returns. So, it is critical to take the inflation rate into consideration to arrive at the real rate of interest.

***Are Bank FDs rated for their Credit Quality?***

No, Bank FDs are not commercially rated. Since Bank FDs are extremely secure; the only thing to check out while investing in one is the interest rate being offered and your convenience.

### Interest Rates Payable on Deposits

|  |  |
| --- | --- |
| **Duration** | **Interest Rates**  **(% p.a.)**  **Effective 11th Dec 2006** |
|  |  |
| 7 days to 14 days (Rs.1 cr and above) | 3.75 |
| 15 days to 45 days | 5.00 |
| 46 days to 179 days | 5.50 |
| 180 days to less than 1 year | 6.50 |
| 1 year to less than 3 years | 7.50 |
| 3 years to less than 5 years | 7.75 |
| 5 years and up to 10 years | 8.00 |
|  |  |
| Source: State Bank of India |  |
|  |  |

## Public Provident Fund (PPF)

A Public Provident Fund (PPF) is a long-term savings plan with powerful tax benefits. Your money grows @ 8 per cent per annum, and this is guaranteed by the Government of India (GOI). You may consider this option if you are not looking for short-term liquidity or regular income. Normal maturity period is 15 years from the close of the financial year in which the initial subscription was made. Maturity values for your PPF account depending on what you invest each year

## Recurring Bank Deposits

Under a Recurring Bank Deposit, you invest a specific amount in a bank on a monthly basis for a fixed rate of return. The deposit has a fixed tenure, at the end of which you get your principal sum as well as the interest earned during that period. The rate of interest, calculated quarterly or as specified by the bank, varies between 4 and 6 per cent, depending on the maturity period and the amount invested. A Recurring Bank Deposit is a powerful tool for regular savings.

## LIFE INSURANCE

A life insurance policy is a contract between an individual (termed as insured) and an insurance company (insurer) to pay the insured, or his nominated heirs, a specified sum of money on the happening of an event. The event could be the expiry of the insurance policy or the death of the insured before the expiry (date of maturity) of the policy as per the terms of the policy. In a simple example, a person takes an insurance policy and nominates his wife as the beneficiary. On the death of this person, his wife gets the amount for which the life insurance policy was purchased. There are many variants of a life insurance policy:

1. ***Whole Life Assurance Plans:*** These are low-cost insurance plans where the sum assured is payable on the death of the insured
2. ***Endowment Assurance Plans:*** Under these plans, the sum assured is pay-able on the maturity of the policy or in case of death of the insured individual before maturity of the policy.
3. ***Term Assurance Plans:*** Under these plans, the sum assured is payable only on the death of the insured individual before expiry of the policy.
4. ***Pension Plans:*** These plans provide for either immediate or deferred pension for life. The pension payments are made till the death of the annuitant (person who has a pension plan) unless the policy has provision of guaranteed period.

Life Insurance Corporation (LIC) is a government company. Till the year 2000, the LIC was the sole provider of life insurance policies to the Indian public. However, the Insurance Regulatory & Development Authority (IRDA) has now issued licenses to private companies to conduct the business of life insurance. Some of the major private players in the sector are:

* Bajaj Allianz Life Insurance Corporation
* Birla SunLife Insurance Co. Ltd.
* HDFC Standard Life Insurance Co. Ltd.
* ICICI Prudential Life Insurance Co. Ltd.
* ING Vysya Life Insurance Co. Pvt. Ltd.
* MAX New York Life Insurance Co. Ltd.
* MetLife India Insurance Co. Pvt. Ltd.
* Kotak Mahindra Old Mutual Life Insurance Co. Ltd.
* SBI Life Insurance Co. Ltd.
* TATA AIG Life Insurance Co. Ltd.
* AMP Sanmar Assurance Co. Ltd.
* AVIVA Life Insurance Co. Pvt. Ltd.
* Sahara India Life Insurance Co. Ltd.
* Shriram Life Insurance Co. Ltd.

## POST OFFICE SAVINGS

Post Office Savings is an investment option that pays annual interest rate of 3.5 percent; Cumulatively compounded yearly, and is available through post-offices across the country.

# TAX IMPLICATIONS

Investment in Post Office Savings account for a maximum investment of Rs.100,000, per financial year is totally exempt from tax under section 80C of the Income Tax Act, 1961. The Interest Income is also exempted from tax under section 10 of Income Tax Act, 1961.

|  |  |
| --- | --- |
| ***Post Office Savings: Savings Account*** | |
|  |  |
| Who can invest? | * 1. Single Account      + An individual (18 years & above)      + A minor who has attained the age of 10 years      + A guardian on behalf of a minor      + A guardian of a person of unsound mind   2. Joint Account – Two or three adults |
| How much you can invest? | * Single Account – Minimum Rs.20 and up to Rs.1 lac * Joint Account – Minimum Rs.20 and up to Rs.2 lac |
| How much do you earn? | 3.5 % |
| When interest is compounded? | Yearly |
| When interest is paid? | Yearly |
| Cumulative/ Non-cumulative? | Cumulative |
| When you can withdraw? | Any time |
| What do you get on redemption? | Amount balance in the account |
| Premature withdrawal facility? | Not applicable |
| Premature withdrawal terms? | Any time |
| Marketability? | Very good |
| Is it safe? | Very safe |
| Is it secured? | Secured |
| Is it convenient? | * Open at any Post Offices * Cheque facility * Minimum balance low |
| Can you get a loan? | Not applicable |
| Is the income taxable? | Totally tax free U/s 80c of Income Tax Act, 1961 |
| Any other tax concessions? | Interest income exempted from income tax U/s 10 of Income Tax Act, 1961 |
| Is nomination facility available? | Yes |
|  |  |

|  |  |
| --- | --- |
| ***Post Office Savings: Recurring Deposit Account*** | |
|  |  |
| Who can invest? | * 1. A Single adult   2. Two adults jointly, the amount due on the account being payable      + To both jointly or survivor      + To either of them or survivor   3. A guardian on behalf of a minor or a person of unsound mind   4. A minor who has attained the age of ten years in his own name |
| How much you can invest? | Rs.10 per month to any amount |
| How much do you earn? | 7.5 % |
| When interest is compounded? | Quarterly |
| When interest is paid? | Yearly |
| Cumulative/ Non-cumulative? | Cumulative |
| When you can withdraw? | After 5 years   * Extension of account after maturity period: Continue account, may be for a further period of five years and make monthly deposits during such extended period. * Retention of amount of repayment beyond maturity period: The Depositor may at his option, continue the account and retain in it the amount of repayment due for a further period up to maximum of five years without making any fresh deposits. |
| What do you get on redemption? | Amount balance in the account |
| Premature withdrawal facility? | After 3 years |
| Premature withdrawal terms? | Only once up to 50% of the balance |
| Marketability? | Good |
| Is it safe? | Very safe |
| Is it secured? | Secured |
| Is it convenient? | Open at any Post Offices |
| Can you get a loan? | 50% of the deposits made in the account may be allowed as loan after the account has been in operation for at least one year |
| Is the income taxable? | * Taxable * No TDS * No Wealth Tax |
| Any other tax concessions? | Rebate on advance deposits   * Deposits – Six or more but not exceeding eleven deposits made in a calendar month; Rebate – Rs.10 for an account of Rs.100 denomination * Deposits – Twelve or more deposits made in a calendar month; Rebate – Rs.40 for every twelve deposits of Rs.100 denomination |
| Is nomination facility available? | Yes |
|  |  |

## SMALL SAVINGS

Small Savings Schemes are basically of two types:

* ***Post Office Savings:*** Savings Deposits; Recurring Deposits; Time Deposits; & Monthly Income Account and
* ***National Savings:*** Public Provident Fund; National Savings Certificates; & Kisan Vikas Patra

We have already discussed the characteristics of Post Office Savings & Public Provident Fund in the earlier sections in this chapter; we further summarize the features of the remaining small savings products.

|  |  |
| --- | --- |
| ***National Savings: Public Provident Fund (PPF)*** | |
|  |  |
| Who can invest? | * 1. An Individual (above 18 years)   2. Hindu Undivided Family   3. A guardian on behalf of a minor |
| How much you can invest? | Minimum Rs.500 and up to Rs.70,000 per annum |
| How much do you earn? | 8% |
| When interest is compounded? | Yearly |
| When interest is paid? | On maturity |
| Cumulative/ Non-cumulative? | Cumulative |
| When you can withdraw? | After 15 years   * Extension of account – Account may be extended for any block period of five years |
| What do you get on redemption? | Entire balance in the account |
| Premature withdrawal facility? | 6th Year to 15th Year |
| Premature withdrawal terms? | Once in a year up to 50% of the balance in 4th preceding or preceding year which ever is lower |
| Liquidity? | Good |
| Is it safe? | Very safe |
| Is it secured? | * Secured * Even courts cannot attach the PPF balance |
| Is it convenient? | * Open at any Post Offices * Or specified bank |
| Can you get a loan? | From 3rd to 6th Year   * Up to 25% of the amount available in the preceding 2nd year |
| Is the income taxable? | Totally tax free |
| Any other tax concessions? | * Rebate U/s 80c of Income Tax Act, 1961 * No Wealth Tax |
| Is nomination facility available? | Yes |
|  |  |

|  |  |
| --- | --- |
| ***National Savings: National Savings Certificates (NSC VIII)*** | |
|  |  |
| Who can invest? | * 1. An Individual (above 18 years)   2. Two individuals   3. A guardian on behalf of a minor |
| How much you can invest? | Minimum Rs.100 and up to any amount, in denomination of Rs.100, Rs.500, Rs.1000 and Rs.10,000 |
| How much do you earn? | 8% |
| When interest is compounded? | Half Yearly |
| When interest is paid? | On maturity |
| Cumulative/ Non-cumulative? | Cumulative |
| When you can withdraw? | After 6 year |
| What do you get on redemption? | Amount outstanding with interest |
| Premature withdrawal facility? | In exceptional cases |
| Premature withdrawal terms? | On the death of the holder or any of the holders |
| Liquidity? | Good |
| Is it safe? | Very safe |
| Is it secured? | Secured |
| Is it convenient? | Open at any Post Offices |
| Can you get a loan? | Can be pledged as a security for loans |
| Is the income taxable? | * Taxable * No TDS |
| Any other tax concessions? | * Annual accrued interest is also eligible for rebate U/s 80c of Income Tax Act, 1961 * No Wealth Tax |
| Is nomination facility available? | Yes |
|  |  |

|  |  |
| --- | --- |
| ***National Savings: Kisan Vikas Patra (KVP)*** | |
|  |  |
| Who can invest? | * 1. An Individual (above 18 years)   2. Two or three individuals in joint names   3. A guardian on behalf of a minor |
| How much you can invest? | Minimum Rs.100 and up to any amount, in denomination of Rs.100, Rs.500, Rs.1000, Rs.10,000 and Rs.50,000 |
| How much do you earn? | 8.25% approximately |
| When interest is compounded? | Yearly |
| When interest is paid? | On maturity |
| Cumulative/ Non-cumulative? | Cumulative |
| When you can withdraw? | 8 years 7 months |
| What do you get on redemption? | Double the amount invested |
| Premature withdrawal facility? | Available after 2.5 years |
| Premature withdrawal terms? | Early withdrawal at fixed rates anytime in case of death of holder or any of the holders |
| Liquidity? | Poor |
| Is it safe? | Very safe |
| Is it secured? | Secured |
| Is it convenient? | Open at any Post Offices |
| Can you get a loan? | Can be pledged as a security for loans |
| Is the income taxable? | * Taxable * No TDS |
| Any other tax concessions? | * No Wealth Tax |
| Is nomination facility available? | Yes |
|  |  |

## GOLD

Of all the choice of investments available, can this yellow metal take pride of the place as a financial investment alternative option? Opinion on the subject of gold is divided, on several issues – are the yields from an investment in gold positive? Are its uses productive? Is the strain on the economy evident? Should gold be allowed to be brought into India freely for purposes of investment or otherwise?

Well, yields or no yields, there is hardly an Indian household that can ignore gold and keep its entire savings in financial assets alone. Every investment has an intrinsic appeal to its holder and to suggest that hundreds of tones of gold is bought every year without regard to its economic value is to suggest that Indians don’t act rationally. The fact is, they do and probably do it better than others.

Indian’s faith in GOD and GOLD dates back to the Vedic times; they worshipped both. According to the World Gold Council Report, India stands today as the world’s largest single market for gold consumption. In developing countries, people have often trusted gold as a better investment than bonds and stocks. Gold is an important and popular investment for many reasons:

* In many countries gold remains an integral part of social and religious customs, besides being the basic form of saving. Shakespeare called it ‘the saint – seducing gold’.
* Superstition about the healing powers of gold persists. Ayurvedic medicine in India recommends gold powder and pills for many ailments.
* Gold is indestructible. It does not tarnish and is also not corroded by acid – except by a mixture of nitric and hydrochloric acids.
* Gold has aesthetic appeal. Its beauty recommends it for ornament making above all other metals.
* Gold is so malleable that one ounce of the metal can be beaten into a sheet covering nearly a hundred square feet.
* Gold is so ductile that one ounce of it can be drawn into fifty miles of thin gold wire.
* Gold is an excellent conductor of electricity; a microscopic circuit of liquid gold ‘printed’ on a ceramic strip saves miles of wiring in a computer.
* Gold is so highly valued that a single smuggler can carry gold worth Rs.50 lac underneath his shirt.
* Gold is so dense that all the tones of gold, which has been estimated; to be mined through history could be transported by one single modern super tanker.
* Finally, gold is scam-free. So far, there have been no Mundra – type or Mehta – type scams in gold.

Apparently, gold is the only product, which has an investment as well as ornamental value. Going beyond the narrow logic of yield and maturity values, thus, the lure of this yellow metal continues.

**EQUITY SHARE**

Equity, also called shares or scrips, is the basic building blocks of a company. A company’s ownership is determined on the basis of its shareholding. Shares are, by far, the most glamorous financial instruments for investment for the simple reason that, over the long term, they offer the highest returns. Predictably, they’re also the riskiest investment option.

The BSE Sensex is the most popular index that tracks the movements of shares of 30 blue-chip companies on a weighted average basis. The rise and fall in the value of the Sensex, measured in points, broadly indicates the price-movement of the value of shares. Of late, technology has played a major role in enhancing the efficiency, safety, and transparency of the markets. The introduction of online trading has made it possible for an investor to trade in equities at the click of a mouse.

## DEBENTURES/BONDS

A Bond is a loan given by the buyer to the issuer of the instrument. Companies, financial institutions, or even the government can issue bonds. Over and above the scheduled interest payments as and when applicable, the holder of a bond is entitled to receive the par value of the instrument at the specified maturity date.

Bonds can be broadly classified into:

* Tax-Saving Bonds
* Regular Income Bonds

Tax-Saving Bonds offer tax exemption up to a specified amount of investment, examples are:

* + 1. ICICI Infrastructure Bonds under Section 88 of the Income Tax Act, 1961
    2. REC Bonds under Section 54EC of the Income Tax Act, 1961
    3. RBI Tax Relief Bonds

Regular-Income Bonds, as the name suggests, are meant to provide a stable source of income at regular, pre-determined intervals, examples are:

1. Double Your Money Bond
2. Step-Up Interest Bond
3. Retirement Bond
4. En-cash Bond
5. Education Bonds
6. Money Multiplier Bonds/Deep Discount Bond

# Tax-Saving Bonds

Some bonds have a special provision that allows the investor to save on tax. These are termed as Tax-Saving Bonds, and are widely used by individual investors as a tax-saving tool. Examples of such bonds are:

1. Infrastructure Bonds under Section 88 of the Income Tax Act, 1961
2. Capital Gains Bonds under Section 54EC of the Income Tax Act, 1961
3. RBI Savings Bonds (erstwhile, RBI Relief Bonds)
4. ***What are Tax Saving Infrastructure Bonds?*** Infrastructure bonds are available through issues of ICICI Bank and IDBI, brought out in the name of ICICI Safety Bonds and IDBI Flexi bonds. These provide tax-saving benefits under Section 88 of the Income Tax Act, 1961, up to an investment of Rs.1, 00,000, subject to the bonds being held for a minimum period of three years from the date of allotment.

**Unit –II Primary Market**

## PRIMARY MARKETS

Companies raise funds to finance their projects through various methods. The promoters can bring their own money of borrow from the financial institutions or mobilize capital by issuing securities. The funds maybe raised through issue of fresh shares at par or premium, preferences shares, debentures or global depository receipts. The main objectives of a capital issue are given below:

* To promote a new company
* To expand an existing company
* To diversify the production
* To meet the regular working capital requirements
* To capitalize the reserves

Stocks available for the first time are offered through primary market. The issuer may be a new company or an existing company. These issues may be of new type or the security used in the past. In the primary market the issuer can be considered as a manufacturer. The issuing houses, investment bankers and brokers act as the channel of distribution for the new issues. They take the responsibility of selling the stocks to the public.

# THE FUNCTION

The main service functions of the primary market are origination, under writing and distribution. Origination deals with the origin of the new issue. The proposal is analyzed in terms of the nature of the security, the size of the issue, timing of the issue and floatation method of the issue. Underwriting contract makes the share predictable and removes the element of uncertainty in the subscription (underwriting is given in the latter part of this chapter). Distribution refers to the sale of securities to the investors. This is carried out with the help of the lead managers and brokers to the issue.

**THE RISE AND FALL OF PRIMARY MARKETS**

Only a few years back, any investor worth his salt thought that investing in primary issues was the easiest and simplest way to make money. He scoffed at other “inferior” options like mutual funds and bank deposits because they did not double or triple his money in a few months time! Believe it or not, primary markets did that precisely – they posted near indecent returns like 300 to 400% just in two months time. When the common investor benchmarked all other investment options against these phenomenal returns, obviously they stood no chance. Returns apart, investing in primary issues appeared so simple and “risk free”! All that was required of investors to partake in the manna was to simply put as large an application as possible because the proportionate allotment rule worked to the favor of big investors (small investors were supposed to have gone to mutual funds) and pray for a large allotment. Once they received some shares on the large subscription, they just offloaded their holdings at the listed prices, which were at a hefty premium to the issue price not because of any good fundamentals of the issuing company but simply because demand was far greater than the supply and waited for the next IPO to make another killing.

As profit booking became so simple, money flowed from all directions, some legal and some not so legal – the markets boomed and promoters, brokers and investors all made merry. “Entrepreneurs” of all sorts mushroomed to float companies with fancy projects and launched IPOs with tall promises to give high earnings and dividends. But no one bothered to check the prospectuses or the credentials of these promoters because there was enough money to be made by every one or so they thought, until the markets crashed like the proverbial nine pins.

What drove the primary markets to these dizzy heights only to collapse later? Those were the early days of liberalization and the foreign institutional investors and mutual funds had no clue as to the levels of transparency or corporate governance absent in the Indian companies. They believed in the picture specially painted for them by the wily promoters, liked it and invested heavily believing in what was right in the West would be right in the East as well. They were rudely shaken when the promised projects failed to take off because of rampant diversion of money, plain incompetence and severe change in the economic climate.

Then came, the ice winter of stock market gloom, which lasted for probably the longest period in the near history. As investors lost money and faith in the primary market, they punished all the issuers – IPO after IPO failed to get the desired response from the markets – it almost became impossible for any company to raise money from the stock markets. Genuine companies, which lined up on-going projects for funds to be raised from the market were driven to desperation and borrowed at usurious rates that broke the back of their balance sheets. The high cost of borrowing made debt servicing difficult and defaults occurred even from corporate organizations known for their high credit worthiness.

The South Asian crisis further made life very difficult for Indian entrepreneurs as their exports failed to take off and money got locked up in huge inventories. This was the perfect recipe for disaster and doomsayers were busy writing the epitaph on the Indian economic revival. As the economy teetered on the verge of collapse, the outlook has changed slowly but surely – software sector came to the rescue of the markets, a few robust companies lifted the market from their lowest depths to the present peaks of unprecedented highs.

And the Bull Run began all over again. Markets are in frenzy with institutional buying and as the index zoomed to 14500 levels, the primary market issues were back with a bang. Do you see any red herrings here?

Many analysts said investors were climbing up the same learning curve all over again. Some of the ‘companies’ that came out with IPOs hardly had the right credentials or performance track record to justify the public offer. But the investors starved so long for ‘good’ issues were merrily lapping up all of them. Happily so far, they all made money as the scripts listed above their issue prices posted handsome returns in very short term. But don’t the happenings appear so disturbingly familiar?

If you were a discerning investor, you would know speculation and serious investing are very different. As our discursion here deals with the second, we make an attempt to list the factors that an investors should consider as a checklist to guide your primary market investments.

# FACTORS TO BE CONSIDERED BY THE INVESTORS

The number of stocks, which has remained inactive, increased steadily over the past few years, irrespective of the overall market levels. Price rigging, indifferent usage of funds, vanishing companies, lack of transparency, the notion that equity is a cheap source of fund and the permitted free pricing of the issuers are leading to the prevailing primary market conditions.

In this context, the investor has to be alert and careful in his investment. He has to analyze several factors. They are given below:

|  |  |
| --- | --- |
| Factors to be considered: | |
|  |  |
| Promoter’s Credibility | * Promoter’s past performance with reference to the companies promoted by them earlier. * The integrity of the promoters should be found out with enquiries and from financial magazines and newspapers. * Their knowledge and experience in the related field. |
|  |  |
| Efficiency of the Management | * The managing director’s background and experience in the field. * The composition of the Board of Directors is to be studied to find out whether it is broad based and professionals are included. |
|  |  |
| Project Details | * The credibility of the appraising institution or agency. * The stake of the appraising agency in the forthcoming issue. |
|  |  |
| Product | * Reliability of the demand and supply projections of the product. * Competition faced in the market and the marketing strategy. * If the product is export oriented, the tie-up with the foreign collaborator or agency for the purchase of products. |
|  |  |
| Financial Data | * Accounting policy. * Revaluation of the assets, if any. * Analysis of the data related to capital, reserves, turnover, profit, dividend record and profitability ratio. |
|  |  |
| Litigation | * Pending litigations and their effect on the profitability of the company. Default in the payment of dues to the banks and financial institutions. |
|  |  |
| Risk Factors | * A careful study of the general and specific risk factors should be carried out. |
|  |  |
| Auditor’s Report | * A through reading of the auditor’s report is needed especially with reference to significant notes to accounts, qualifying remarks and changes in the accounting policy. In the case of letter of offer the investors have to look for the recently audited working result at the end of letter of offer. |
|  |  |
| Statutory Clearance | * Investor should find out whether all the required statutory clearance has been obtained, if not, what is the current status. The clearances used to have a bearing on the completion of the project. |
|  |  |
| Investor Service | * Promptness in replying to the enquiries of allocation of shares, refund of money, annual reports, dividends and share transfer should be assessed with the help of past record. |
|  |  |

# INVESTORS PROTECTION IN THE PRIMARY MARKET

To ensure healthy growth of primary market, the investing public should be protected. The term investor’s protection has a wider meaning in the primary market. The principal ingredients of investor protection are:

* Provision of all the relevant information,
* Provision of accurate information and
* Transparent allotment procedures without any bias.

To provide the above-mentioned factors several steps have been taken. They are project appraisal, under writing, clearance of the issue document by the stock exchange and SEBI’s scrutiny of the issue document.

***Project Appraisal:*** This is the first step in the entire process of the project. Technical and economic feasibility of the project is evaluated. If the project itself is not technically feasible and economically viable, whatever may be the other steps taken to protect the investors are defeated. Appraisal shows whether the project is meaningful and can be financed. The investors’ protection starts right from the protection of the principal amount of investment. Based on the appraisal, the project cost is finalized. The cost should be neither understand nor overstated. The profitability of the project should be estimated and given. To ensure fair project appraisal, SEBI has made it mandatory for the project appraisal body to participate a certain amount in the forthcoming issue.

***Underwriting:*** Once the issue is finalized the under writing procedure starts. Reputed institutions and agencies, providing credibility to the issue normally underwrite the issue. If the lead managers participate more than 5 percent of the minimum stipulated amount offered to the public, it would increase the confidence of the public regarding the pricing and sale ability of the issue.

***Disclosures in the Prospectus:*** SEBI has issued stringent norms for the disclosure of information in the prospectus. It is the duty of the lead manager to verify the accuracy of the data provided in the prospectus. The pending litigation should be given clearly. The promoters’ credibility in fulfilling the promises of the previous issues (if any) should be stated. A clear version of the risk factors should be given. Any adverse development that affects the normal functioning and the profit of the company should be highlighted in the risk factor.

***Clearance by the Stock Exchange:*** The issue document has to be cleared by the stock exchange on which the proposed listing is offered. The stock exchanges verify the factors related with the smooth trading of the shares. Any bottleneck in this area will be eliminated since the transferability is the basic right of the shareholders. Trading of the shares helps the investor to liquidate his share at anytime. If the issues were not traded in the secondary market at a good price, they would dampen the spirit of the investor. According to a study conducted by Mr. Prithvi Haldea, between April 1992 and March 1996 out of 3,872 issues, 2,987 were traded below the offer price. As on January 14, 1997 nearly 205 shares were not traded at all and another 118 companies just proved to be fly by night operators.

***Signing by Board of Directors:*** The Board of Directors should sign the prospectus. A copy is also filed with the office to the Registrar of the Companies. This along with the other material documents referred to in the prospectus are available for inspection by the members of the public. The minimum amount to be subscribed by the promoters and maintained for a minimum number of years also safeguards the interest of the investors.

***SEBI’s Role:*** (a) SEBI scrutinizes the various offer documents from the viewpoint of investors’ protection and full disclosure. It has the power to delete the unsubstantiated claims and ask for additional information wherever needed. This makes the lead manager to prepare the offer document with due care and diligence; (b) When the disclosure of the information is complete, wide publicity has to be given in the newspapers; (c) In the allotment procedure to make sure of transparency, SEBI’s nominee is appointed apart from the stock exchange nominee in the allotment committee. Inclusion of valid applications and rejection of invalid applications are checked. The representative of the SEBI see to it that un-due preference is not given to certain group of investors.

***Redressal of Investors Grievances:*** The Department of Company Affairs has introduced computerized system of processing the complaints to handle it effectively. The companies are requested to give feed back regarding the action taken on each complaint within a stipulated time period. If the companies do not respond and are slow in the process of settlement of complaints, penal action can be taken against the companies under the provisions of the Companies Act. If the performance of the Registrar to the issue is not satisfactory in settling the complaints, SEBI can take appropriate action against such Registrar. Several Investors Associations are also functioning to help the investors complaints redressed promptly.

# PRIMARY MARKET TRENDS – OVER NINETIES

The liberalization policy adopted by the government in the early nineties resulted in a boom in the secondary market. The boom was not restricted to the secondary market alone, the primary market that till then was working under the Controller of Capital Issue also enjoyed the boom with the repealing of the Controller of Capital Issue Act. With the dawn of an era of free pricing more and more companies accessed the primary market.

There was a fall in the amount raised through primary market from March 1995 with much-publicized M.S. shoe episode. This episode put a break on the new issues activity. The collapse of the CRB capital market was another fatal blow on the primary market. The primary market was dull and insipid in 1997-98. The number of primary issues, which were 813 in 1996-97 drastically, fell down to 62 issues in 1997-98. It is interesting to note that out of every 100 public issues 39 was over subscribed in 1995-96 but in 1996-97 it was 8. At the same time 7 out of every 100 companies in 1996-97 had to return application money to investors for failing to raise minimum stipulated amount in capital issue. The reasons for this sordid state of affairs are given below.

***Aggressive Pricing:*** This is the major cause for the sorry state of affairs in the primary market. The near complete freedom given to the issuers and the merchant bankers to fix the premium following the repeal of Capital Issue Act resulted in high premium, sharp erosion of post listing prices and very little scope for appreciation. This made the investors to shy away from the market.

***Poor Liquidity:*** The poor quality of the primary issues has contributed to a growing inactive list in the stock market. A glance at the profile of the in active scrips as on June 1997, provides an interesting insight of the 3617 scrips that were on the inactive list (based on trading in the first half of 1997). In those shares, 2,900 were listed prior to 1996 and 1,200 were companies listed prior to 1994. There is no way out for the investors and their fears have resulted in poor response to the primary market.

***Low Returns:*** Non-implementation of projects, delays, changes in the scope and scale of projects to justify the cost and non-attainment of projected earnings have resulted in the fall in listing price. Though large sums were raised in 1992-96 period, capital formation with concomitant earnings has been nowhere near that reflected in the offer documents. Poor returns have drained the investors’ confidence.

***Low Volume:*** The scrips that are traded in the market, the number of transactions and the amount traded are so low that an investor wanting to sell the scrip would have difficulty in doing so. Many scrips in the current B1 group show this trend.

***Economic Slow Down:*** The growth of the GDP has fallen from 7 per cent in 1995-96 to mere 6 per cent in 1996-97. Recession faced-by the economy had a direct impact on the secondary and tertiary sector. It had an indirect effect upon the primary market.

One should not jump to the conclusion that there are no takers in primary market. Even today there are takers for good quality issues. Several new issues by the banks - both private and public sectors have proved to be quite a success on the stock market in the recent past. Stocks like HDFC Bank, Global Trust Bank, Satyam Computers, Infosys etc. are performing well on the stock market.

The year 1999 saw renewed entrees in the primary market. The initial public offer from companies of IT sector was received well. The funds mobilized through the debt and equity route aggregated to Rs.54,352 cr, a rise of around 24 per cent compared Rs.44,115 crores in 1998.

# MEASURES TAKEN TO REVIVE THE MARKET

* A listed company having immediate three years of dividend paying track record only can access the market.
* If a manufacturing company did not have such a track record, it could access the public issue market provided the financial institution or a scheduled commercial bank appraised its project and such appraising entities also participated in the project fund.
* The companies were required to complete the allotment of securities within 30 days of the closure of the issue.
* It would be necessary for a corporate body making a public issue to have at least five public shareholders who has been made a net capital offer to the tune of Rs.1 lakh forever.
* SEBI does not vet offer documents of companies having track record of 3 years dividend payment.
* Removal of mandatory requirement of 90 per cent subscription clause in cases of offer for sale.
* Reducing the minimum application size for subscribing to a public issue from Rs.5000 to Rs.2000.
* In case of no-underwritten public issues, promoters could bring in their own money or procure subscription from elsewhere within 60 days of the closure of the issue subject to such disclosures in the offer documents.
* SEBI lifted the provision of the lock in period for promoters’ contribution in case of listed companies with 3 years track record of dividend.
* SEBI has made it mandatory to disclose un-audited results of companies for every quarter. Timely information would now be available to the public.
* SEBI has directed different stock exchange to segregate the cash flow statement of all companies that came out with IPO since 1992-93 and have asked the exchange to have a check over these companies.
* SEBI abolished the fixed par value concept and, instead companies can fix the par value of the shares. HCL Technologies IPO has a par value of Rs.4 per share, offered at Rs.580 per share.

# PRIMARY MARKET FOR EQUITY – TODAY

Primary market for equity, which consists of both the ‘initial public offering’ (IPO) market and the ‘seasoned equity offering’ (SEO) markets, experienced considerable activity in 2004 and 2005 (see Table below). In 2005, Rs.30,325 crore of resources were raised on this market, of which Rs.9,918 crore were made up by 55 companies which were listed for the first time (IPOs). The number of IPOs per year has risen steadily from 2002 onwards. A level of 55 IPOs in the year translates to roughly 4 IPOs every month. The mean IPO size, which was elevated in 2004, returned to Rs.180 crore, which is similar to the value prevalent in 2003.

The primary issuance of debt securities, as per SEBI, fell to a low of around Rs. 66 crore in 2005, which is one facet of the far-reaching difficulties of the debt market. Unlike equity securities, companies redeem debt securities issued at previous dates every year. Hence, a year with a low issuance of fresh debt securities is a year in which the stock of outstanding debt securities drops.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Table: Primary Market | | | | |
| *(Rs.crores)* | | | | |
|  | **Calendar Year** | | | |
|  |  | | | |
|  | **2002** | **2003** | **2004** | **2005** |
|  |  |  |  |  |
| Debt | 4,549 | 5,284 | 2,383 | 66 |
| Equity | 2,420 | 2,891 | 33,475 | 30,325 |
| Of which, IPOs | 1,981 | 1,708 | 12,402 | 9,918 |
| Number of IPOs | 6 | 12 | 26 | 55 |
| Mean IPO size | 330 | 142 | 477 | 180 |
| Total | 6,970 | 8,175 | 35,859 | 30,391 |
| Number | 28 | 43 | 65 | 109 |
|  |  |  |  |  |
| Source: SEBI |  |  |  |  |

In addition to resource mobilization by the issuance of debt and equity securities, one of the most important mechanisms of financing that has been used by Indian firms is retained earnings, which are also a part of equity financing.

Primarily, issues can be classified as a Public, Rights or Preferential issues (also known as private placements). While public and rights issues involve a detailed procedure, private placements or preferential issues are relatively simpler. The classification of issues is illustrated further.

## INITIAL PUBLIC OFFER (IPO)

## Parties Involved in the IPO

In the sixties and seventies, the company and its personnel managed IPO. But, at present initial public offering involves a number of agencies. The rules and regulations, the changing scenario of the capital market necessitated the company to seek for the support of many agencies to make the public issue a success. As a student of financial market management, one should know the number of agencies involved and their respective role in the public issue. The promoters also should have a clear idea about the agencies to coordinate their activities effectively in the public issue. The manager to the issue, registrars to the issue, underwriters, bankers, advertising agencies, financial institutions and government /statutory agencies.

# MANAGERS TO THE ISSUE

Lead managers are appointed by the company to manage the initial public offering campaign. Their main duties are:

* Drafting of prospectus
* Preparing the budget of expenses related to the issue
* Suggesting the appropriate timings of the public issue
* Assisting in marketing the public issue successfully
* Advising the company in the appointment of registrars to the issue, underwriters, brokers, bankers to the issue, advertising agents etc.
* Directing the various agencies involved in the public issue.

Many agencies are performing the role of lead managers to the issue. The merchant banking division of the financial institutions, subsidiary of commercial banks, foreign banks, private sector banks and private agencies are available to act as lead mangers. Such as SBI Capital Markets Ltd., Bank of Baroda, Canara Bank, DSP Financial Consultant Ltd. ICICI Securities & Finance Company Ltd., etc. The company negotiates with prospective mangers to its issue and settles its selection and terms of appointment. Usually companies appoint lead managers with a successful background. There may be more than one manager to the issue. Some times the banks or financial institutions impose a condition while sanctioning term loan or underwriting assistance to be appointed as one of the lead managers to the issue. The fee payable to the lead managers is negotiable between the company and the lead manager. The fee agreed upon is revealed in the memorandum of the understanding filed along with the offer document.

# REGISTRAR TO THE ISSUE

After the appointment of the lead managers to the issue, in consultation with them, the Registrar to the issue is appointed. Quotations containing the details of the various functions they would be performing and charges for them are called for selection. Among them the most suitable one is selected. It is always ensured that the registrar to the issue has the necessary infrastructure like Computer, Internet and telephone.

The Registrars normally receive the share application from various collection centers. They recommend the basis of allotment in consultation with the Regional Stock Exchange for approval. They arrange for the dispatching of the share certificates. They hand over the details of the share allocation and other related registers to the company. Usually registrars to the issue retain the issuer records at least for a period of six months from the last date of dispatch of letters of allotment to enable the investors to approach the registrars for redressal of their complaints.

# UNDERWRITERS

Underwriting is a contract by means of which a person gives an assurance to the issuer to the effect that the former would subscribe to the securities offered in the event of non-subscription by the person to whom they were offered. The person who assures is called an underwriter. The underwriters do not buy and sell securities. They stand as back-up supporters and underwriting is done for a commission. Underwriting provides an insurance against the possibility of inadequate subscription. Underwriters are divided into two categories:

* Financial Institutions and Banks
* Brokers and approved investment companies.

Some of the underwriters are financial institutions, commercial banks, merchant bankers, members of the stock exchange, Export and Import Bank of India etc. The underwriters are exposed to the risk of non-subscription and for such risk exposure they are paid an underwriting commission.

Before appointing an underwriter, the financial strength of the prospective underwriter is considered because he has to undertake and agree to subscribe the non-subscribed portion of the public issue. The other aspects considered are:

* Experience in the primary market
* Past underwriting performance and default
* Outstanding underwriting commitment
* The network of investor clientele of the underwriter and
* His overall reputation.

The company after the closure of subscription list communicates in writing to the underwriter the total number of shares/debentures under subscribed, the number of shares/debentures required to be taken up by the underwriter. The underwriter would take up the agreed portion. If the underwriter fails to pay, the company is free to allot the shares to others or take up proceeding against the underwriter to claim damages for any loss suffered by the company for his denial.

# BANKERS TO THE ISSUE

Bankers to the issue have the responsibility of collecting the application money along with the application form. The bankers to the issue generally charge commission besides the brokerage, if any. Depending upon the size of the public issue more than one banker to the issue is appointed. When the size of the issue is large, 3 to 4 banks are appointed as bankers to the issue. The number of collection centers is specified by the central government. The bankers to the issue should have branches in the specified collection centers. In big or metropolitan cities more than one branch of the various bankers to the issue are designated as collecting branches. Branches are also designated in the different towns of the state where the project is being set up. If the collection centers for application money are located nearby people are likely to invest the money in the company shares.

# ADVERTISING AGENTS

Advertising plays a key role in promoting the public issue. Hence, the past track record of the advertising agency is studied carefully. Tentative program of each advertising agency along with the estimated cost are called for. After comparing the effectiveness and cost of each program with the other, a suitable advertising agency if selected in consultation with the lead managers to the issue. The advertising agencies take the responsibility of giving publicity to the issue on the suitable media. The media may be newspapers/magazines/hoardings/press release or a combination of all.

# THE FINANCIAL INSTITUTIONS

Financial institutions generally underwrite the issue and lend term loans to the companies. Hence, normally they go through the draft of prospectus, study the proposed program for public issue and approve them. IDBI, IFCI & ICICI, LIC, GIC and UTI are the some of the financial institutions that underwrite and give financial assistance. The lead manager sends copy of the draft prospectus to the financial institutions and includes their comments, if any in the revised draft.

# GOVERNMENT AND STATUTORY AGENCIES

The various regulatory bodies related with the public issue are:

* Securities Exchange Board of India
* Registrar of companies
* Reserve Bank of India (if the project involves foreign investment)
* Stock Exchange where the issue is going to be listed
* Industrial licensing authorities
* Pollution control authorities (clearance for the project has to be stated in the prospectus)

# COLLECTION CENTERS

Generally there should be at least 30 mandatory collection centers inclusive of the places where stock exchanges are located. If the issue is not exceeding Rs.10 Cr (excluding premium if any) the mandatory collection centers are the four metropolitan centers viz. Mumbai, Delhi, Kolkatta and Chennai and at all such centers where stock exchanges are located in the region in which the registered office of the company is situated. The regional divisions of the various stock exchanges and the places of their locations are given in the following table.

|  |  |  |
| --- | --- | --- |
| ***Region*** | ***Exchange*** | ***City*** |
|  |  |  |
| Northern Region | Ludhiana Stock Exchange  Delhi Stock Exchange  Jaipur Stock Exchange  U P Stock Exchange | Ludhiana  Delhi  Jaipur  Kanpur |
|  |  |  |
| Southern Region | Hyderabad Stock Exchange  Bangalore Stock Exchange  Mangalore Stock Exchange  Madras Stock Exchange  Coimbatore Stock Exchange  Cochin Stock Exchange | Hyderabad  Bangalore  Managlore  Chennai  Coimbatore  Cochin |
|  |  |  |
| Eastern Region | Calcutta Stock Exchange  Gawahati Stock Exchange  Magadh Stock Exchange  Bhubaneswar Stock Exchange | Kolkatta  Gawahati  Patna  Bhubaneswar |
|  |  |  |
| Western Region | Bombay Stock Exchange  National Stock Exchange  OTCEL Stock Exchange  M P Stock Exchange  Pune Stock Exchange  Vadodara Stock Exchange  Ahmedabad Stock Exchange  Sauashtra Kutch Stock Exchange | Mumbai  Mumbai  Mumbai  Indore  Pune  Vadodara  Ahmedabad  Rajkot |
|  |  |  |

In addition to the collection branch, authorized collection agents may also be appointed. The names and addresses of such agent should be given in the offer documents. The collection agents are permitted to collect such application money in the form of cheques, draft, and stock-invests and not in the form of cash. The application money so collected should be deposited in the special share application account with the designated scheduled bank either on the same day or latest by the next working day.

The application collected by the bankers to the issue at different centers are forwarded to the Registrar after realization of the cheques, within a period of 2 weeks from the date of closure of the public issue. The applications accompanied by stock-invests are sent directly to the Registrars to the issue along with the schedules within one week from the date of closure of the issue. The investors, who reside in places other than mandatory and authorized centers, can send their application with stock-invests to the Registrar to the issue directly by registered post with acknowledgement due card.

## Placement of the IPO

Initial public offers are floated through Prospectus; Bought out deals/offer for sale; Private Placement; Right Issue and Book Building.

# OFFER THROUGH PROSPECTUS

According to Companies (Amendment) Act 1985, application forms for shares of a company should be accompanied by a Memorandum (abridged prospectus). In simple terms a prospectus document gives details regarding the company and invites offers for subscription or purchase of any shares or debentures from the public. The draft prospectus has to be sent to the Regional Stock Exchange where the shares of the company are to be listed and also to all other stock exchanges where the shares are proposed to be listed. The stock exchange scrutinizes the draft prospectus. After scrutiny if there is any clarification needed, the stock exchange writes to the company and also suggests modification if any. The prospectus should contain details regarding the statutory provisions for the issue, program of public issue – opening, closing and earliest closing date of the issue, issue to be listed at, highlights and risk factors, capital structure, board of directions, registered office of the company, brokers to the issue, brief description of the issue, cost of the project, projected earnings and other such details. The board, lending financial institutions and the stock exchanges in which they are to be listed should approve the prospectus. Prospectus is distributed among the stock exchanges, brokers and underwriters, collecting branches of the bankers and to the lead managers.

|  |  |
| --- | --- |
| Salient Features of the Prospectus: | |
|  |  |
| General Information | * Name and address of the registered office of the company. * The name(s) of the stock exchange(s) where applications have been made for permission to deal in and for official quotations of shares/debentures. * Opening, closing and earliest closing dates of the issue. * Name and address of lead managers. * Name and address of Trustees under Debenture Trust Deed (in case of debenture issue). * Rating for debenture/preference shares, if any, obtained from CRISIL or any other recognized rating agency. |
|  |  |
| Capital Structure of the Company | * Issued, subscribed and paid-up capital. * Size of the present issue giving separately reservation for preferential allotment to promoters and others. * Paid-up capital – (a) After the present issue and (b) After conversion of debentures (if applicable). * Details regarding the promoter’s contribution. |
|  |  |
| Terms of the Present Issue | * Authority for the issue, terms of payment, procedure and time schedule for allotment, issue of certificate and rights of the instrument holders. * How to apply – availability of forms, prospectus and mode of payment. * Special tax benefits to the company and share holders under the Income Tax Act, if any. |
|  |  |
| Particulars of the Issue | * Object of the issue * Project cost * Means of financing (including promoter’s contribution). |
|  |  |
| Company, Management and Project | * History, main objects and present business of the company. * Subsidiary (ies) of the company, if any. * Promoters and their background. * Names, addresses and occupation of managing directors and other directors including nominee directors and whole-time directors. * Location of the project. * Plant and machinery, technological process etc. * Collaboration, any performance guarantee or assistance in marketing by the collaborators. * Infrastructure facilities for raw materials and utilities like water, electricity etc. * Schedule of implementation of the project and progress so far, giving details of land acquisition, civil works, installation of plant and machinery, trail production, consumer production etc. * The Product – (a) Nature of the products – Consumer or Industrial and the end users; (b) Approach to marketing and proposed marketing set-up; (c) Export possibilities and export obligations, if any. * Future prospects – expected capacity utilization during the first three years from the date of commencement of production and the expected year when the company would be able to earn cash profit and net profit. * Stock market data for shares, debentures of the company (high – low price for each of the last years in consideration). * Particulars regarding the other listed companies under the same management, which have made any capital issues during the last three years. |
|  |  |
| Outstanding Litigations | * Details of the outstanding litigations pertaining to matters likely to affect the operations and finances of the company including disputed tax liabilities of any nature, any other default and criminal prosecution launched against the company. |
|  |  |
| Risk Factors | * Management perception of risk factors like sensitivity to foreign exchange rate fluctuations, difficulty in the availability of raw materials or in marketing of products, cost, time over-run etc. |
|  |  |
| Justification of the issue premium | The justification for price is given, taking into account the following parameters:   * Performance of the company – reflected by earnings per share and book value of shares for the past five years. * Future projections in terms of EPS and book value of shares in the next three years. * Stock market data. * Net asset value as per the latest audited balance sheet.   If the projections are not based on the past data, appraisal made by a banker or financial institution should be specifically stated. |
|  |  |
| Financial Information | * Financial performance of the company for last five years should be given from the audited annual accounts in tabular form. * Balance sheet date – equity capital, reserves (revaluation reserve, the year of revaluation and its monetary effect on assets) and borrowings. * Profit and loss data – sales, gross profit, net profit, and dividend paid, if any. * Any change in the accounting policy during the last three years and its effect on the profit and reserves of the company. |
|  |  |
| Statutory and other information | * Minimum subscription. * Details of the fee payable to Advisers, Registrar, Managers, Trustees of the debenture holders and underwriters. * Details regarding the previous issues, if any. |

**BOUGHT OUT DEALS (OFFER FOR SALE)**

Here, the promoter places his shares with an investment banker (bought out dealer or sponsor) who offers it to the public at a later date. In other works in a bought out deal, an existing company off-loads a part of the promoters’ capital to a wholesaler instead of making a public issue. The wholesaler is invariably a merchant banker or some times just a company with surplus cash. In addition to the main sponsor, there could be individuals and other smaller companies participating in the syndicate. The sponsors hold on to these shares for a period and at an appropriate date they offer the same to the public. The hold on period may be as low as 70 days or more than a year.

In a bought out deal, proving is the essential element to be decided. The bought out dealer decides the price after analyzing the viability, the gestation period, promoters’ background and future projections. A bough out dealer sheds the shares at a premium to the public. There are many advantages for the issuing company:

* ***Firstly,*** a medium or small sized company, which is already facing working capital shortage, cannot afford to have long lead-time before the funds could be mobilized from the public. Bought out deal helps the promoters to realize the funds without any loss of time.
* ***Secondly,*** the cost of raising funds is reduced in bought out deals. For issuing share to the public the company incurs heavy expenses, which may invariably be as high as 10 percent of the cost of the project, if not more.
* ***Thirdly,*** bought out deal helps the entrepreneurs who are not familiar with the capital market but have sound professional knowledge to raise funds. Sponsors of the deal are mostly concerned with the promoters’ background and government policies than about the past track record or financial projections. This helps the new entrepreneur to raise adequate capital from the market.
* ***Fourthly,*** for a company with no track record of projects, public issues at a premium may pose problems, as SEBI guidelines come in the way. The stipulations can be avoided by a bought out deal. Companies sell the shares at a premium to the sponsors and they can off-load the shares to the public at a higher premium.
* ***Fifthly,*** to the investors bought out deals possess low risk since the sponsors have already held the shares for a certain period and the projects might have been completed or may be in the verge of completion, the investors need not wait for returns

The major disadvantage of the bought out deals is that the sponsors are able to create a positive image about the shares and sell them at a hefty premium. Single investment banker gives scope for manipulation of the results. Insider trading and price rigging could be carried out, which can be neither detected nor penalized.

# PRIVATE PLACEMENT

In this method the issue is placed with a small number of financial institutions, corporate bodies and high net worth individuals. The financial intermediaries purchase the shares and sell them to investors at a later date at a suitable price. The stock is placed with issue house client with the medium of placing letter and other documents which taken together contribute a prospectus, giving the information regarding the issue. The special feature of the private placement is that the issues are negotiated between the issuing company and the purchasing intermediaries. Listed public limited company as well as closely held private limited company can access the public through the private placement method. Mostly in the private placement securities are sold to financial institutions like Unit Trust of India, mutual funds, insurance companies, and merchant banking subsidiaries of commercial banks and so on.

Through private placement equity shares, preference shares, cumulative convertible preference shares, debentures and bonds are sold. In India private placement market is witnessing the introduction of several innovative debt market instruments such as step-down/step-up debentures, liquid debentures, bonds etc. Private placement has several inherent advantages:

* ***Cost Effective:*** Private placement is a cost-effective method of raising funds. In a public issue underwriting, brokerage, printing, mailing and promotion account for 8 to 10 percent of the issue cost. In the case of the private placement several statutory and non-statutory expenses are avoided.
* ***Time Effective:*** In the public issue the time required for completing the legal formalities and other formalities takes usually six months or more. But in the private placement the requirements to be fulfilled are less and hence, the time required to place the issue is less, mostly 2 to 3 months.
* ***Structure Effectiveness:*** It can be structured to meet the needs of the entrepreneurs. It is flexible to suit the entrepreneurs and the financial intermediaries. To make the issue more attractive the corporate can provide discounts to the intermediaries who are buying it. This is not possible with the public issue with stringent rules and regulations. In the case of debentures the interest ceiling cannot be breached in a public issue. Here the terms of the issue can be negotiated with purchasing institutions easily since they are few in number.
* ***Access Effective:*** Through private placement a public limited company listed or unlisted can mobilize capital. Like-wise issue of all size can be accommodated through the private placement either small or big where as in the public issue market, the size of the issue cannot fall below a certain minimum size.

# RIGHTS ISSUE

According to Sec 81 of the Companies Act 1956, if a public company wants to increase its subscribed capital by allotment of further shares after two years from the date of its formation or one year from the date of its first allotment, which ever is earlier should offer share at first to the existing share holders in proportion to the shares held by them at the time of offer. The shareholders have no legal binding to accept the offer and they have the right to renounce the offer in favor of any person. Shares of this type are called right shares. Generally right shares are offered at an advantageous rate compared with the market rate.

According to Section 81, the company has to satisfy certain conditions to issue right shares.

* Right shares must be offered to the equity shareholders in the proportion to the capital paid on those shares.
* A notice should be issued to specify the number of shares issued.
* The time given to accept the right offer should not be less than 15 days.
* The notice also should state the right of the shareholders to renounce the offer in favor of others.
* After the expiry of the time given in the notice, the Board of Directors has the right to dispose the unsubscribe shares in such a manner, as they think most beneficial to the company.

# BOOK BUILDING

Book building is a mechanism through which the initial public offerings (IPOS) take place in the U.S. and in India it is gaining importance with every issue. Most of the recent new issue offered in the market has been through Book Building process. Similar mechanisms are used in the primary market offerings of GDRs also. In this process the price determination is based on orders placed and investors have an opportunity to place orders at different prices as practiced in international offerings.

The recommendations given by Malegam Committee paved way for the introduction of the book building process in the capital market in Oct 1995. Book building involves firm allotment of the instrument to a syndicate created by the lead managers who sell the issue at an acceptable price to the public. Originally the potion of book building process was available to companies issuing more than Rs.100 cr. The restriction on the minimum size was removed and SEBI gave impression to adopt the book building method to issue of any size. In the prospectus, the company has to specify the placement portion under book building process. The securities available to the public are separately known as net offer to the public. Nirma by offering a maximum of 100 lakh equity shares through this process was set to be the first company to adopt the mechanism.

Among the lead managers or the syndicate members of the issue or the merchant bankers as member. The issuer company as a book runner nominates this member and his name is mentioned in the draft prospectus. The book runner has to circulate the copy of the draft prospectus to be filed with SEBI among the institutional buyers who are eligible for firm allotment. The draft prospectus should indicate the price band within which the securities are being offered for subscription.

The offers are sent to the book runners. He maintains a record of names and number of securities offered and the price offered by the institutional buyer within the placement portion and the price for which the order is received to the book runners. The book runner and the issuer company finalize the price. The issue price for the placement portion and offer to the public should be the same. Underwriting agreement is entered into after the fixation of the price.

One day earlier to the opening of the issue to the public, the book runner collects the application forms along with the application money from the institutional buyers and the underwriters. The book runner and other intermediaries involved in the book building process should maintain records of the book building process. The SEBI has the right to inspect the records.

## BOOK BUILDING THROUGH ONLINE IPO

Book building as discussed earlier is a process of offering securities in which bids at various prices from investors through syndicate members are collected. Based on bids, demand for the security is assessed and its price discovered. In case of normal public issue, investor knows the price in advance and the demand is known at the close of the issue. In case of public issue through book building, demand can be known at the end of everyday but price is known at the close of issue.

An issuer company proposing to issue capital through book building has two options viz., 75% book building route and 100% book building route. In case of 100% book building route is adopted, not more than 60% of net offer to public can be allocated to QIBs (Qualified Institutional Buyers), not less than 15% of the net offer to the public can be allocated to non-institutional investors applying for more than 1000 shares and not less than 25% of the net offer to public can be allocated to retail investors applying for up to 1000 shares. In case 75% of net public offer is made through book building, not more than 60% of the net offer can be allocated to QIBs and not less than 15% of the net offer can be allocated to non-institutional investors. The balance 25% of the net offer to public, offered at a price determined through book building, are available to retail individual investors who have either not participated in book building or have not received any allocation in the book built portion. Allotment to retail individual or non-institutional investors is made on the basis of proportional allotment system. In case of under subscription in any category, the un-subscribed portions are allocated to the bidder in other categories. The book built portion, 100% or 75%, as the case may be, of the net offer to public, are compulsorily underwritten by the syndicate members or book runners.

Other requirements for book building include:

* Bids remain open for at least 5 days.
* Only electronic bidding is permitted.
* Bids are submitted through syndicate members.
* Bids can be revised.
* Bidding demand is displayed at the end of every day.
* Allotments are made not later than 15 days from the closure of the issue etc.

The 100% book building has made the primary issuance process comparatively faster and cost effective and trading can commence from T+16.

The SEBI guidelines for book building provides that the company should be allowed to disclose the floor price, just prior to the opening date, instead of in the Red herring prospectus, which may be done by any means like a public advertisement in newspaper etc. Flexibility should be provided to the issuer company by permitting them to indicate a 20% price band. Issuer may be given the flexibility to revise the price band during the bidding period and the issuers should be allowed to have a closed book building i.e. the book will not be made public. The mandatory requirement of 90% subscription should not be considered with strictness, but the prospectus should disclose the amount of minimum subscription required and sources for meeting the shortfall. The Primary Market Advisory Committee recommended the practice of ‘green-shoe option’ available in markets abroad which is an ‘over allotment’ option granted by the issuer to the underwriter in a public offering. This helps the syndicate member to over allocate the shares to the extent of option available and to consequently purchase additional shares from the issuer at the original offering price in order to cover the over-allotments.

**ON-LINE INITIAL PUBLIC OFFERS (IPO)**

A company proposing to issue capital to public through on-line system of the stock exchange has to comply with Section 55 to 68A of the Companies Act, 1956 and SEBI Guideline, 2000. The company is required to enter into an agreement with the stock exchange(s), which have the requisite system for on-line offer of securities. The agreement should cover rights, duties, responsibilities and obligations of the company and the stock exchanges inter-se, with provision for a dispute resolution mechanism between the company and the stock exchange. The issuer company appoints a Registrar to the Issue having electronic connectivity with the stock exchanges. The issuer company can apply for listing of its securities at any exchange through which it offers its securities to public through on-line system, apart from the requirement of listing on the regional stock exchange. The stock exchange appoints brokers for the purpose of accepting applications and placing orders with the company. The lead manager would co-ordinate all the activities amongst various intermediaries connected in the system.

In addition to the above, the SEBI guidelines also provide details of the contents of the offer document and advertisement, other requirements for issues of securities, like those under Rule 19(2)(b) of SC(R) Rules, 1957. The guidelines also lay down detailed norms for issue of debt instruments, Issue of capital by designated financial institutions and preferential/bonus issues.

# BOOK BUILDING THROUGH ON-LINE IPO SYSTEM

Book building is basically a process used in IPO for efficient price discovery, wherein during the period for which the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The offer price is determined after the bid closing date. In it’s strive to continuously improve Indian Securities Market; NSE offers its infrastructure for conducting online IPOs through book building. It helps to discover price as well as demand for a security to be issued through a process of bidding by investors. The advantages of this new system are:

* The investor parts with money only after allotment,
* It eliminates refunds except in case of direct applications and,
* It reduces the time taken for issue process.

The securities get listed within 15 days from the closure of the issue. Though the guidelines for book building were issued in 1995, it is being used for IPOs from 1999. Till June 2003, 19 issuers have used this route for making IPO issues. During 2002-03, two issuers used the on-line IPO system of NSE to issue 71.66 lakh shares.

## ELIGIBILITY TO ISSUE SECURITIES

The issues of capital to public by Indian companies are governed by the Disclosure and Investor Protection (DIP) Guidelines of SEBI, which were issued in June 1992. SEBI has been issuing clarifications to these guidelines from time to time aiming at streamlining the public issue process. In order to provide a comprehensive coverage of all DIP guidelines, SEBI issued a compendium series in January 2000, known as SEBI (DIP) Guidelines, 2000. The guidelines provide norms relating to eligibility for companies issuing securities, pricing of issues, listing requirements, disclosure norms, lock-in period for promoter’s contribution, contents of offer documents, pre-and post-issue obligations, etc. The guideline applies to all public issues, offers for sale and rights issues by listed and unlisted companies.

***Eligibility Norms:*** Any company issuing securities through the offer document has to satisfy the following conditions:

* A company making a public issue of securities has to file a draft prospectus with SEBI, through an eligible merchant banker, at least 21 days prior to the filing of prospectus with the Registrar of Companies (RoCs). The filing of offer document is mandatory for a listed company issuing security through a rights issue where the aggregate value of securities, including premium, if any, exceeds Rs.50 lakh. A company cannot make a public issue unless it has made an application for listing of those securities with stock exchanges(s). The company must also have entered into an agreement with the depository for dematerialization of its securities and also the company should have given an option to subscribers/ shareholders/ investors to receive the security certificates or securities in dematerialized form with the depository. A company cannot make an issue if the company has been prohibited from accessing the capital market under any order or discretion passed by SEBI.
* An unlisted company can make public issue of equity shares or any other security convertible into equity shares, on fixed price basis or on book building basis, provided:

1. It has a pre-issue net worth of not less than Rs.1 crore in 3 out of the preceding 5 years and has minimum net worth in immediately preceding two years,
2. It has a track record of distributable profits in terms of section 205 of the Companies Act, 1956, for at least 3 out of immediately preceding 5 years, and
3. The issue size (offer through offer document + firm allotment + promoters contribution through the offer document) does not exceed five times its pre-issue net worth.
4. A listed company is eligible to make a public issue, on fixed price basis or on book building basis, if the issue size does not exceed five times its pre-issue net worth.

If the company, listed or unlisted, does not meet the above criteria, then the issue will have to be compulsorily made through book building route. In such a case, 60% of the issue size will have to be allotted to the ‘Qualified Institutional Buyers’ (QIBs) failing which the full subscription money shall be refunded.

* Infrastructure companies are exempt from the requirement of eligibility norms if their project has been appraised by a public financial institution or infrastructure development finance corporation or infrastructure leasing and financing services and not less than 5% of the project cost is financed by any of the institutions, jointly or severally, by way of loan and/or subscription to equity or a combination of both. Banks and rights issues of listed companies are also exempt from the eligibility norms.
* For public and rights issues of debt instruments irrespective of their maturities or conversion period, it is mandatory to obtain credit rating from a registered credit rating agency and to disclose the same in the offer document. If the credit rating is obtained from more than one credit rating agency, all the credit ratings, including the rejected ones, need to be disclosed. For a public and rights issue of debt securities with issue size greater than or equal to Rs.100 crore, credit rating from two rating agencies is mandatory. In case of issue of debentures with maturity of more than 18 months, the issuer shall create a debenture redemption reserve and appoint a debenture trustee to protect the interest of debenture holders.

Thus the quality of the issue is demonstrated by track record/appraisal by approved financial institutions/credit rating/subscription by QIBs.

## PRICING OF ISSUES

The Controller of Capital Issues Act governed issue of capital prior to May 27, 1992 1947. Under the Act, the premium was fixed as per the valuation guidelines issued. The guidelines provided for fixation of a fair price on the basis of the net asset value per share on the expanded equity base taking into account, the fresh capital and the profit earning capacity.

The repealing of the Capital Issue Control Act resulted in an era of free pricing of securities. Issuers and merchant bankers fixed the offer prices. Pricing of the public issue has to be carried out according to the guidelines issued by SEBI.

***At Premium:*** Companies are permitted to price their issues at premium in the case of the following:

* First issue of new companies set up by existing companies with the track record.
* First issue of existing private/closely held or other existing unlisted companies with three-year track record of consistent profitability.
* First public issue by exiting private/closely held or other existing unlisted companies without three-year track record but promoted by existing companies with a five-year track record of consistent profitability.
* Existing private/closely held or other existing unlisted company with three-year track record of consistent profitability, seeking disinvestments by offers to public without issuing fresh capital (disinvestments).
* Public issue by existing listed companies with the last three years of dividend paying track record.

***At Par Value:*** In certain cases companies are not permitted to fix their issue prices at premium. The prices of the share should be at par. They are for:

* First public issue by existing private, closely held or other existing unlisted companies without three-year track record of consistent profitability and
* Existing private/closely held and other unlisted companies without three-year track record of consistent profitability seeking disinvestments offer to public without issuing fresh capital (disinvestments).

## FIXED VERSUS BOOK BUILDING ISSUES

The main difference between offer of shares through book building and offer of shares through normal public issue can be identified on the following parameters:

* ***Price***at which securities will be allotted is not known in case of offer of shares through Book Building while in case of offer of shares through normal public issue, price is known in advance to investor. Under Book Building, investors bid for shares at the floor price or above and after the closure of the book building process the price is determined for allotment of shares.
* In case of Book Building, the ***demand***can be known everyday as the book is being built. But in case of the public issue the demand is known at the close of the issue.

AMERICAN DEPOSITORY RECEIPTS (ADRs)/ GLOBAL DEPOSITORY RECEIPTS (GDRs)

Indian companies are permitted to raise foreign currency resources through two main sources:

* Issue of Foreign Currency Convertible Bonds (FCCBs)
* Issue of Ordinary equity shares through depository receipts, namely, Global Depository Receipts/ American Depository Receipts to foreign investor’s i.e. institutional investors or investors residing abroad.

A Depository Receipt (DR) is any negotiable instrument in the form of a certificate denominated in US dollars. The certificate is issued by an overseas depository bank against certain underlying stocks/shares. The shares are deposited by the issuing company with the depository bank. The depository bank in turn tenders DRs to the investors. A DR represents a particular bunch of shares on which the receipt holder has the right to receive dividend, other payments and benefits which company announces from time to time for the shareholders. However, it is non-voting equity holding. DRs facilitate cross border trading and settlement, minimize transaction cost and broaden the potential base, especially among institutional investors. More and more Indian companies are raising money through ADRs and GDRs these days.

**WHAT ARE ADRs OR GDRs?**

American Depositary Receipts (ADRs) are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. These are deposited in a custodial account in the US. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange. ADRs are issued by an approved New York bank or trust company against the deposit of the original shares. When transactions are made, the ADRs change hands, not the certificates. This eliminates the actual transfer of stock certificates between the US and foreign countries.

Global Depositary Receipts (GDRs) are negotiable certificate held in the bank of one country representing a specific number of shares of a stock traded on the exchange of another country. This is a financial instrument used by the companies to raise capital in either dollars or Euros. GDRs are also called European Depositary Receipt. These are mainly traded in European countries and particularly in London.

However, ADRs and GDRs make it easier for individuals to invest in foreign companies, due to the widespread availability of price information, lower transaction costs, and timely dividend distributions.

**WHY DO COMPANIES GO FOR ADRs OR GDRs?**

Indian companies need capital from time to time to expand their business. If any foreign investor wants to invest in any Indian company, they follow two main strategies. Either the foreign investors can buy the shares in Indian equity markets or the Indian firms can list their shares abroad in order to make these shares available to foreigners.

But the foreign investors often find it very difficult to invest in India due to poor market design of the equity market. Here, they have to pay hefty transaction costs. This is an obvious motivation for Indian firms to bypass the incompetent Indian equity market mechanisms and go for the well-functioning overseas equity markets. When they issue shares in forms of ADRs or GDRs, their shares commanded a higher price over their prices on the Indian bourses.

Another problem faced by the foreign investors is restrictions on equity ownership by foreigners. Only foreign institutional investors can buy shares in India whereas in case of ADRs or GDRs, anyone can buy this. FIIs face restrictions of ceilings or stakes in Indian companies. In contrast, there is no such restriction on GDRs or ADRs, and hence GDRs or ADRs generally enjoy a premium.

**WHICH INDIAN COMPANIES ARE LISTED ABROAD?**

Infosys Technologies was the first Indian company to be listed on NASDAQ in 1999. However, the first Indian firm to issue sponsored GDR or ADR was Reliance industries Limited. Beside, these two companies there are several other Indian firms are also listed in the overseas bourses. These are Satyam Computer, Wipro, MTNL, VSNL, State Bank of India, Tata Motors, Dr Reddy's Lab, Ranbaxy, Larsen & Toubro, ITC, ICICI Bank, Hindalco, HDFC Bank and Bajaj Auto.

**WHAT ARE THE PRICES OF INDIAN ADRs & GDRs?**

The ADR and GDR prices of the Indian companies are much higher compared to the prices on the Indian bourses. While, Infosys trades at $72.14 at NASDAQ, it quotes at Rs 2,245 on the BSE. Satyam at $24.25, Wipro at $21.50, Tata Motors at $10.20, MTNL at $6.34, Dr Reddy's Lab at $16.27, HDFC Bank at $41.94, Bajaj Auto at $28.14, RIL at $24.83 and ITC at $35.30 were all quoting at a higher price than their Indian peers.

**HOW TO TRADE IN ADRs?**

ADRs can be traded either by trading existing ADRs or purchasing the shares in the issuer's home market and having new ADRs created, based upon availability and market conditions.

When trading in existing ADRs, the trade is executed on the secondary market on the New York Stock Exchange (NYSE) through Depository Trust Company (DTC) without involvement from foreign brokers or custodians. The process of buying new, issued ADRs goes through US brokers, Helsinki Exchanges and DTC as well as Deutsche Bank.

**WHAT ARE THE NORMS FOR INDIAN ADRs AND GDRs?**

There are no ceilings on investment in ADRs or GDRs. An applicant company seeking the government's approval in this regard should have a consistent good track record for a minimum period of 3 years. This condition can be relaxed for infrastructure projects such as power generation, telecomm, petroleum exploration and refining, ports, airports and roads.

There is no restriction on the number of GDRs or ADRs to be floated by a company or a group of companies in a financial year. The government has also relaxed the conversion and re-conversion (i.e. two-way conversion or fungibility) of shares of Indian companies into depository receipts listed in foreign bourses.

The companies have been allowed to invest 100 per cent of the proceeds of ADR or GDR issues for acquisitions of foreign companies and direct investments in joint ventures.

## ALLOTMENT OF SHARES

# PROHIBITION OF ALLOTMENT UNLESS MINIMUM SUBSCRIPTION RECEIVED

* A company’s offer to the public for subscription of equity shares cannot be allotted unless the minimum amount is subscribed for. This minimum amount is decided by the Board of Directors, which according to them must be raised by the issue of share capital in order to provide for the specific objective as mentioned in the prospectus and which has been subscribed by the public for.
* The amount payable on application on each share cannot be less than five per cent of the nominal amount of the share.
* All money received from applicants for issue of shares is kept deposited in a Schedule Bank until the certificate to commence business is obtained by the company. Where such certificate has already been obtained, the deposits are kept until the company has received the entire amount payable on applications for shares up to minimum subscription.
* On the expiry of 120 days after the issue of the prospectus, if the above conditions are not complied with, all money received from applicants has to be repaid without interest. Incase money is not repaid within 130 days after the issue of the prospectus, directors of the company is held responsible to repay that money with interest at the rate of 6% per annum from the expiry of the 130th day.
* The above conditions do not apply to any allotment of shares made subsequent to the first allotment of share by the company to the public.

# PROHIBITION OF ALLOTMENT IN CERTAIN CASES UNLESS STATEMENT IN LIEU OF PROSPECTUS DELIVERED TO REGISTRAR

* If a company having a share capital did not issue a prospectus or has issued a prospectus but has not proceeded to allot any of the shares offered to the public for subscription, cannot allot any of its shares or debentures unless at least 3 days before the first allotment of either shares or debentures it has delivered a statement in lieu of prospectus signed by all director in writing to the Registrar for registration.
* This prohibition of allotment does not apply to a private company.
* If this statement in lieu of prospectus delivered to the Registrar includes any untrue statement, then the person authorizing the delivery is held responsible and is liable for punishment. This is a punishable offence with imprisonment for a term up to 2 years or with fine which may be up to the extend of 50000 or with both.

# EFFECT OF IRREGULAR ALLOTMENT

* An allotment made by a company to an applicant shall be void able at the instance of the applicant – (a) within two months after the holding of the statutory meeting of the company, and not later or; (b) in case where the company is not required to hold a statutory meeting or where the allotment is made after the holding of the statutory meeting, within two months after the date of the allotment and not later.
* If any director of a company is responsible of willful contravention of any of the provisions of allotment, he is liable to compensate the company and the allottees for any loss incurred thereby. Provided any such proceedings to recover losses is not commenced after the expiration of two years from the date of the allotment.

# APPLICATIONS FOR, AND ALLOTMENT OF, SHARES AND DEBENTURES

* The applications for allotment of share or debentures of a company, done through a prospectus issue, is not done until the beginning of the 5th day after the prospectus is first issued or any time later as specified in the prospectus.
* The validity of an allotment is not affected by any contravention of the above point, but in the event of any such contravention, every officer of the company is held responsible and subject to a punishment of fine up to the extend of Rs.50000.
* An application for shares or debentures of a company made through issue of a prospectus is generally not revocable until after the expiration of the 5th day after the opening of the subscription.

# ALLOTMENT OF SHARES AND DEBENTURES TO BE DEALT IN ON STOCK EXCHANGE

* Every company intending to offer shares or debentures to the public for subscription by the issue of a prospectus shall, before making such issue is required to make an application to one or more recognized stock exchanges for seeking permission to list the shares and debentures such issued on the stock exchanges. Where an appeal against the decision of any recognized stock exchange refusing permission for the shares or debentures to be listed on the stock exchange has been preferred, such allotment shall not be void until the dismissal of the appeal.
* Where the permission has not been applied, the company will repay all money received from applicants without interest, and if, any such money is not repaid within 8 days after the company becomes liable to repay it, the directors are held responsible. From the expiry of 8th day, they will be jointly liable to repay that money with interest, not less than 4% and not more than 15%, depending upon the length of the period of delay in making the repayment of such money.
* All money received as aforesaid shall be kept in a separate bank account maintained with a Scheduled Bank, and if default is made in complying with the conditions aforesaid, then every officer of the company is held responsible and this offense is punishable with fine which may extend to 50000 rupees. Money standing to the credit of the separate bank account, shall not be utilized for any purpose other than the following purposes, namely – (a) adjustment against allotment of shares, where the shares have been permitted to be listed on the stock exchanges as specified in the prospectus; or (b) repayment of money received from applicants, where shares have not been permitted to be listed on the stock exchanges as specified in the prospectus.
* No prospectus shall state that application has been made for permission for the shares or debentures offered thereby to be listed on any stock exchange, unless it is recognized stock exchange.

# RETURN AS TO ALLOTMENTS

Whenever a company having a share capital makes any allotment of its shares, the company shall, within 30 days thereafter:

* File with the Registrar a return of the allotments, stating the number and nominal amount of the shares comprised in the allotment, the names, addresses and occupations of the allottees, and the amount, if any, paid or due and payable on each shares.
* In the case of shares (not being bonus shares) allotted as fully or partly paid-up, is produced for inspection and examination of the Registrar in the form of a contract constituting the title of the allottee to the allotment together with any contract of sale or services or other consideration in respect of which that allotment was made. This contract is duly stamped and filed with the Registrar.
* In the case of bonus shares a return stating the number and nominal amount of such shares comprised in the allotment and the names, addresses and occupations of the allottees and a copy of the resolution authorizing the issue of such shares is filed with the Registrar.
* In the case of issue of shares at a discount, a copy of the resolution passed by the company authorizing such issue together with a copy of the order of the Tribunal sanctioning the issue and where the maximum rate of discount exceeds 10%, a copy of the order of the Central Government permitting the issue at the higher percentage is filed with the Registrar.
* If default is made in complying with the conditions aforesaid, every officer of the company is held responsible and this offense is punishable with fine, which may extend to 5000 rupees for every day during which the default continues.
* No aforesaid conditions will apply to the issue and allotment of shares by a company, which under the provisions of its articles were forfeited for non-payment of calls.

## BASIS OF ALLOTMENT

According to SEBI regulation, the allocation of shares is done under proportionate allotment method. The allotment for each category is inversely proportional to the over subscription ratio. The applications will be categorized according to the number of shares applied for. The allocation is done by proportionate basis. If the allocation to a applicant works out to be more than hundred but is not a multiple of hundred, the number excess of hundred and fifty would be rounded off to the higher multiple of 100 i.e. 200. If it were 148 then, it would be rounded off to 100. If the shares allocated on a proportionate basis to any category are more than the shares allotted to applications in that category, the balance share allotment shall be first adjusted against any other category where the allotment of shares are not sufficient for proportionate allotment in that category. The balance shares, if any remaining after such adjustment will be added to the category comprising of applicants applying for minimum number of shares.

# ALLOTMENT METHOD

Total number of applicants in the category of 100s = 2000

Total number of shares applied for = 2,00,000

Number of times over subscribed = 5

Proportionate allotment to that category (2,00,000 × 1/5) = 40,000

Since the allotment has to be made in marketable lots, 100 shares will be allotted to 400 people.

# ILLUSTRATION

*Basis of Allocation – Reliance Petroleum Limited* ***(Incorporated under the Companies Act, 1956 on October 24, 2005)***

***Issue Detail:*** Issue of 135,00,00,000 equity shares of Rs.10 each for cash at a price of Rs.60 per equity share (Including a share premium of Rs.50 per equity share) aggregating to Rs.81,000 million including promoter contribution of 90,00,00,000 equity shares of Rs.10 each for cash at a price of Rs.60 per share (“Promoter Contribution”) and the net issue to public of 45,00,00,000 equity shares of Rs.10 each (“Net Issue”). The net issue will constitute 10% of the fully diluted post issue paid up capital of Reliance Petroleum Limited (“Company” or “Issuer”). The face value per equity share is Rs.10. The issue price per equity share is Rs.60 and it is 6 times of the face value.

The issue was made through the 100% Book Building Process where at least 60% of the Net Issue was to be allocated on proportionate basis to Qualified Institutional Buyers (“QIBs”) (including 5% of the QIB portion that was to specifically be allotted to mutual funds on proportionate basis). Further, not less than 10% of the Net Issue was available for allocation on proportionate basis to Non-Institutional Bidders and not less than 30% of the Net Issue was available for allocation on proportionate basis to Retail Bidders, subject to valid bids being received at or above the Issue Price.

The Issue received 21,08,279 applications for 23,04,97,33,824 equity shares resulting in 51.22 times subscription. The details of the applications received in the Issue from Qualified Institutional Buyers, Non-Institutional and Retail Individual Investors categories are as under (*Before technical rejections*):

|  |  |  |  |
| --- | --- | --- | --- |
| **Category** | No. of Applications | **No. of Shares** | **Subscription** |
|  |  |  |  |
| Retail Bidders | 2094659 | 2011656932 | 14.90 |
| Non Institutional Bidders | 13209 | 2622131892 | 58.27 |
| Qualified Institutional Bidders | 411 | 18415945000 | 68.20 |
|  |  |  |  |

***Final Demand:*** The final demand at different bid prices is as under:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Bid Price | **No. of Shares** | % to Total | **Cumulative Total** | **Cumulative % to Total** |
|  |  |  |  |  |
| 57 | 3493900 | 0.02 | 23087276300 | 100.00 |
| 58 | 1031800 | 0.00 | 23083782400 | 99.98 |
| 59 | 107000 | 0.00 | 23082750600 | 99.98 |
| 60 | 34334100 | 0.15 | 23082643600 | 99.98 |
| 61 | 2020200 | 0.01 | 23048309500 | 99.83 |
| 62 & Cut Off | 23046289300 | 99.82 | 23046289300 | 99.82 |
|  |  |  |  |  |
|  | **23087276300** | **100.00** |  |  |
|  |  |  |  |  |

The Basis of Allocation was finalized in consultation with Bombay Stock Exchange Limited on May 3, 2006. The Committee of Directors of the Company at its Meeting held at Hyderabad on May 3, 2006 has approved the following Basis of Allocation of shares of the Issue and has allotted the shares to the successful applicants.

***Allocation to Retail Investors:*** The category was subscribed 13.80 times. The total number of shares allotted in this category is 13,50,00,000 equity shares and the number of allottees is 1247592. The category-wise details of the Basis of Allocation (*Sample*) are as under:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Category | **No. of Applications** | **% to Total** | **Total No. of Shares Applied** | **% to Total** | No. of Shares Allocated | **Ratio** | **Total No. of Shares Allocated** |
|  |  |  |  |  |  |  |  |
| 100 | 74871 | 3.86 | 7487100 | 0.40 | 100 | 5:69 | 542500 |
| 200 | 100887 | 5.20 | 20177400 | 1.08 | 100 | 10:69 | 1462100 |
| 300 | 67209 | 3.47 | 20162700 | 1.08 | 100 | 15:69 | 1461100 |
| 400 | 64367 | 3.32 | 25746800 | 1.38 | 100 | 20:69 | 1865700 |
| 500 | 189368 | 9.76 | 94684000 | 5.08 | 100 | 25:69 | 6861200 |
| 600 | 45310 | 2.34 | 27186000 | 1.46 | 100 | 3:7 | 1941900 |
| 700 | 34686 | 1.79 | 24280200 | 1.30 | 100 | 1:2 | 1734300 |
| 800 | 562408 | 29.00 | 449926400 | 24.14 | 100 | 40:69 | 32603400 |
| 900 | 5022 | 0.26 | 4519800 | 0.24 | 100 | 5:8 | 313900 |
| 1000 | 115074 | 5.93 | 115074000 | 6.17 | 100 | 55:76 | 8327700 |
| 1100 | 8673 | 0.45 | 9540300 | 0.51 | 100 | 11:14 | 681500 |
| 1200 | 10712 | 0.55 | 12854400 | 0.69 | 100 | 6:7 | 918200 |
| 1300 | 3446 | 0.18 | 4479800 | 0.24 | 100 | 14:15 | 321600 |
| 1400 | 3440 | 0.18 | 4816000 | 0.26 | 101 | FIRM | 347440 |
| ***ADDITIONAL*** | | | | | 100 | 9:16 | 1944 |
| 1500 | 32200 | 1.66 | 48300000 | 2.59 | 109 | FIRM | 3509800 |
| 1600 | 621601 | 32.05 | 994561600 | 53.36 | 116 | FIRM | 72105716 |
|  |  |  |  |  |  |  |  |

***Allocation to Non Institutional Investors:*** The category was subscribed 57.59 times. The total number of shares allotted in this category is 450,00,000 equity shares and the number of allottees is 7328. The category-wise details of the Basis of Allocation (*Sample*) are as under:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Category | **No. of Applications** | **% to Total** | **Total No. of Shares Applied** | **% to Total** | No. of Shares Allocated | **Ratio** | **Total No. of Shares Allocated** |
|  |  |  |  |  |  |  |  |
| 1700 | 299 | 3.41 | 508300 | 0.02 | 100 | 3:10 | 9000 |
| 1800 | 71 | 0.81 | 127800 | 0.00 | 100 | 1:3 | 2400 |
| 10000 | 416 | 4.75 | 4160000 | 0.16 | 174 | FIRM | 72384 |
| 50000 | 137 | 1.56 | 6850000 | 0.26 | 868 | FIRM | 118916 |
| 100000 | 177 | 2.02 | 17700000 | 0.68 | 1736 | FIRM | 307272 |
| 120000 | 7 | 0.08 | 840000 | 0.03 | 2083 | FIRM | 14581 |
| 150000 | 48 | 0.55 | 7200000 | 0.28 | 2604 | FIRM | 124992 |
| 200000 | 50 | 0.57 | 10000000 | 0.39 | 3472 | FIRM | 173600 |
| 500000 | 48 | 0.55 | 24000000 | 0.93 | 8681 | FIRM | 416688 |
| 1000000 | 15 | 0.17 | 15000000 | 0.58 | 17362 | FIRM | 260430 |
| 1500000 | 6 | 0.07 | 9000000 | 0.35 | 26044 | FIRM | 156264 |
| 2000000 | 6 | 0.07 | 12000000 | 0.46 | 34725 | FIRM | 208350 |
| 4000000 | 6 | 0.07 | 24000000 | 0.93 | 69450 | FIRM | 416700 |
| 5000000 | 1 | 0.01 | 5000000 | 0.19 | 86812 | FIRM | 86812 |
| 11300000 | 1 | 0.01 | 11300000 | 0.44 | 196195 | FIRM | 196195 |
| 32258000 | 2 | 0.02 | 64516000 | 2.49 | 560077 | FIRM | 1120154 |
| 93540000 | 1 | 0.01 | 93540000 | 3.61 | 1624080 | FIRM | 1624080 |
| 111290000 | 1 | 0.01 | 111290000 | 4.29 | 1932244 | FIRM | 1932244 |
|  |  |  |  |  |  |  |  |

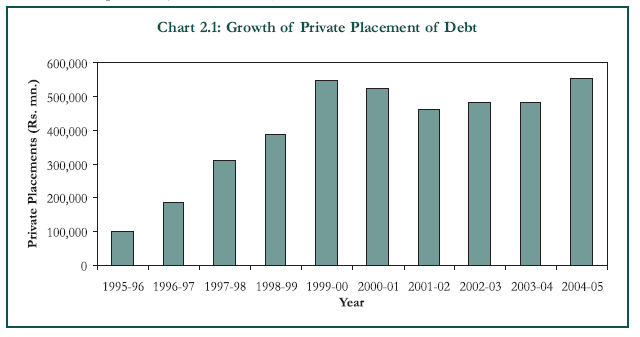
***Allocation to QIBs:*** The category was subscribed 68.20 times. Allocations to QIBs have been done on a proportionate basis. As per the SEBI guidelines, Mutual Funds were initially allotted 5% of the quantum of shares available (135,00,000) on proportionate basis and other QIBs and unsatisfied demands of Mutual Funds were allotted the remaining available shares (2565,00,000) on proportionate basis. The sectoral cap and other limits applicable to the holding of shares in company have been taken into account while allotting shares. Mutual Funds were allotted 11.51% for QIB segment and other QIB applicants were allotted 88.49% of the shares for QIB segment. The total number of allottees is 411.

|  |  |
| --- | --- |
| **Category** | **No. of Shares** |
|  |  |
| FIs/Banks | 15861666 |
| MFs | 31072909 |
| FIIs | 216366000 |
| VC | 17714 |
| Insurance Companies | 6681711 |
|  |  |
| **Total** | **270000000** |

## PRIVATE PLACEMENT

The private placement involves issue of securities, debt or equity, to selected subscribers, such as banks, FIs, MFs and high net worth individuals. It is arranged through a merchant/investment banker, who acts as an agent of the issuer and brings together the issuer and the investor(s). Since these securities are allotted to a few sophisticated and experienced investors, the stringent public disclosure regulations and registration requirements are relaxed. The Companies Act, 1956, states that an offer of securities to more than 50 persons is deemed to be public issue.

In sharp contrast to a shrinking public issues market for corporate securities, the last few years have witnessed huge resource mobilization through private placement. According to Prime Database estimates, a total of 114 issuers (institutional and corporate) raised Rs.5,51,838 million through 319 privately placed issues in 2004-05. 176 issues out of 319 were made by the government sector units, which together mobilized 82% of the total. The amount raised through the private placement of debt issues have been on an increasing trend over the past few years (Chart 2.1).



Mostly, debt securities were privately placed. Though, there were some instances of private placements of equity shares, there is no comprehensive data coverage of this. The two sources of information regarding private placement market in India are Prime Database and RBI. The former data set, however, pertains exclusively to debt issues. RBI data, which is compiled from information gathered from arrangers, covers equity private placements also. RBI estimates the share of equity in total private placements as rather insignificant. Some idea, however, can be derived from the equity shares issued by NSE-listed companies on private placement basis. A total of 96 companies privately placed equities mobilizing around Rs.58,982 million during 2004-05.

Of the 319 debt private placements, 176 (55%) were from the government/banking sector that together mobilized 82% of the total amount mobilized. The All India Financial Institutions (AIFIs) & Banks continued to top the list with 59% (Rs.326,522 million), followed by the Private Sector Undertakings with 18% share (Rs.101,910 million). The top ‘10’ issuers accounted for 53.9% of total private placement during 2004-05.

### Table: Issuer-wise Distribution of Private Placement of Debt

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Issuer | **Issue Amount (Rs. mn.)** | | **% of Issue Amount** | |
| **2003-04** | **2004-05** | **2003-04** | **2004-05** |
|  |  |  |  |  |
| All India Financial Institutions/Banks | 253,088 | 326,522 | 52.26 | 59.17 |
| State Financial Institutions | 42,084 | 23,808 | 8.69 | 4.31 |
| Public Sector Undertakings | 58,809 | 64,412 | 12.14 | 11.67 |
| State Level Undertakings | 65,642 | 35,186 | 13.55 | 6.38 |
| Private Sector | 64,656 | 101,910 | 13.35 | 18.47 |
|  |  |  |  |  |
| **Total** | **484,279** | **551,838** | **100.00** | **100.00** |

Source: Prime Database

Sectoral distribution shows that the banking and financial services continued to dominate the private placement market, raising 64% in 2004-05 followed by power sector, which accounted for 16% during the year.

### Table: Sectoral Distribution of Resources Mobilized by Private Placement

### (In per cent)

|  |  |  |
| --- | --- | --- |
|  | **2003-04** | **2004-05** |
|  |  |  |
| Financial & Banking | 76 | 64 |
| Power | 17 | 16 |
| Water Resources | 5 | 2 |
| Telecommunications | 1 | 2 |
| Others | 1 | 10 |
|  |  |  |
| **Total** | **100** | **100** |

Source: Prime Database

The maturity profile of issues in the private placement market ranged between 12 months to 204 months during 2004-05. The largest number of placements was for 36 months (87 placements) and 60 months (57 placements). A total of 78 offers had a put option, while 83 offers had a call option.

Unlike public issues of bonds, it is not mandatory for corporate issuing bonds in the private placement market to obtain and disclose credit rating from an approved credit rating agency. Rating is, however, required for listing. Of the 319 debt private placement deals during 2004-05, 297 issues (93%) went for rating and 22 did not get rated.

Private placement accounted for 68.4% of total resources mobilized by the corporate sector from the primary market. The corresponding share of public issues was a meager 26.6%.

### Table: Resources Raised by Corporate Sector

### (Amount in Rs. mn.)

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Year** | **Public Equity Issues** | **Debt Issues** | | | **Total Resource Mobilization (2+5)** | **Share (%) of Private Placement in** | | **Share (%) of Debt in Total Resource Mobilization (5/6\*100)** |
| **Public Issues** | **Private Placements\*** | **Total (3+4)** | **Total Debt (4/5\*100)** | **Total Resource Mobilization (4/6\*100)** |
| **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** |
|  |  |  |  |  |  |  |  |  |
| 1995-96 | 88,820 | 29,400 | 100,350 | 129,750 | 218,570 | 77.34 | 45.91 | 59.36 |
| 1996-97 | 46,710 | 69,770 | 183,910 | 253,680 | 300,390 | 72.50 | 61.22 | 84.45 |
| 1997-98 | 11,320 | 19,290 | 309,830 | 329,120 | 340,450 | 94.14 | 91.01 | 96.67 |
| 1998-99 | 5,040 | 74,070 | 387,480 | 461,550 | 466,580 | 83.95 | 83.05 | 98.92 |
| 1999-00 | 29,750 | 46,980 | 547,010 | 593,990 | 623,740 | 92.09 | 87.70 | 95.23 |
| 2000-01 | 24,790 | 41,390 | 524,335 | 565,725 | 590,520 | 92.68 | 88.79 | 95.80 |
| 2001-02 | 10,820 | 53,410 | 462,200 | 515,610 | 526,430 | 89.64 | 87.80 | 97.94 |
| 2002-03 | 10,390 | 46,930 | 484,236 | 531,166 | 541,556 | 91.16 | 89.42 | 98.08 |
| 2003-04 | 178,210 | 43,240 | 484,279 | 527,519 | 705,729 | 91.80 | 68.62 | 74.75 |
| 2004-05 | 214,320 | 40,950 | 551,838 | 592,788 | 807,108 | 93.09 | 68.37 | 73.45 |
|  |  |  |  |  |  |  |  |  |

\*Data from 2000-01 onwards include only issues with a tenor and put/call option of 1 year or more, while data for earlier years include all privately placed debt issues irrespective of tenor.

*Source:* Prime Database

**Unit -IV**

## MUTUAL FUNDS

Mutual funds are investment companies that use the funds from investors to invest in other companies or investment alternatives. They have the advantage of professional management, diversification, convenience and special services such as cheque writing and telephone account service. It is generally easy to sell mutual fund shares/units although you run the risk of needing to sell and being forced to take the price offered. Mutual funds come in various types, allowing you to choose those funds with objectives, which most closely match your own personal investment objectives. A load mutual fund is one that has sales charge or commission attached. The fee is a percentage of the initial investment. Generally, mutual funds sold through brokers are load funds while funds sold directly to the public are no-load or low-load. As an investor, you need to decide whether you want to take the time to research prospective mutual funds yourself or pay the commission and have a broker who will do that for you. All funds have annual management fees attached.

Mutual Fund Schemes may be classified on the Basis of its Structure and its Investment Objective. Let us first discuss the classification by Structure:

## Open - Ended Mutual Funds

An open-ended mutual fund is the one whose units can be freely sold and repurchased by the investors. Such funds are not listed on bourses since the Asset Management Companies (AMCs) provide the facility for buyback of units from unit-holders either at the NAV, or NAV-linked prices. Instant liquidity is the USP of open-ended funds: you can invest in or redeem your units at will in a matter of 2-3 days. In the event of volatile markets, open-ended funds are also suitable for investment appreciation in the short-term. This is how they work: if you expect the interest rates to fall, you park your money in an open-ended debt fund. Then, when the prices of the underlying securities rise, leading to an appreciation in your fund’s NAV, you make a killing by selling it off. On the other hand, if you expect the Bombay Stock Exchange Sensitivity Index – the Sensex – to gain in the short term, you can pick up the right open-ended equity fund whose portfolio has scrips likely to gain from the rally, and sell it off once its NAV goes up.

# INVESTMENT OBJECTIVES

***How Suitable Are Open-Ended Funds for An Increase In My Investment?*** Open-ended equity funds are, indeed, suitable for an increase or appreciation in your investment. Again, your choice in an equity fund can vary, depending on your appetite for risk. Sector specific funds like Infotech/Technology or Pharma funds invest only in companies of that particular sector, and are more risky. At the same time, if the scrips of a particular sector are doing well, the returns from investing in an sector specific mutual fund may prove to be worth the risk.

***Are Open-Ended Mutual Funds Suitable For Regular Income?*** An open-ended debt fund is best suited for income. Debt funds generally give you an option of receiving dividend on a monthly, quarterly, half-yearly or on annual basis.

***To What Extent Do Open-Ended Funds Protect Me Against Inflation?*** Open-Ended Mutual Funds provide a fair amount of protection against inflation. But funds with an equity portfolio – growth funds – provide better protection than debt funds because equities, over the long term, provide the best means of beating inflation. Moreover, long-term capital gains are tax exempted.

***Can I Borrow Against Open-Ended Mutual Funds?*** There are some banks that offer loans against your mutual funds. Different banks have their own criteria on which they approve the loans.

# RISK CONSIDERATIONS

***How Assured Can I Be Of Getting My Full Investment Back?*** You cannot be completely sure of getting your full investment back. It depends on the quality and the kind of portfolio you invest in. In fact, in an equity fund, there are no guarantees at all since the fund trades in the secondary markets, and a crash there could result in a major part of your investment coming to nothing. However, in debt funds, the credit ratings of the constituents of the portfolio are a good indicator to how safe the fund, and, thus, your principal amount are. For instance, if the portfolio consists of mostly government securities, it is the safest.

***How Assured Is My Income?*** It again depends on the quality of the portfolio of the mutual fund you invest in. The returns from your fund are related to the market. In the simplest sense if the stock market or the debt market is performing well you can expect to receive a good return over your investment in the fund. Some funds give you a dividend or growth option. Also, income is more assured in case of debt funds as compared to equity funds.

***Are There Any Risks Unique To Investing In An Open-Ended Fund?*** Since Open-Ended Mutual Funds invest in scrips in the secondary market, volatility in their portfolio reflects on the returns. An open-end fund may be subject to inflows at one time or sudden redemptions, which leads to a spurt or a fall in the NAV, thus affecting your returns. Also, the value of the scrips in the portfolio can fluctuate due to various market forces, thus affecting the returns of the fund.

***Are Open-Ended Mutual Funds rated for their credit quality?*** Open-ended equity funds are not credit rated. However, the holdings of debt funds are. The portfolio list of debt funds provides the details of all the instruments held by the fund and their respective credit ratings.

# BUYING, SELLING, AND HOLDING

***How Do I Buy An Open-Ended Fund?*** Units of Mutual Funds can be purchased through investment service centres of the Asset Management Company (AMC) or through the distributors. Also some AMC offer units through NSE Brokers also. The price per unit of a mutual fund is linked to the Net Asset Value (NAV) of the fund.

***What Is The Minimum Investment And The Range Of Investment For Open-Ended Mutual Funds?*** Minimum investment in an open-ended mutual fund varies between Rs.500 and Rs.5,000. Some open-ended funds charge an entry load, i.e., a sales charge, expressed as a percentage of the NAV, is deducted from the amount invested. Also, the AMC gives you the option to invest through SIP. In Systematic Investment Plan you invest a fixed portion every fixed period to take advantage of the concept of rupee cost averaging where you buy more units when the prices are down and less units when the prices rule high. This reduces your average cost of purchase of the units.

***What Is The Duration Of Open-Ended Mutual Funds?*** Open-ended funds, by definition, have no time duration. They can be purchased or redeemed at any time.

***Can Open-Ended Mutual Funds Be Traded In The Secondary Market?*** No, open-ended mutual funds cannot be sold or purchased in the secondary market. They are directly repurchased by the AMC. However, they can be bought from certain brokers who deal in them.

***What Is The Liquidity Of Open-Ended Mutual Funds?*** Open-ended funds provide instant liquidity as mutual funds redeem units daily, either at NAV, or at NAV plus a small exit load. There is a concept of Contingent Deferred Sales Charge where the exit load is charged only if the redemption takes place before a specified time period or above a specified amount. A majority of open-ended mutual funds allow switching among the various funds of the same AMC without any load. You generally get your redemption requests processed promptly, and receive the cheque in 3-4 days. However, in case of Equity Linked Savings Schemes (ELSS) there is a lock in period of three years.

***How Is The Market Value Of Open-Ended Mutual Funds Determined, And How Do I Keep Track Of It?*** Although the units of open-ended mutual funds are not traded in the secondary market, their sale and repurchase price is a function of the NAV of the fund. If the value of the portfolio of the fund rises, so will the NAV and, hence, the market value of the open-ended mutual fund. Thus, the NAV is the most important information an investor must seek. And this information is available through newspapers where it is given daily, the AMC themselves, the Internet, and also through the periodic mails that your AMC is supposed to send you. So you can judge the market value of your investment by tracking the movement of the NAV.

***What Is The Mode of Holding Open-Ended Mutual Funds?*** When you subscribe to an open-ended mutual fund, you receive an account statement stating your ownership of the number of units in the mutual fund. Thereafter, you get an account statement for every transaction you make. In some cases, certificates are also issued. Your AMC may give you the option of holding the certificates in the physical form, or you can receive these certificates in the dematerialized (demat) form, i.e., the certificates are not physically issued to you; instead, they are credited to your demat account.

# TAX IMPLICATIONS

***Equity Fund******Debt Fund***

Short Term Tax – 10% Short Term Tax – 10%

Long Term Tax – NIL Long Term Tax – 20%

Income received from Mutual Funds, according to the latest Budget proposals dividends from Mutual Funds will not be taxed in the hands of the investor. Before the new proposals, dividend from debt funds was subject to a 10 per cent dividend distribution tax plus surcharge. Dividends received from open-ended equity funds were completely tax-free.

***Capital gains tax:*** The difference between the sale consideration and the cost of acquisition of the asset is called capital gain. If the investor sells his units and earns capital gains he is liable to pay capital gains tax. Capital gains are of two types: Short-term and Long-term capital gains.

***Short Term Capital Gains;*** If the units are held for a period of less than one year they will be treated as short-term capital gains and the investor will be taxed depending on the income tax rate applicable to him.

***Long Term Capital Gains;*** All units held for a period of more than 12 months will be classified as long-term capital assets. The investor has to pay long-term capital gains on the units held by him for period of more than 12 months. In this case the investor of a debt fund will

* Pay tax at a flat rate of 10 % (plus surcharge of the applicable tax rate) on the capital gains without indexation or
* Avail cost indexation on capital gains and pay 20 % tax (plus surcharge of the applicable tax rate) whichever is lower.

Indexation means that the purchase price is marked up by an inflation index resulting in lower capital gains and hence lower tax.

Inflation index for the year of transfer

Inflation index = -----------------------------------------------------

Inflation index for the year of acquisition

## Close – Ended Mutual Funds

Closed-ended mutual funds have a fixed number of units, and a fixed tenure (3, 5, 10, or 15 years), after which their units are redeemed or they are made open-ended. These funds have various objectives: generating steady income by investing in debt instruments, capital appreciation by investing in equities, or both by making an equal allocation of the corpus in debt and equity instruments.

# INVESTMENT OBJECTIVES

***How Suitable are Closed-Ended Funds For an Increase in My Investment?*** Since units of closed-ended funds rise and fall in the market like any other stock, they are well suited for an increase in your investment. However, a mutual fund is more influenced by the value of its own portfolio than any other factor. Units of an equity fund are more frequently traded than a debt fund. Also, the NAV of an equity fund rises and falls at a much faster pace. On the other hand, an equity fund provides healthy appreciation in NAV in the long term.

***Are Closed-Ended Mutual Funds Suitable For Regular Income?*** Closed-ended debt funds, with their conservative investment approach, are best suited for income. These funds declare dividend annually or semi-annually

***To What Extent Do Closed-Ended Funds Protect Me Against Inflation?*** With stocks being better than bonds in providing returns on a long-term basis, an equity closed-ended fund is better equipped to guard your investment against inflation in the long run.

***Can I Borrow Against Closed-Ended Mutual Funds?*** No, if you require liquidity there is an option of selling these closed-ended mutual fund’s units in the secondary market.

|  |  |  |  |
| --- | --- | --- | --- |
| **Morgan Stanley Growth Fund** | | | |
| **AMC** | Morgan Stanley Investment Management Pvt. Ltd. | | |
| **Fund** | Morgan Stanley Mutual Fund | **Category** | Equity - Diversified |
| **Scheme Plan** | Growth | **Scheme Type** | **Closed Ended** |

|  |
| --- |
| **NAV Chart (Three Years)** |
| **8305162762** |

# RISK CONSIDERATIONS

***How Assured Can I Be Of Getting My Full Investment Back?*** You cannot be completely sure of getting your full investment back. Depending on their investment objective and underlying portfolio, closed-ended funds can be very volatile or be fairly stable. Hence, your principal is not assured.

***How Assured Is My Income?*** It depends on the portfolio of your closed-ended fund. A portfolio of debt instruments or shares of some blue-chip companies may provide regular dividends.

***Are There any Risks Unique to Investing in a Closed-End Fund?*** The value of a closed-end mutual fund can fluctuate drastically. So, your units can trade at a hefty discount to their NAV, thus depriving you from realizing the true value of your units. This is because although closed-ended funds are, generally, listed, there is no liquidity. Investors must buy a fund if its portfolio is good; units are trading at a good discount, and the stock market is poised to rise.

***Are Closed-Ended Mutual Funds rated for their credit quality?*** Closed-end funds are not rated. However, it is important to note that the holdings of a debt fund are generally rated, and this serves as an indicator of the safety of the portfolio.

# BUYING, SELLING, AND HOLDING

***How Do I Buy a Closed-Ended Fund?*** Closed-ended funds tap the market with their initial offers. Alternatively, if the funds are listed, the units can also be picked up from the secondary market.

***What is The Minimum Investment And The Range Of Investment for Closed-Ended Mutual Funds?*** Minimum investment in closed-ended mutual funds varies, and normally ranges between Rs.2,000 and Rs.5,000. There is no maximum limit of investment.

***What is The Duration Of Closed-Ended Mutual Funds?*** A closed-end fund is, typically, a five-year fund. However, the duration period may vary between 3 and 15 years.

***Can Closed-Ended Mutual Funds be traded in the Secondary Market?*** Yes, closed-ended funds are listed on the stock exchanges and, thus, can be traded in the secondary market. However, the liquidity of closed-ended funds is poor, and they trade on a hefty discount to their NAV in the secondary market.

***What is The Liquidity of Closed-Ended Mutual Funds?*** The Indian stock markets lack depth and, thus, the closed-ended mutual funds are illiquid where they are listed and trade with a heavy discount to their NAVs. Besides listing, some mutual funds also offer repurchase options in their closed-ended funds at a NAV-linked price after a certain lock-in period.

***How is the Market Value of Closed-Ended Mutual Funds Determined, and How do I Keep Track of It?*** The market price of a closed-ended fund is a direct function of its NAV. The higher the NAV, the higher the market price and vice-versa. However, units of a closed-ended fund always trade at a discount to their NAV. For instance, if the NAV of a fund is Rs.13, units may be trading at around Rs.11. However, units of assured return funds are an exception. Their unit price on the bourses does not chase the NAV; it chases the assured return. The NAV is the most important information an investor must seek while investing in a closed-ended mutual fund. And this information is available through various newspapers, the AMC themselves, the Internet, and also through the periodic mails which your AMC is supposed to send to you.

***What is The Mode of Holding Closed-Ended Mutual Funds?*** When you subscribe to a closed-ended mutual fund, you receive either physical certificates, or the account number if they are held in the demat form.

# TAX IMPLICATIONS

While dividend paid on closed-ended mutual funds is fully tax exempt, on redemption or sale of units in the secondary market, your realization will attract short-term capital gains tax of 10 per cent. However, you can save tax by investing in Equity-Linked Savings Scheme (ELSS) under Section 88 of the Income Tax Act, 1961, according to which 20 per cent of the amount invested in ELSS which have a lock-in period of 3 years-can be deducted from your tax liability subject to a maximum investment of Rs.10,000 per year. Also available under Section 88 are two pension plans: Unit Trust of India’s Retirement Benefit Unit Plan (RBP) and Kothari Pioneer’s Pension Plan.

## Interval Funds

Interval funds combine the features of open-ended and close-ended schemes. They are open for sale or redemption during pre-determined intervals at NAV related prices.

Let us now classify Mutual Fund Schemes on the Basis of its Investment Objective:

## Growth Funds

The aim of growth funds is to provide capital appreciation over the medium to long-term. Such schemes normally invest a majority of their corpus in equities. It has been proven that returns from stocks, have outperformed most other kind of investments held over the long term. Growth schemes are ideal for investors having a long-term outlook seeking growth over a period of time.

## Income Funds

The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures and Government securities. Income Funds are ideal for capital stability and regular income.

## Balanced Funds

The aim of balanced funds is to provide both growth and regular income. Such schemes periodically distribute a part of their earning and invest both in equities and fixed income securities in the proportion indicated in their offer documents. In a rising stock market, the NAV of these schemes may not normally keep pace, or fall equally when the market falls. These are ideal for investors looking for a combination of income and moderate growth.

## Money Market Funds

The aim of money market funds is to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money. Returns on these schemes may fluctuate depending upon the interest rates prevailing in the market. These are ideal for Corporate and individual investors as a means to park their surplus funds for short periods.

## Load Funds

A Load Fund is one that charges a commission for entry or exit. That is, each time you buy or sell units in the fund, a commission will be payable. Typically entry and exit loads range from 1% to 2%. It could be worth paying the load, if the fund has a good performance history. The maximum load – as specified by SEBI, entry and exit put together is 7% of the NAV.

## No-Load Funds

A No-Load Fund is one that does not charge a commission for entry or exit. That is, no commission is payable on purchase or sale of units in the fund. The advantage of a no load fund is that the entire corpus is put to work.

We can further classify Mutual Fund Schemes on the Basis of specialty:

## Industry Specific Schemes

Industry Specific Schemes invest only in the industries specified in the offer document. The investment of these funds is limited to specific industries like InfoTech, FMCG, Pharmaceuticals etc.

## Index Schemes

Index Funds attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE Nifty.

## Sectoral Schemes

Sectoral Funds are those, which invest exclusively in a specified industry or a group of industries or various segments such as ‘A’ Group shares or initial public offerings.