SECURITIES LAWS AND COMPLIANCES
PART A — SECURITIES LAWS
STUDY IV - CAPITAL MARKET INSTRUMENTS
LEARNING OBJECTIVES
The study will enable the students to understand

- Classification of instruments
- Preference shares and its various kinds
- Tracking stocks
- Sweat Equity shares
- Foreign Currency Convertible Bonds/Global Depository Receipts
- Derivatives

INTRODUCTION
The instruments used by the corporate sector to raise funds are selected on the basis of—(i) investor preference for a given instrument and (ii) the regulatory framework, whereunder the company has to issue the security. Investor preferences vary with their attitude towards risk, and their investment goals and investment horizon. The tax liability of the investor too effects the choice of investment media. The firm on the other hand, is affected by the debt-equity ratio permissible, SEBI guidelines on issue of capital, and the formalities to be complied with while raising an issue. The tax liability of the company, the purpose for which funds are required, debt servicing ability and willingness to broad base the shareholding of the company, all influence the choice of the instrument. The corporate sector and financial/investment institutions have been issuing new instruments to attract investors. However, the range of instruments used is still very narrow. Convertible debenture is the most popular instrument in the current scenario to raise funds from the markets. The attraction for the instrument for both the corporate sector and the investor lies in—(a) the investor gets a reasonable return during the initial years, followed by equity participation on conversion, and (b) the issue involves lower post-tax cost of capital, thereby entailing a lesser strain on liquidity.

CLASSIFICATION OF INSTRUMENTS
Instruments can be classified into three categories: Pure, Hybrid and Derivatives. Pure Instruments: Equity shares, preference shares and debentures/bonds which were issued with their basic characteristics in tact without mixing features of other classes of instruments are called Pure instruments.

Hybrid instruments: Hybrid instruments are those which are created by combining the features of equity with bond, preference and equity etc. Examples of Hybrid instruments are: Convertible preference shares, Cumulative convertible preference shares, non convertible debentures with equity warrants, partly convertible debentures, partly convertible debentures with Khokha (buy-back arrangement), Optionally convertible debenture, warrants convertible into debentures or shares, secured premium notes with warrants etc. Futures and

options belong to the categories of derivatives.
The salient features of various financial instruments available in the financial markets have been discussed in the study material. Money market instruments have already been discussed in the chapter ‘Money Market’ and the salient features of instruments available in securities markets are discussed below:

Equity Shares

Equity shares, commonly referred to as ordinary share also represents the form of fractional ownership in which a shareholder, as a fractional owner, undertakes the maximum entrepreneurial risk associated with business a business venture. The holder of such shares are member of the company and have voting rights. A company may issue shares with differential rights as to voting, payment of dividend etc.

Equity capital and further issues of equity capital by a company are generally based on the condition that they will rank pari passu alongwith the earlier issued share capital in all respects. However,as regards dividend declared by the company such additional capital shall be entitled to dividend ratably for the period commencing from the date of issue to the last day of the accounting year, unless otherwise specified in the articles or in the terms of the issue.

Important characteristics of equity shares are given below:

1. Equity shares, other than non-voting shares, have voting rights at all general meetings of the company. These votes have the affect of the controlling the management of the company.
2. Equity shares have the right to share the profits of the company in the form of dividend (cash) and bonus shares. However even equity shareholders cannot demand declaration of dividend by the company which is left to the discretion of the Board of Directors.
3. When the company is wound up, payment towards the equity share capital will be made to the respective shareholders only after payment of the claims of all the creditors and the preference share capital.
4. Equity share holders enjoy different rights as members such as:
   a. right of pre-emption in the matter of fresh issue of capital (Section 81)
   b. right to apply to the court to set aside variations of their rights to their detriment (Section 107)
   c. right to receive a copy of the statutory report before the holding of the statutory meeting by public companies (Section 165)
   d. right to apply to Central Government to call for the Annual General Meeting, if the company fails to call such a meeting (Section 167)
   e. right to apply to Company Law Board for calling for an extra-ordinary general meeting of the company (Section 186)
   f. right to receive annual accounts along with the auditors report, directors report and other information (Section 210, 217 & 219).

[The rights mentioned at 4(b), 4(c), 4(d), 4(e) and 4(f) are also available to the preference shareholders. The right of pre-emption in the matter of fresh issue of capital is available only to the equity shareholders vide Section 81(1)(a)].

Equity shareholders, other than non-voting shares are entitled to voting rights in all matters, whereas preference shareholders are entitled to voting rights if the assured dividend to which they are entitled has been in arrears for a specified period. In the normal course where there is no dividend in arrears to be paid to them they have no voting rights except in a class meeting convened for preference share holders for specific purposes.

Shares with Differential Voting Rights

The Central Government notified Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001 vide GSR No. 167(E) dated 9th March, 2001.

Rules 3 of the Rules enables companies limited by shares to issue shares with differential rights as to dividend, voting or otherwise, subject to fulfilment of certain conditions. The conditions are required to be fulfilled at the time of issue of equity shares with differential rights for the simple reason that these are the conditions subject to which a company may issue shares with differential rights. The conditions are :

1. The company has distributable profits in terms of section 205 of the Companies Act, 1956 for preceding three financial years preceding the year in which it was decided to issue such shares.
2. The company has not defaulted in filing annual accounts and annual returns for three financial years immediately preceding the financial year of the year in which it was decided to issue such share. The period of three financial years prescribed above shall be reduced proportionately in the case of companies, which are in existence for less than three financial years. In cases where the default has been condoned by the prescribed authority, it shall be deemed, for the purpose of this clause that the company had not defaulted in filing of the documents. In other words, the condition does not apply to companies, which have made good the default.
3. The company has not failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay dividend.
   The above two conditions are similar to the provisions of section 274(1)(g) disqualifying a director under that section.
4. The Articles of Association of the company authorizes the issue of shares with differential voting rights. Where the articles of association of a company do not authorize issue such shares, then a special resolution under section 31 of the Act shall be passed in the general meeting to suitably alter the articles.
5. The company has not been convicted of any offence arising under, Securities Exchange Board of India Act, 1992; Securities Contracts (Regulation) Act, 1956. Foreign Exchange Management Act, 1999. All the above rules are stringent, for they prohibit companies having defaulted/ convicted, as the case may be, in the specified areas once in a lifetime. The clause, however, does not cover the offences under Companies Act, 1956.
6. The company has not defaulted in meeting investors' grievances. The definition of "meeting" of investors' grievances is not clear. In true sense, it means satisfaction of investor or doing the rightful thing, which will reach the logical end. One may say that replying investors may amount to meeting investor's grievance. This argument seems justifiable in cases where the investors do not respond by submitting necessary information/ documents, whereby the cases remains pending at their end.

7. The company has obtained the approval of shareholders in general meeting by passing resolution as required under the provision of sub-clause (a) of sub-section (1) of section 94 read with sub-section (2) of the said section. This rule requires companies to obtain approval of the shareholders in the general meeting by passing resolution under section 94(1)(a) for increase in share capital by issuing new shares. However, such resolution is not required in cases where a company does not issue new shares with differential rights, but varies the rights of the existing equity shares to include an element of difference in rights attached to those shares, subject to compliance with the conditions prescribed under sections 106 and 107 and the provisions in the articles of association of the company.
   The opening words of Rule 3 namely, "Every company limited by shares may issue with..." do not supersede the provisions of sections 106 and 107 and do not, thereby, require companies to issue fresh shares with differential rights. Sections 106 and 107 deal with the shares of different classes of shares. Therefore, a company having equity share capital may have two classes of shares e.g. — A—class equity shares and B—class equity shares. Further, section 94(1)(a) deals with increase in share capital by issue of new shares only. However, there is a room for debate on this issue.
8. The listed public company has obtained the approval of shareholders through postal ballot. One will have to carry out necessary procedures under the Rules governing Postal Ballot.
9. The notice of the meeting at which resolution is proposed to be passed is accompanied by an explanatory statement stating—
   a. the rate of voting rights which the equity share capital with differential voting right shall carry (differential voting right here includes right to voting, dividend or otherwise);
   b. the scale or in proportion to which the rights of such class or type of shares will vary (the particulars of the differential right shall be provided for);
   c. the company shall not convert its equity capital with voting rights into equity share capital with differential voting rights and the shares with differential voting rights into equity share capital with voting rights (however, one may take shelter under Sections 106 and 107 as explained above);
   d. the shares with differential voting rights shall not exceed 25% of the total share capital issued; (this clause limits the quantum of shares that may be issued with differential rights). The limit could have been restricted to paid-up capital rather than issued capital.
      Clauses (c) and (d) of Rule 9 of the Rules, could have been bifurcated into sub-rules stipulating conditions, rather than requiring companies to make them a part of the explanatory statement;
   e. that a member of the company holding any equity share with differential right shall be entitled to bonus shares, right shares of the same class;
   f. the holders of the equity shares with differential right shall enjoy all other rights to which the holder is entitled to excepting the differential right as indicated in (a) above.

The holders of the equity shares with differential voting rights shall enjoy all other rights to which the holder is entitled to excepting the differential right.
Rule 4 of the Rules requires every company referred to in rule 3 to maintain a register as required under section 150 of the Act containing the particulars of differential rights to which the holder is entitled.
As per section 2(46A) a share with differential rights means a share that is issued with differential rights in accordance with the provisions of section 86 of the Act. The equity shares with differential rights include equity shares with differential rights as to—(a) voting; (b) dividend; and (c) otherwise.
Neither the Act nor the Rules define the term—"otherwise", which may include any other right attached to equity shares.

Preference Shares

Owners of this kind of shares are entitled to a fixed dividend or dividend calculated at a fixed rate to be paid regularly before dividend can be paid in respect of equity shares. They also enjoy privity over the equity shareholders in payment of surplus. But in the event of liquidation their claims rank below the claims of company's creditors, bondholders/debenture holders.
The following kinds of preference shares are dealt with by the companies:

1. cumulative preference shares
2. non-cumulative preference shares
3. convertible preference shares
4. redeemable preference shares
5. irredeemable preference shares
6. participating preference share
7. non participating preference shares

Cumulative preference shares

In the case of this type of share the dividend payable every year becomes a first claim while declaring dividend by the company. In case the company does not have adequate profit or for some reason the company does not want to pay preference dividend, it gets accumulated for being paid subsequently. Such arrears of preference dividend will be carried forward and paid out of the profits of the subsequent years, before payment of equity dividend. However, if a company goes into the liquidation no arrears of preference dividend will be payable unless the Articles of Association of the issuing company contains a specific provision to make such payment even in winding up.

Non-cumulative preference shares

In the case of these shares, dividend does not accumulate. If there are no profits or the profits are inadequate in any year, the shares are not entitled to any dividend for that year. Unless there is a specific provision in the Articles of Association of the company, the preference shareholders have no right to participate in the surplus profits or in the surplus assets in a winding up. They are entitled to payment of the declared preference dividend in any particular year and to the repayment of their preference capital in the event of winding up before payment to the equity shareholders.

Convertible preference shares

If the terms of issue of preference shares includes a right for converting them into equity shares at the end of a specified period they are called convertible preference shares. In the absence of such condition or right, the preference shares are not converted into equity shares to become eligible for various rights such as voting, higher dividend, bonus issue etc. as in the case of equity shares. These shares are some times referred to as quasi equity shares in common parlance. Companies may even charge a premium as part of the terms of conversion of preference shares, as they do sometimes while converting debentures into equity shares.

Redeemable preference shares

If the articles of a company so authorise, redeemable preference shares can be issued. This is in contrast to the principle that the company normally can not redeem or buy back its own shares vide Section 77 of the Act, except by following the procedure for reduction of capital and getting the sanction of the High Court in pursuance of Sections 100 to 104 or of Section 402. With effect from 31st October, 1998 a new Section 77A has been inserted in the Act empowering companies to purchase its own securities under certain circumstances and subject to certain conditions.

Section 80 regulates the redemption of redeemable preference shares as follows:

1. The partly paid shares, if any, must be made fully paid up.
2. The shares are to be redeemed only out of the profits of the company, which would otherwise be available for distribution of dividend or out of the proceeds of a fresh issue of shares made for the purpose.
3. The premium, if any payable, on redemption should be provided for out of the profits of the company or its security premium account.
4. Where redemption is made out of profits, a sum equal to the nominal value of the shares redeemed, must be transferred to a capital redemption reserve account which can be utilised only to pay up unissued shares of the company to be issued as fully paid bonus shares.

   With effect from 1st March, 1997 a new sub-section 5A has been inserted under section 80 laying down that no company limited by shares shall issue any preference shares which is irredeemable or is redeemable after the expiry of a period of 20 years from the date of its issue.

Irredeemable preference shares

If the terms of issue provide that the preference shares are not redeemable except on the happening of certain specified events which may not happen for an indefinite period such as winding up, these shares are called irredeemable preference shares. Issue of irredeemable preference shares was permitted till the amendment of the Act by introduction of Section 80A with effect from 15th June, 1988 (This has been further amended by sub-section 5A with effect from 1st March, 1997). As per the 1988 amendment all preference shares existing on 15th June, 1988 which were not redeemable within 10 years from the date of the issue and had not been redeemed on or before 15th June, 1998 were to be compulsorily redeemed by the company on the due date of redemption or within a period not exceeding 10 years from 15th June, 1988. Where a company was not in a position to redeem any shares within the period aforesaid and to pay the dividend thereon, the company may with the consent of Company Law Board on a petition made by it in this behalf, issue further redeemable shares equal to the amounts due including the dividend thereon in respect of unredeemed preference shares. On the issue of such further redeemable preference shares, the unredeemed shares shall be deemed to have been redeemed.

Participating preference shares

Preference shareholders are not entitled to dividend more than what has been indicated as part of the terms of issue, even in a year in which the company has made huge profits. Subject to provision in the terms of issue these shares can be entitled to participate in the surplus profits left, after payment of dividend to the preference and the equity shareholders to the extent provided therein. Subject to provisions in the terms of issue such preference shares can be entitled even to bonus shares.

Non participating preference shares

Unless the terms of issue indicate specifically otherwise, all preference shares are to be regarded as non-participating preference shares.

Debentures

Section 2(12) of the Companies Act, 1956 defines debentures as follows: Debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not. Debenture is a document evidencing a debt or acknowledging it and any document which fulfills either of these conditions is a debenture. The important features of a debenture are:

1. It is issued by a company as a certificate of indebtedness.
2. It usually indicates the date of redemption and also provides for the repayment of principal and payment of interest at specified date or dates.
3. It usually creates a charge on the undertaking or the assets of the company. In such a case the lenders of money to the company enjoy better protection as secured creditors, i.e. if the company does not pay interest or repay principal amount, the lenders may either directly or through the debenture trustees bring action against the company to realise their dues by sale of the assets/undertaking earmarked as security for the debt.

Debentures are issued in the following forms:

a. Naked or unsecured debentures.
b. Secured debentures.
c. Redeemable debentures.
d. Perpetual debentures.
e. Bearer debentures.
f. Registered debentures.

Their features are as follows:

a. *Naked or unsecured debentures:* Debentures of this kind do not carry any charge on the assets of the company. The holders of such debentures do not therefore have the right to attach particular property by way of security as to repayment of principal or interest.

b. *Secured debentures:* Debentures that are secured by a mortgage of the whole or part of the assets of the company are called mortgage debentures or secured debentures. The mortgage may be one duly registered in the formal way or one which is secured by the deposit of title deeds in case of urgency.

c. *Redeemable debentures:* Debentures that are redeemable on expiry of certain period are called redeemable debentures. Such debentures after redemption can be reissued in accordance with the provisions of Section 121.
d. *Perpetual debentures:* If the debentures are issued subject to redemption on the happening of specified events which may not happen for an indefinite period, e.g. winding up, they are called perpetual debentures.
e. *Bearer debentures:* Such debentures are payable to bearer and are transferable by mere delivery. The name of the debenture holder is not registered in the books of the company, but the holder is entitled to claim interest and principal as and when due. A bonafide transferee for value is not affected by the defect in the title of the transferor.
f. *Registered debentures:* Such debentures are payable to the registered holders whose name appears on the debenture certificate/letter of allotment and is registered on the companies register of debentureholders maintained as per Section 152 of the Act.

Based on convertibility, debentures can be classified under three categories:

1. Fully Convertible Debentures (FCDs).
2. Non Convertible Debentures (NCDs).
3. Partly Convertible Debentures (PCDs).

1. *Fully Convertible Debentures (FCDs):* These are converted into equity shares of the company with or without premium as per the terms of the issue, on the expiry of specified period or periods. If the conversion is to take place at or after eighteen months from the date of allotment but before 36 months, the conversion is optional on the part of the debenture holders in terms of SEBI Guidelines. Interest will be payable on these debentures upto the date of conversion as per transfer issue.
2. *Non Convertible Debentures (NCDs):* These debentures do not carry the option of conversion into equity shares and are therefore redeemed on the expiry of the specified period or periods.
3. *Partly Convertible Debentures (PCDs):* These may consist of two kinds namely - convertible and non-convertible. The convertible portion is to be converted into equity shares at the expiry of specified period. However, the non convertible portion is redeemed at the expiry of the stipulated period. If the conversion takes place at or after 18 months, the conversion is optional at the discretion of the debenture holder.

Basic features of convertible debentures

1. Debentures are issued for cash at par.
2. They are converted into specified or unspecified number of equity shares at the end of the specified period. The ratio at which the convertible debentures are exchanged for equity shares is known as conversion price or conversion ratio which is worked out by dividing the face value of a convertible debenture by its conversion price. For instance if the face value of a convertible debenture is Rs.100 and it is convertible into two equity shares, the conversion price is Rs.50 and the conversion ratio is 2. The difference between the conversion price and the face value of the equity share is called conversion premium.

3. Convertible debentures may be fully or partly convertible. In case it is fully convertible the entire face value is converted into equity shares on expiry of the stipulated period. If partly convertible, the convertible portion is converted into equity shares on expiry of the specified period and the non convertible portion is redeemed at the expiry of certain period.
4. Conversion into equity shares may take place in one or more stages at the end of specified period or periods in the case of fully or partly convertible debentures.
5. If one or more parts of the debentures are convertible after 18 months, a company should get a credit rating done by a credit rating agency approved by SEBI. Fresh rating is required if debentures are rolled over.
6. Earlier upto July, 1991 the Controller of capital issues had imposed a maximum interest rate of 14% per annum payable on convertible debentures for non FERA, non MRTP companies and 12.5% per annum in other cases. However from 1st August, 1991 interest rates of debentures were deregulated and companies were allowed to pay interest at rates they considered reasonable.
7. Convertible debentures of public companies are listed on the stock exchanges to assure liquidity to the holders. However even these instruments are not actively traded in Indian stock exchanges except those of well established companies.

Advantages of convertible debentures

The advantages of convertible debentures to the company are—

1. Capitalisation of interest cost till the date of commissioning of the project is allowed in accordance with accounting principle. If the conversion of the debentures is duly linked with the commissioning of the project the entire interest cost can be capitalised, without charging the interest to profit & loss account and pulling down the profits of the company.
2. Convertible debentures carry lower interest 14% to 16% as compared to the rate charged by the Banks and Financial Institutions and the interest rate on non convertible debentures.
3. From the point of view of the debt equity ratio the convertible part of the debentures is treated as equity by financial institutions. The company is thus enabled to have a high degree of flexibility in financing its future projects.
4. Equity capital gets increased after each conversion, facilitating easier servicing of equity by payment of dividend.
5. Tax benefits are higher as interest on debentures is allowed as a deduction in computation of taxable income of the company. Additionally a company having a proven track record and future earning potential will be able to reasonable premium at the time of conversion. This will result in reducing the servicing cost of equity.
6. This is a popular form of financing in companies as the interest rates are cheaper than those charged by Financial Institutions on term loans.
7. In the case of term loans from FIs and Banks they usually impose many conditions on management including placing their representative on the board. In the case of convertible debentures there is thus a greater degree of autonomy for the companies.

The advantages of the convertible debentures to the investors are -

1. The investor is assured of a fixed return by way of interest on the debentures till conversion. On conversion into equity the investor becomes entitled to receive dividend declared on equity shares. The advantage to the investor is that he receives a fixed return on his investment by way of interest even during the gestation period and project implementation period.
2. As price of equity shares tends to rise on completion of the project of the company, the investor gets value appreciation on his investment, if converted into equity.
3. In most cases, debentures carry security with a charge on all or a part of movable/immovable properties of the company. This assures prompt payment of principal and interest by invoking the assistance of a debenture trustee. However in terms of SEBI Guidelines where the debentures have a maturity period of 18 months or less it is mandatory for the company to create security on the debentures.
4. A fair amount of liquidity is enjoyed by convertible debentures listed on the stock exchanges depending on the track record of the companies. Even if debentures are not traded as actively as equity shares, convertible debentures of good companies command reasonable liquidity. Where a debenture has several parts, each part of the convertible debentures can be traded separately or in full on the stock exchanges.
5. The following options are available to the investor who has bought convertible debentures issued in several parts:
   a. To sell all the parts immediately on allotment;
   b. To sell one or more parts and retain other or others till conversion and to obtain equity shares for retention or sale.

The distinctions between fully convertible and partly convertible debentures are—

Characteristics	*Partly convertible debentures*	*Fully convertible debentures*
Suitability	Better suited for companies with established track record	Better suited for companies without established track record
Capital base	Relatively lower equity capital on conversion of debentures	Higher equity capital on conversion of debentures
Flexibility in financing	Favourable debt equity ratio	Highly favourable debt equity ratio
Classification for debt-equity ratio computation	Convertible portion classified as ‘equity’ and non-convertible portion as ‘debt’	Classified as equity for debt-equity computation
Popularity	Not so popular with investors	Highly popular with investors
Servicing of equity	Relatively lesser burden of equity servicing	Higher burden of servicing of equity

In the case of partly convertible debentures, debenture redemption reserve has

to be created for 50% of the face value of the non-convertible portion. The facility of buy-back is also permissible in respect of non-convertible portion of debentures.
In contrast non reserve for debenture redemption is required for fully convertible debentures nor buy-back arrangements permissible. (Amendment Act of 2000 inserted new provisions regarding debenture trust deed, appointment of debenture trustees, defining their duties, liability of the company to create security and debenture redemption reserve etc.).
Detachable warrants issued alongwith both convertible and non convertible debentures afford many advantages.
The warrant entitles the debenture holders to get equity shares specified in the warrants on expiry of a certain period at a price not exceeding the cap price mentioned in the warrant. Equity warrant is commonly issued with non convertible
debentures to brighten their marketability. Warrants attached to convertible debentures and equity shares make the latter hot cakes in the market. The warrant is a negotiable instrument which is easily tradable if listed on the stock exchange.
Convertible bonds are issued in developed capital markets with a conversional price well above the current market price per share. The pricing is generally higher by 15% to 20% than the current price of the shares in the market. The investor has the option to avoid the conversion, if the market price of the security falls below the conversion price. The timing of the conversion also can be kept flexible by the company.
In view of the attraction offered by equity warrant, companies issue them by private placement without employing the services of brokers/sub-brokers etc.
In the case of issues made to the market, wider disposal of equity reduces the risk of takeover bids. The management can buy these shares gradually through intermediaries observing SEBI guidelines.
Sometimes companies issue zero *interest fully* convertible debentures. In this case, investors are not paid any interest till the date of conversion or upto the notified date, after which they are converted into shares. For the investor the investment amount is lower and cost of conversion also is less. Further this helps them as a means of tax planning since interest which is otherwise taxable is not paid. The capital appreciation at the time of conversion is treated as capital gains where tax rate is less. Companies also prefer this instrument because they are able to avoid payment of interest.

Secured Premium Notes (SPN)

These instruments are issued with detachable warrants and are redeemable after a notified period say 4 to 7 years. The warrants enable the holder to get equity shares allotted provided the secured premium notes are fully paid. During the lock in period no interest is paid. The holder has an option to sell back the SPN to the company at par value after the lock in period. If the holder exercises this option, no interest/premium is paid on redemption. In case the holder keeps it further, he is repaid the principal amount along with the additional interest/premium on redemption in installments as per the terms of issue. The conversion of detachable warrants into equity has to be done within the specified time. TISCO took the lead in July, 1992 by making a mega rights issue of equity shares and secured premium notes aggregating to Rs.1,212 crores. The terms of the SPN were so formulated that the return on investment was treated as capital gain and not regular income. Consequently, the rate of tax applicable was lower.

Equity Shares with Detachable Warrants

Essar Gujarat, Ranbaxy and Reliance issued this type of instrument. The holder of the warrant is eligible to apply for the specified number of shares on the appointed date at the pre-determined price. These warrants are separately registered with the stock exchanges and traded separately. The practice of issuing non convertible debentures with detachable warrants also exists in the Indian market. Reliance has used this method.

Deep Discount Bond

IDBI and SIDBI had issued this instrument. For a deep discount price of Rs.2,700/- in IDBI the investor got a bond with the face value of Rs.1,00,000. The bond appreciates to its face value over the maturity period of 25 years. Alternatively, the investor can withdraw from the investment periodically after 5 years. The capital appreciation is charged to tax at capital gains rate which is lower than normal income tax rate. The deep discount bond is considered a safe, solid and liquid instrument and assigned the best rating by CRISIL.

Fully Convertible Debentures with Interest (Optional)

In this case there is no interest payment involved say for the first 6 months. Then the holder can exercise option and apply for securities at a premium without paying additional amount. However interest will be payable at a determined rate from the date of first conversion to second/final conversion and in lieu thereof equity shares are issued.

Partly convertible debentures can also be issued with similar or modified features as indicated above.

Fully Convertible Cumulative Preference Share (Equipref)

This instrument is in two parts A & B. Part A is convertible into equity shares automatically and compulsorily on the date of allotment without any application by the allottee, and Part B is redeemed at par/converted into equity after a lock in period at the option of the investor, at a price 30% lower than the average market price. The dividend is given only for part B shares.

Upon conversion of each part, the face value stands reduced proportionately on the date of conversion.

Sweat Equity Shares

Sweat equity share is a instrument permitted to be issued by specified Indian companies, under Section 79A of Companies Act, 1956 inserted by Companies (Amendment) Act, 1999 w.e.f. 31st October, 1998. According to this section a public company may issue sweat equity shares of a class of shares already issued if the following conditions are fulfilled:

a. The issue of sweat equity share is authorised by a special resolution passed by the company in the general meeting.
b. The resolution specifies the number of shares, current market price, consideration if any and the class or classes of directors or employees to whom such equity shares are to be issued.

c. Not less than one year has elapsed at the date of the issue, since the date on which the company was entitled to commence business.
d. The sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by SEBI in this regard.

However, in the case of a company whose equity shares are not listed on any recognised stock exchange, the sweat equity shares are to be issued in accordance with the guidelines as may be prescribed.

The expression “company” means company incorporated, formed and registered under the Companies Act, 1956, and includes its subsidiary company incorporated in a Country outside India.

All the limitations, restrictions and provisions relating to equity shares are also applicable to such sweat equity shares issued under the new Section 79A.

As per explanation II under the Section, sweat equity shares can be issued by the company to employees or directors at a discount or for consideration other than cash, for providing know how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

It may be noted that the intellectual property right, know how or value additions arise as of now mainly in the case of Information Technology related companies and Pharmaceutical companies. Categories of industries which are eligible to issue sweat equity shares have not been indicated by the Government either in the Act or otherwise.

The term “sweat equity” indicates equity issued to directors and long time employees who have toiled from the inception of the company to build it with a brand image and thus contributed significantly by their efforts in this direction. Since these shares are issued at a discount or for consideration other than cash, the company will generally select those employees and directors as per norms approved by the Board of Directors, based on the know how provided or intellectual property rights created and given for value additions made by such directors and employees to the company.

Tracking Stocks

Dr. J.J. Irani Expert Committee constituted by the Government to make recommendation on the Concept Paper on Company Law has recommended in its report for the introduction of ‘Tracking Stocks’ in the Indian Capital Market.

A Tracking stock is a type of common stock that “tracks” or depends on the financial performance of a specific business unit or operating division of a company, rather than the operations of the company as a whole. As a result, if the unit or division performs well, the value of the tracking stocks may increase, even if the company’s performance as a whole is not up to mark or satisfactory. The opposite may also be true.

A tracking stock is a special type of stock issued by a publicly held company to track the value of one segment of that company. By issuing a tracking stock, the different segments of the company can be valued differently by investors.

Tracking stocks are generally issued by a parent company in order to create a financial vehicle that tracks the performance of a particular division or subsidiary. When a parent company issues a tracking stock, all revenues and expenses of the applicable division are separated from the parent company’s financial statements and bound to the tracking stock. Often this is done to separate a high-growth division from large losses shown by the financial statements of the parent company. The parent company and its shareholders, however, still control operations of the subsidiary.

Tracking stock carries dividend rights tied to the performance of a targeted division without transferring ownership or control over divisional assets. In contrast to a spin-off or an equity carve-out, the parent retains full control, allowing it to enjoy any operating synergies, or economies of scale in administration or finance.

Shareholders of tracking stocks have a financial interest only in that unit or division of the company. Unlike the common stock of the company itself, a tracking stock usually has limited or no voting rights. In the event of a company's liquidation, tracking stock shareholders typically do not have a legal claim on the company's assets. If a tracking stock pays dividends, the amounts paid depends on the performance of the business unit or division. But not all tracking stocks pay dividends.

A company has many good reasons to issue a tracking stock for one of its subsidiaries (as opposed to spinning it off to shareholders).

i. First, the company keeps control over the subsidiary (although they don't get all the profit), but all revenues and expenses of the division are separated from the parent company's financial statements and attributed to tracking stock. This is often done to separate a high growth division with large losses from the financial statements of the parent company.
ii. Second, they might be able to lower their costs of obtaining capital by getting a better credit rating
iii. Third, the businesses can share marketing, administrative support functions, etc.
iv. Finally, if the tracking stock shoots up, the parent company can make acquisitions and pay in stock of subsidiary instead of cash.

When a tracking stock is issued, the company can choose to sell it to the markets (i.e., via an initial public offering) or to distribute new shares to existing shareholders. Either way, the newly tracked business segment gets a longer lease, but can still run back to the parent company in tough times.

Advantages of Tracking Stock

A key advantage of tracking stock is that it offers divisional managers a degree of decision-making authority that might otherwise be unattainable, given top management's reluctance to dilute its control over the division's assets. The practical effect should be to enhance job satisfaction for divisional managers, thus reducing retention risk and also increasing the company's responsiveness to changing market conditions. Also, investors have more direct access to the specific businesses of the parent, which can be highly useful in the case of a diversified company. Another possible reason for the growing popularity of trackers is that trackers allow mainstream companies to exploit the dual stock market pricing between conventional and high-tech or Internet businesses. By creating tracked business units, conventional businesses too can benefit from the pricing frenzy.

Disadvantages of Tracking Stock

For investors, tracking stocks can be of a mixed bag. Like regular stocks, tracking stockholders are entitled to dividends paid out by the subsidiaries issuing the tracking stock. Yet the holders of tracking stocks do not have ownership in the company, instead, at-times tracking stock shareholders vote on issues affecting the corporate parent, not the subsidiary whose stocks they own. Another downside is the fact that the board of directors of the tracking-stock subsidiary is often put in place by the parent company and is not elected by tracking stock shareholders, which would cause conflicts of interests.

The tracking stocks are highly skeptical also. Shareholders have limited voting rights, if any, and they cannot elect their own boards. Moreover, if the parent company falls on hard times, conflict could develop between the shareholders of a tracked division, especially if it continues to do well, and the shareholders of the parent company. The potential for such conflict could affect the performance of the tracking stock.

Another important drawback with tracking stock is that it can dramatically increase the potential for conflict and litigation over accounting policy. It is because the owners of the tracking stock have rights only over dividends, and dividend payouts are driven by the recognition of divisional profits, the arguments over profit recognition are almost sure to arise whenever tracking stock investors are disappointed in their returns. They will surely be tempted to accuse corporate management of adopting policies that deliberately understate their profits.

Disaster Bonds

These are issued by companies and institutions to share the risk and expand the capital to link investors return with the size of insurer losses. The bigger the losses, the smaller the return and vice-versa. The coupon rate and the principal of the bonds are decided by the occurrence of the casualty of disaster and by the possibility of borrowers defaults.

Option Bonds

This instrument covers those cumulative and non-cumulative bonds where interest is payable on maturity or periodically and redemption premium is offered to attract investors.

Easy Exit Bonds

This instrument covers both bonds which provide liquidity and an easy exit route to the investor by way of redemption or buy back where investors can get ready encashment in case of need to withdraw before maturity.

Pay in Kind Bonds

This refers to bonds wherein interest for the first three to five years is paid through issue of additional bonds, which are called baby bonds as they are derived from parent bond.

Split Coupon Debentures

This instrument is issued at a discounted price and interest accrues in the first two years for subsequent payment in cash. This instrument helps better management of cash outflows in a new project depending upon cash generating capacity.

Floating Rate Bonds and Notes

In this case interest is not fixed and is allowed to float depending upon market conditions. This instrument is used by the issuers to hedge themselves against the volatility in interest rates.

Some of the above instruments have been used selectively by companies and institutions recently to raise funds.

Clip and Strip Bonds

Clip and strip bonds also referred to as coupon notes, split the principal and coupon portions of a bond issue and two separate coupon instruments are sold to the investors.

In structuring a coupon note issue, a conventional current coupon bond is sold to the investor. The streams of coupon payments are stripped away and the principal amount of bond is sold as a deep discount bond. The gain to the investor is difference between the purchase price and the par value. The coupon streams are sold like zero coupon bonds where the investor pays discount for it and receives the payment at a lower rate.

Dual Convertible Bonds

A dual convertible bond is convertible into either equity shares or fixed interest rate debentures/preference shares at the option of the lender. Depending on the prospects of the project during the conversion period, the lender may exercise either of the options. The fixed interest rate debenture may have certain additional features including higher rate of interest distinct from the original debt instrument.

Debt Instruments with Debt Warrants

Debt instruments may be issued with debt warrants which give the holder the option to invest in additional debt on the same terms within the period specified in the warrant. This instrument is beneficial to the investors in periods of falling interest rates when the holder can exercise the debt warrant option and hold additional debt at, interest rates above market rates.

Indexed Rate Notes

In indexed rate notes, the interest rate fixation is postponed till the actual date of placement, rather than fixing it on the date of the commitment. The interest rate is computed on the date of take down at the then prevailing private placement rates, using a formula based on the index such as the 182 days treasury bill yield rates. These instruments are beneficial to a company in a high interest rate environment, if the interest rates are expected to decline between the date of commitment and the date of takedown.

Stepped Coupon Bonds

Under stepped coupon bonds, the interest rate is stepped up or down during the tenure of the bond. The main advantage to the investor is the attraction of higher rate of interest in case of general rise in interest rates.

Dual Option Warrants

Dual option warrants are designed to provide the buyer with good potential of capital appreciation and limited downside risk. Dual option warrants may be used to sell equity shares in different markets. For example, equity shares or debentures may be issued with two warrants - one warrant giving right to the purchaser to be allotted one equity share at the end of a certain period and another warrant with a debt or preference share option.

Extendable Notes

Extendable notes are issued for 10 years with flexibility to the issuer to review the interest rate every two years. The interest rate is adjusted every two years to reflect the then prevailing market conditions by trying the interest rate to a spread over a bond index such as two years treasury notes. However, investors have a put option at par value every two years i.e. they have the right to sell the bond to the issuer at a fixed rate on the expiry of every two years.
This instrument encourages long term investor participation in the scheme by favourable review of interest rates every two years.

Level Pay Floating Rate Notes

Level pay floating rate notes are issued for a long period of time say 20 years, with adjustment in interest rate every five years. These notes provide for level payments for time intervals during the term of the note, with periodic interest adjustments tied to an index, and adjustments to the principal balance to reflect the difference between the portion of the payment allocable to interest and the amount of floating rate interest actually incurred. Maximum limits on upward adjustments to principal are specified at the outset to protect the lender from runaway floating exposure. The level pay note has the advantage to the issuer of having a predictable level of debt service for a period of years, thereby avoiding the uncertainties of floating debt on cash flows during that time.

Industrial Revenue Bonds

Industrial revenue bonds are issued by financial institutions in connection with the development or purchase of industrial facilities. These may become attractive if certain income-tax and wealth-tax concessions are offered.
The bond proceeds could be used to purchase or a construct facilities which are subsequently leased or sold to the company. The institution acts as a conduit of funds between the lenders and the company in order to take advantage of tax benefits enjoyed by the institutions.

Commodity Bonds

Commodity bonds are bonds issued to share the risk and profitability of future commodity prices with the investor. For example, petro bonds, silver bonds, gold bonds and coal bonds.
A petro bond may carry a fixed rate of interest with part of the face value of the bonds denominated in barrels of oil. There would be a floor in the face value of the bond. In view of the upside profit potential in oil prices, the interest rate could be lower than the market rate of interest. These bonds may be issued for decontrolled items.

Participating Preference Shares

These are quasi equities and can be issued by companies to bolster the net worth without dilution of management control. They are similar in all respects to non voting equity shares except for preference over equity in the event of winding up. The face value of the share may be Rs.10 or Rs.100. The coupon rate may be linked into equity dividend. These shares will have the right to fully participate in the profits of the company and also be eligible for bonus shares. These are irredeemable in nature and hence an amendment to Section 80 of the Companies Act is necessary to enable the issue of such shares.
They are issued to risk averse investors interested in a study return.

Participating Debentures

These debentures are profit sharing debentures which are unsecured with a right to participate in the profits of companies. These debentures can be issued upto a maximum of 50% of the voting equity shares. They shall have a maturity period of 3-10 years, and shall be listed separately on the stock exchanges. These instruments are suited for high growth oriented existing dividend paying companies and may be issued by companies with a track record of dividend payment in the last two years and in 4 out of 5 or in 5 out of 7 previous years. These debentures may be offered to all classes of investors including NRIs and foreigners. The investors in these instruments may also be given entitlement in right and bonus issues.

Third Party Convertible Debentures

These are debt instruments with warrant attached which gives an option to subscribe to the equity shares of another company at a price lower than the market price. These are similar to convertible debentures with warrant option except that these debentures give an option to the investor to subscribe for shares in another company. The coupon rates on these debentures are lower than pure debt in view of the warrant option. The debentures are secured and can be issued to all classes of investors. These instruments are suitable for high profile companies raising resources for greenfield projects.

Possible variations of the instruments are detachable equity coupons and debentures with equity coupons.

Mortgage Backed Securities

These securities assure a fixed return which is derived from the performance of the specific assets. They are issued with a maturity period of 3 to 10 years and backed by pooled assets like mortgages, credit card receivables, etc. There is a commitment from the loan originator and/or intermediary institution to ensure a minimum yield on maturity.

Features of Assets to be Securitised

The assets to be securitised shall have the following features:

a. The cash flows generated from the assets should be received periodically in accordance with a pre-determined schedule.
b. The actual cash flows generated from the assets should be predictable.
c. The assets should be large in number and total value to be issued in securitised form.
d. The assets should be sufficiently similar in nature to enable pooling of their cash flows.
e. The assets should be marketable.

Types of Asset backed Securities: There are two types of asset backed securities. In the first type, the investors have an interest in the underlying assets, usually through a special purpose trust. These are known as ‘Unitisation’ in UK and ‘Pass through Securities’ in USA.

The second type is where a special purpose vehicle, usually a company issues negotiable securities whose value is derived from and secured by the assets held by the vehicle. These are known as ‘securitisation’ in UK and ‘asset backed securities’ in USA.

Advantages of Asset backed Securities to Issuer:

a. The issuer can generate cash from the assets immediately enabling funds to be redeployed in other projects.

b. The issuer may be able to improve balance sheet ratios by excluding the original assets and the securities created by the assets from the balance sheet by suitable structuring of the transaction.

Advantages of Asset backed Securities to Investor.

These instruments have a relatively low credit risk since the securities are backed by good quality collateral and offer a higher yield than Government securities.

Convertible Debentures Redeemable at Premium

These are convertible debentures issued at face value with a put option to the investor to resell the debentures to the issuer at a premium on a future date. The date value of the debentures is higher than the market value of the equity shares into which they are to be converted.

The pricing of the debenture is a very vital factor to the issuer, since the value of the debentures is fixed higher than the market value of the equity shares into which they are to be converted. Accordingly, the issuer is able to lower the financing cost by raising debentures at a high price and lower coupon rate as compared to convertible debenture redeemable at par.

If the price of the underlying equity shares does not rise sufficiently to make conversion attractive to the investor, he may exercise his put option and sell the debentures to the issuer at a premium.

The investor is not required to pay any tax on conversion of debentures into equity shares. The investor stands to gain if there is rise in price of the equity shares.

Carrot and Stick Bond

Another variation of the above instrument is the carrot and stick bond. The carrot is the lower than normal conversion premium i.e. the premium over the present market price of the equity shares is fixed at a reasonable level so that the price of the equity shares need not increase significantly to make conversion practical. The stick is the issuer’s right to call the issue at a specified premium if the price of the equity shares is traded above a specified percentage of the conversion price.

Capital indexed bonds

Capital indexed bonds are inflation-protection securities. Such bonds, therefore, provide good hedge against inflation risk. The benefits do extend beyond hedging. Capital index bonds can be used as a market indicator for inflation expectation. This will help investors take a more intelligent decision on their current consumption. Finally, the spot yield curve can be better constructed based on the real yields.

Inflation risk: A nominal bond is exposed to high inflation risk. This is the risk that inflation will increase, leading to increase in interest rate. Essentially then, inflation risk is a sub-component of interest rate risk. A capital indexed bonds lowers the interest rate risk by neutralising the inflation risk.

The effectiveness of the hedge will, however, depend on the appropriateness of the inflation index. The purpose of issuing capital indexed bonds will not be fully served if the RBI were to use the Wholesale Price Index (WPI) or the Retail Price Index (RPI) as the index for inflation. The reason is that these indices do

not adequately capture inflation as it affects the investors, especially the retail class.
If banks are protected against inflation risk, they may, perhaps, pass on the benefits in the form of higher interest rate to the retail investors. That, in turn, provides retail investors a higher cushion against inflation risk. In such cases, more the inflation index is aligned to price levels affecting retail consumption, better the hedge.
Inflation expectation: Investors buy bonds by postponing their current consumption. There is, therefore, a trade-off between investment and consumption. To make an intelligent decision between these two states of nature, investors need an indicator to measure inflation expectations. At present, due to lack of adequate measures, we assume that inflation expectation is the same as current inflation. If actual inflation were higher in the future, the investment decision may be unattractive. It is, therefore, important to proxy inflation expectation. A capital indexed bond helps in this regard.
If the RBI were to issue capital indexed bonds across the yield curve, we will have real yields for each maturity sector. We already have nominal yields as well for these sectors. The difference between the nominal and the real yields is a proxy for inflation expectation.
Moreover, the RBI also proposes to introduce STRIPs. Such instruments will make more sense on real interest-bearing bonds than the nominal ones.

Debt for Equity Swap

These instruments give an offer to the debt holders to exchange the debt for equity shares of the company.
The issuers offering debt for equity swaps are interested in increasing equity capital by improving their debt-equity ratios and enhancing their debt issuing capacity. They reduce their interest burden and replace it with dividend burden which is payable at the discretion of the issuer. However, the issuer faces the risk of dilution of earnings per share by a sharp rise in the equity. In addition, dividends are not tax deductible.
From the investors point of view, there is potential gain from rise in the value of the equity shares. The potential rise in price of equity shares may or may not materialise.
Variations of this instrument are mortgage backed securities that split the monthly payment from underlying mortgages into two parts - each receiving a specified portion of the principal payments and a different specified portion of the interest payments.

Zero Coupon Convertible Notes

These are debt convertible into equity shares of the issuer. If investors choose to convert, they forgo all the accrued and unpaid interest. These convertibles are generally issued with put option to the investors. The advantages to the issuer is the raising of convertible debt without heavy dilution of equity. Since the investors give up acquired interest by exercise of conversion option, the conversion option may not be exercised by many investors.
The investor gains in the event of appreciation in the value of the equity shares. Even if the appreciation does not materialise, the investor has the benefit of a steady stream of implied income. If the instrument is issued with put option, the

investor can resell the securities to the investor.

Global Depository Receipts

It is a form of depository receipt or certificate created by the Overseas Depository Bank outside India denominated in dollar and issued to non-resident investors against the issue of ordinary shares or foreign currency convertible bonds of issuing company. In simple words, it is basically a negotiable instrument denominated in US dollars. It is traded in Europe or the US or both. After getting approval from the Ministry of Finance and completing other formalities, a company issues rupee denominated shares in the name of depository which delivers these shares to its local custodian bank, the holder on records, thus depository. The depository then issues dollar denominated depository receipts (or GDR) against the shares registered with it. Generally one GDR is equivalent to one or more (rupee denominated) shares. It is traded like any other dollar denominated security in the foreign markets, in addition to equity financing (as GDR represents equity) over debt financing. GDR issue also possesses merits like less issue formalities, less administrative works as regards dividend payment, information dissemination, annual general meeting etc. as the issuer deal only with a single shareholder, the depository; easy availability of foreign exchange and no foreign exchange risk. Besides issuing companies, foreign investors especially FIIs also get advantage of investing in the Indian companies without getting registration with SEBI, relief from cumbersome settlement and delivery procedures, adequate liquidity (as GDR is as liquid as the shares of the company in its home market) and generally higher returns. In fact, GDR holders enjoy all economic benefits of the underlying shares but has none of the corporate rights like right to vote.

Foreign Currency Convertible Bonds (FCCBs)

A foreign currency convertible bond (FCCB) is a quasi debt instrument which is issued by any corporate entity, international agency or sovereign state to the investors all over the world. They are denominated in any freely convertible foreign currency. Euro Convertible Bonds are usually issued as unsecured obligation of the borrowers. FCCBs represent equity linked debt security which can be converted into shares or into depository receipts. The investors of FCCBs has the option to convert it into equity normally in accordance with pre-determined formula and sometimes also at a pre-determined exchange rate. The investor also has the option to retain the bond. The FCCBs by virtue of convertibility offers to issuer a privilege of lower interest cost than that of similar non convertible debt instrument. By issuing these bonds, a company can also avoid any dilution in earnings per share that a further issue of equity might cause whereas such a security still can be traded on the basis of underlying equity value. The agreement providing for the issuance of FCCBs normally carry less restrictive covenants as they relate to the issuer. Further, FCCBs can be marketed conveniently and the issuer company can expect that the number of its shares will not increase until investors see improved earnings and prices for its common stock. Like GDRs, FCCBs are also freely tradeable and the issuer has no control over the transfer mechanism and cannot be even aware of ultimate beneficiary. The Finance Ministry vide Notification dated 20.6.1994 stated that w.e.f. this date FCCBs will be considered an approved instrument of accessing external commercial borrowings. The terms and conditions normally applicable to commercial borrowing would be binding on convertible bonds. This would include restrictions on end-use, import of capital goods and minimum maturity for bonds. Priority for accessibility to this facility would be given to firms with good forex earnings record or potential.

The following are some of the special features of FCCBs:

1. Convertible Euro Bonds are similar to Convertible Bonds as issued in domestic capital markets since they give the investor the right to convert the fixed interest bond into equity shares or common stock of the issuing company.
2. The Bonds themselves have fixed rate of interest which is lower than coupons or straight bonds of comparable terms.
3. The conversion rights stipulate that the bondholder may convert the bond into ordinary shares, either on a series of given dates or at any time between specified dates in the future. The price at which the shares may be purchased through such conversion provisions are specified at the time the convertible bonds are issued.
4. Convertible bonds are attractive to the issuer because they are available to the investor at a cost less than that of the alternative fixed interest debt instruments. For the investor, convertible bonds offer an opportunity to participate in the capital growth of a company. He receives a fixed income from the bonds for as long as he holds them but stands to make a capital gain by converting the bonds to equity, provided that by the conversion date, the price of the shares has risen higher than the fixed conversion price. On the other hand, if the share price fails to rise, or falls, the risk is limited by the income return available from the fixed interest feature of the bond.
5. Convertible bonds thus offer a mixture of the attributes of fixed interest and equity investments. They have a higher yield than equities but have the potential of capital gain while the risk of capital loss is limited by the ability to hold to maturity. They provide a fixed return coupled with possible capital appreciation although the price of convertible bonds is more volatile than for straight bonds, being influenced by the share price of the issuing company, as well as by yields in the international fixed interest market.
6. Convertible Euro bonds offer an additional advantage to the investor which is not available with convertible domestic bonds. They may be issued in a currency that differs from the currency in which the shares of the company are denominated. In the last three or four years the Japanese companies, in particular, have issued convertible bonds denominated in US dollars and Deutschemark of Swiss Francs but with options to convert into shares of the borrowing company, denominated in yen. Such issues give the bondholders the opportunity to participate in the Japanese stock market as well as the option to diversify the currency risk.
7. Convertible bonds are normally issued with fixed exchange rate clauses specifying the rates at which the bonds may be converted into ordinary shares of the issuer. The investor’s decision of whether to opt for conversion or hold convertible bonds is, therefore greatly influenced by relative exchange rate movements.

Derivatives
Derivatives are contracts which derive their values from the value of one or more of other assets (known as underlying assets). Some of the most commonly traded derivatives are futures, forward, options and swaps. A brief detail of futures and options are given as under:

Futures

Futures is contract to buy or sell an underlying financial instrument at a specified future date at a price when the contract is entered. Underlying assets for the purpose include equities, foreign exchange, interest bearing securities and commodities. The idea behind financial futures contract is to transfer future changes in security prices from one party in the contract to the other. It offers a means to manage risk in participating financial market. Futures basically transfer value rather than create it. It is a means for reducing risk or assuming risk in the hope of profit. Every futures contract entered into has two side willing buyer and a willing seller. If one side of contract makes a profit, the other side must make a loss. All futures market participants taken together can neither lose nor gain, the futures market is a zero sum game.

For successful futures, two types of participants i.e. hedgers and speculators are essential. Financial futures contracts may be of various types such as: -

— Interest Rate Futures
— Treasury Bill Futures
— Euro-Dollar Futures
— Treasury Bond Futures
— Stock Index Futures
— Currency Futures.

However, future prices reflect demand and supply conditions in future market. As in other markets, an increase or decrease in supply lowers or increases the prices of instruments for future delivery.

Options

An option contract conveys the right to buy or sell a specific security or commodity at specified price within a specified period of time. The right to buy is referred to as a call option whereas the right to sell is known as a put option. An option contract comprises of its type a put or call, underlying security or commodity expiry date, strike price at which it may be exercised. Options are generally described by the nature of underlying commodity. An option on common stock is said to be stock option; an option on a bond, a bond option; an option on a foreign currency, a currency option, an option on future contract, a future option; and so on. The specified price at which the underlying commodity may be bought (in the case of call) or sold (in the case of put) is called exercise price or the striking price of the option. To buy or sell the underlying commodity pursuant to option contract is to exercise the option. Most of the option may be exercised at any time, upto and including the expiration date.

The buyer of an option pays the option writer (seller) an amount of money called the option premium or option price. In return, the buyer receives the privilege, but not the obligation, of buying (in the case of call) or selling (in the case of a put) the underlying commodity for the exercise price. In the case of a call option, if the price of the commodity exceeds the exercise price, the call option is said to be in the money and the call option buyer could exercise the option, thereby earning the difference between the two prices-the exercise value or intrinsic value. On the other hand, if the price of the commodity is below the exercise price, the call option is out-of the money and will not be exercised, its intrinsic value is zero. In the case of a put option, if the price of the commodity is below the exercise price, the put option is said to be in-the-money. The put option buyer could exercise the option to earn the difference between the exercise price and the price of the commodity. A put option is said to be out of the money when the commodity price exceed the exercise price.

Option provide investors with the opportunity to hedge investments in the underlying shares and share portfolios and can thus reduce the overall risk related to the investments significantly.

Mini contracts on derivatives

Mini derivative contract on Index (Sensex and Nifty) with a minimum contract size of Rs. 1 lakh at the time was being introduced by SEBI.

Mini Derivative contracts on sensex

Bombay Stock Exchange offers mini Futures and Options contracts on the leading Indian equity Index 'SENSEX ' for retail investors to participate in the ever growing Derivatives market.

Mini Derivative contracts on Nifty

Mini derivative (futures and options) contracts on S&P CNX Nifty index was introduced for trading in F&O segment w.e.f. January 1, 2008 by National Stock Exchange.

PARTICIPATORY NOTES

Participatory notes are derivative instruments which are issued by FIIs to foreign investors. Underlying securities in participatory notes are Indian Stocks. Foreign investors who want to trade in Indian securities anonymously use PN route without obtaining registration from SEBI. It is an understanding between a foreign institutional investor (FIIs) who is registered here and the other one who is not registered. The registered Investor (broker) places an order for an un-registered investor in anonymous name and these types of trade are carried through the internal account of the FIIs.

PNs can be misused for money laundering and there is an added risk in allowing those offshore investors to invest in India as the Indian regulators may not be able to catch hold of them.

Though SEBI has made certain regulations on FIIs and made certain Know Your Client norms applicable to them, there has been much non-compliance in this regard.

Maximum level of transparency and comfort regarding the kind of players and origin of money is what is imperative to remove such lapses.

Threats on Issuance of Particiaptory Notes (PNs)

1. **Encourages anonymous transactions by brokers as identity of investors is not known.**
   Participatory Notes permits FIIs to transact for a foreign investor who is not registered or who has not fulfilled the formalities relating to KYC norms. They transact through their internal account for this purpose without disclosing the details of the ultimate investor.

As PNs are freely transferable, trading of these instruments makes it all the more difficult to know the identity of the owner. Some of the money coming into the market through PNs could be unaccounted wealth of some rich Indians in the disguise of FII investment.

2. **Creation of multi-layers**
   The ultimate unregistered investor/beneficiary, who explores the Indian market without evolving himself into any regulation, is not known because of many artificial layers created between FII and the ultimate investors. Many a times Participatory Notes are held indirectly with an account holder of the clearing systems through a chain of intermediaries and custodians and identifying and linking this chain is really a difficult task.
2. **Abuse of system by unknown investors and suspicious transactions**
   PN routes leads to round tripping of Indian capital moved out and routed back through the various FII accounts and sub-accounts, taking advantage of the tax breaks.
   The existing system encourages the flow of unaccounted money.

Hedge Funds*

1.1 Defining the Hedge Fund

There is no exact definition to the term "Hedge Fund"; it is perhaps undefined in any securities laws. There is neither an industry wide definition nor a universal meaning for "Hedge Fund". Hedge funds, including fund of funds are unregistered private investment partnerships, funds or pools that may invest and trade in many different markets, strategies and instruments (including securities, non-securities and derivatives) and are not subject to the same regulatory requirements as mutual funds, including mutual fund requirements to provide certain periodic and standardized pricing and valuation information to investors. The term can also be defined by considering the characteristics most commonly associated with hedge funds. Usually, hedge funds:

— are organized as private investment partnerships or offshore investment corporations;

— use a wide variety of trading strategies involving position-taking in a range of markets;

— employ as assortment of trading techniques and instruments, often including short-selling, derivatives and leverage;

— pay performance fees to their managers; and

— have an investor base comprising wealthy individuals and institutions and relatively high minimum investment limit (set at US $100,000 or higher for most funds).

The term "hedge funds", first came into use in the 1950s to describe any investment fund that used incentive fees, short selling, and leverage. Over time, hedge funds began to diversify their investment portfolios to include other financial instruments and engage in a wider variety of investment strategies. Today, in addition to trading equities, hedge funds may trade fixed income securities, convertible securities, currencies, exchange – traded futures, over the counter derivatives, futures contracts, commodity options and other non-securities investments. Furthermore, hedge funds today may or may not utilize the hedging and arbitrage strategies that hedge funds historically employed, and many engage in relatively traditional, long only equity strategies.

1.2 Hedge Fund and Other Pooled Investment Vehicles

Hedge funds are sometimes called as ‘rich man’s mutual fund’. In addition, other unregistered investment pools, such as venture capital funds, private equity funds and commodity pools, are sometimes referred to as hedge funds. Although all of these investment vehicles are similar in that they accept investors’ money and generally invest it on a collective basis, they also have characteristics that distinguish them from hedge funds.

1.2.1 Mutual Fund or Registered Investment Companies

In many ways, hedge funds are similar to mutual funds. Both entities issue units or securities to investors, hold pools of securities to diversify investment, have professional asset manager and may, at times, have similar investment strategies. At the same time, they also differ in a number of ways. Mutual funds are registered with securities markets regulator and are subject to the provisions of the relevant regulations such as, offer/issue of units/securities, disclosure and reporting requirement, valuation for the purpose of computation of NAV, conflict of interest issue and limit leverage. Hedge funds are not required to be registered and therefore, are not subject to similar regulatory provisions.

1.2.2 Private Equity Fund

A private equity fund, like a hedge fund, is an unregistered investment vehicle in which investors pool money to invest. Private equity funds concentrate their investments in unregistered (and typically illiquid) securities. Both private equity funds and US based hedge funds are typically organized as limited partnerships (LLP). Like hedge funds, private equity funds also rely on the exemption from registration of the offer and sale of their securities. Both private equity and hedge funds. The investors in private equity funds and hedge funds typically include high net worth individuals and families, pension funds, endowments, banks and insurance companies. Private equity funds, however, differ from hedge funds in terms of the manner in which contribution to the investment pool is made by the investors. Private equity investors typically commit to invest a certain amount of money with the fund over the life of the fund, and make their contributions in response to “capital calls” from the fund’s general partner. Private equity funds are long term investments, provide for liquidation at the end of the term specified in the fund’s governing documents and offer little, if any, opportunities for investors to redeem their investments. A private equity fund may distribute cash to its investors when it sells its portfolio investment, or it may distribute the securities of a portfolio company.

1.2.3 Venture Capital Fund

Venture capital pools are similar to hedge funds or private equity; they attract the same class of investors. Venture capital funds, however, invest in the start-up or early stages of a company. Unlike hedge fund advisors, general partners of venture capital funds often play an active role in the companies in which the funds invest. In contrast to a hedge fund, which may hold an investment in a portfolio security for an indefinite period based on market events and conditions, a venture capital fund typically seeks to liquidate its investment once the value of the company increases above the value of the investments.

1.2.4 Commodity Pool

Commodity pools are investment rusts, syndicates or similar enterprises that are operated for the purpose of trading commodity futures. The investment concentration in commodity futures distinguishes commodity pools from hedge funds.

1.3 Domestic and Offshore Hedge Fund

1.3.1 Domestic Hedge Fund

Domestic hedge funds are usually organized (in USA) as limited partnerships to accommodate investors that are subject to U.S. income taxation. The fund’s sponsor typically is the general partner and investment adviser. Hedge funds may also take the form of limited liability companies (LLC) or business trusts. LLPs, LLCs and business trusts are generally not separately taxed and, as a result, income is taxed only at the level of the individual investors. Each of three firms also limits investors liability; LLCs offer the additional benefit of limited liability for fund advisors (general partners).

1.3.2 Offshore Hedge Fund

Offshore hedge funds are typically organized as corporations in countries such as the Cayman Islands, British Virgin Islands, the Bahamas, Panama, The Netherlands Antilles or Bermuda. Offshore funds generally attract investments of US. tax exempt entities, such as pension funds, charitable trusts, foundations and endowments, as well as non-U.S. residents. U.S. tax-exempt investors favour investments in offshore hedge funds because they may be subject to taxation if they invest in domestic limited partnership hedge funds.

1.4 Fund of Funds

Rather than investing in individual securities, a Fund of Funds invests in other hedge funds. Technically any fund that pools capital together, while utilizing two or more sub managers to invest money in equity, commodities, or currencies, is considered a Fund of Funds. Investors are allocating assets to Fund of Funds products mainly for diversification amongst the different managers' styles, while keeping an eye on risk exposure. Fund of Funds are structured as limited partnerships, which afford advantages to the investor. One of the advantages is due diligence. Due diligence is a primary advantage because the fund of funds manager may spend his whole day evaluating strategies and speaking with individual fund managers. This would be an extremely hard task for an individual. The fund of fund also may combat risk by achieving manager diversity, because of the different strategies employed by the underlying managers. For example, some fund of funds may have exposure to a long/short fund, a distressed fund, and a private equity fund. By investing within the fund of funds, the investor is given the opportunity to have a unique asset allocation product, while trying to limit the risk on the downside. Fund of funds have some drawbacks however. The first to come to mind is the double layer of fees. When dealing with fund of funds, an investor must understand that the underlying funds charge a fee, as well as the fund of funds manager. This translates to "layers" of fees before the investor receives his first rupee return. Transparency issues are also important. Research such as the individual manager's background and reputation, not to mention the nature of the investments that they are utilizing, are all issues a fund of fund manager must investigate. Therefore, investors have to rely on the fund of funds manager's talent and expertise in choosing managers, when investing in a fund of funds. Investors look for Fund of funds because hopefully, they provide more stable returns while reducing risk.

1.5 Hedge Funds by Strategy Types

Hedge Fund Investment strategies tend to be quite different from those followed by traditional asset managers. Moreover, each fund usually follows its own proprietary strategies which do not always fit within neat definitional categories. However, the FSA, UK stated that the hedge funds could be distinguished by the following three broad types:

1.5.1 *Event driven* - funds investing in securities to take advantage of price movements generated by corporate events. This group includes merger arbitrage funds and distressed asset funds.

1.5.2 *Global macro* – funds that take long and short positions in major financial markets based on views influenced by economic trends and events.

1.5.3 *Market neutral* – funds where the manager attempts to minimize (or significantly reduce) market risk. This category includes long/short equity funds, convertible bonds arbitrage funds, and fixed income arbitrage.

Another approach of classifying hedge funds by strategy types is that of the following table which briefly summarizes the data base according to a classification system recently adopted by FRM1 and MSCI, Inc. Given the wide range and idiosyncratic nature of hedge fund specialties, any classification system will not completely characterize some managers, but the following one is generally considered to be a reasonable description of the universe.

A Taxonomy of Hedge Fund Strategies

Strategy	Description
Directional Trading	Based upon speculation of market direction in multiple asset classes. Both model-based systems and subjective judgment are used to make trading decisions.
Relative Value	Focus on spread relationships between pricing components of financial assets. Market risk is kept to minimum and many managers use leverage to enhance returns.
Specialist Credit	Based around lending to credit sensitive issuers. Funds in this strategy conduct a high level of due diligence in order to identify relatively inexpensive securities.
Stock Selection	Combine long and short positions, primarily in equities, in order to exploit under and overvalued securities. Market exposure can vary substantially

1.6 Size of the Hedge Fund Market

Since hedge funds do not register with SEC their actual data cannot be independently followed; therefore hedge fund data is self reported. Despite the ambivalent image, hedge funds have attracted significant capital over the last decade, triggered by successful track records. The global hedge funds volume has increased from US $ 50 billion in 1988 to US $ 750 billion in 2003 yielding an astonishing cumulative average growth rate (CAGR) of 24 %. The global hedge fund volume accounts for about 1% of the combined global equity and bond market. The number of hedge funds increased from 1500 to about 8000 between 1998 and 2003. Estimates of new assets flowing into hedge funds exceed US $25 billion on average for the last few years. In the next five to ten years, hedge fund assets have been predicted to exceed US $ 1 trillion.

In Europe the overall hedge fund volume is still small with about US $ 80 billion in 2003 which accounts for about 11% of the global hedge fund volume. The number of hedge funds in Europe is about 600. Within Europe, hedge funds become particularly popular in France and Switzerland where already 35% and 30% of all institutional investors have allocated funds into hedge funds. In 2003, Italy's hedge fund industry nearly tripled in size as assets grew from Euro 2.2 billion to Euro 6.2 billion. Germany is at the lower end with only 7% of the institutional investors using hedge funds. But the Investment Modernization Act, may well trigger rising interest from German investors. Overall, hedge fund assets are estimated to increase ten fold in Europe over the next 10 years. The acceptance of hedge funds seems to be growing through out Europe, as investors have sought alternatives that are perceived as less risky during the last three years equity bear market.

This trend is also evident in Asia, where hedge funds are starting to take off. According to Asia Hedge magazine, some 150 hedge funds operate in Asia, till year 2002 which together managed assets estimated at around US $ 15 billion. In Japan, too hedge funds are becoming the focus of more attention. Recently, Japan's Government Pension Fund one of the world's largest pension fund with US $ 300 billion has announced plans to start allocating money to hedge funds. Industry participants believe that Asia could be the next region of growth for the hedge fund industry. The potential of Asian hedge funds is well supported by fundamentals. From an investment perspective, the volatility in the Asian markets in recent years has allowed long-short and other strategic players to out perform regional indices. The relative inefficiency of the regional markets also presents arbitrage opportunities from a demand stand point US and European investors are expected to turn to alternatives in Asia as capacity in their home markets diminish. Further, the improving economic climate in South East Asia should help foreign fund managers and investors to refocus their attention on the region. Overall, hedge funds look set to play a larger role in Asia.

1.7 Reasons for Rapid Growth of Hedge Fund Industry

While high net worth individuals remain the main source of capital, hedge funds are becoming more popular among institutional and retail investors. Fund of funds (hedge funds) and other hedge fund-linked products are increasingly being marketed to the retail investors in some jurisdictions. There are a number of factors behind the rising demand for hedge funds. The unprecedented bull run in the US equity markets during the 1990s swelled investment portfolios. This lead both fund managers and investors to become more keenly aware of the need for diversification. Hedge funds are seen as a natural "hedge" for controlling downside risk because they employ exotic investments strategies believed to generate returns that are uncorrelated to asset classes.

Until recently, the bursting of the technology and telecommunications bubbles, the wave of scandals that hit corporate America and the uncertainties in the US economy have lead to a general decline in the stock markets worldwide. This in turn provided fresh impetus for hedge funds as investors searched for absolute returns.

The growing demand for hedge fund products has brought changes on the supply side of the market. The prospect of untold riches has spurred on many former fund managers and proprietary trades to strike out on their own and set up new hedge funds. With hedge funds entering the main stream and becoming 'respectable', an increasing number of banks, insurance companies, pension funds, are investing in them.

1.8 Performance of Hedge Fund Industry

Hedge fund performance has varied through time, with lower figures in the most recent five-and-a half years. Volatility has also appeared to have increased in more recent periods. In general, however, the risk-adjusted performance of the universe of hedge funds appears to have been superior to traditional active managers and passive benchmarks over the last ten years.

Performance from 1990 through June 2000

	All Hedge Funds	*Direc-tional Trading*	*Relative Value*	*Specialist Credit*	*Stock Selec-tion*	*S&P 500*
Annualised Return	12.2%	17.8%	12.3%	14.5%	18.9%	17.2%
Annualised Volatility	7.7%	13.6%	5.7%	9.3%	13.4%	13.7%
Sharpe Ratio[*a]	1.6	0.9	1.3	1.0	1.1	0.9

It turns out that the hedge fund managers exhibit much lower correlation with one another than traditional active managers. The average correlation among Lipper large cap mutual funds managers has been on the order of 90%, while hedge funds resemble S&P 500 stocks with an average correlation on the order of 10% (its about 20% on average for stocks). There could be a large idiosyncrasies component to the returns of hedge fund managers, even within a particular strategy, whereas Lipper managers tend to be more correlated with their benchmarks and hence with each other. The low average correlation among hedge fund managers suggest that pooling funds into portfolios or indexes can significantly reduce their total risk, providing distinct advantages relative to traditional active strategies.

1.9 Market Benefits of Hedge Funds

Hedge funds can provide benefits to financial markets by contributing to market efficiency and enhance liquidity. Many hedge fund advisors take speculative trading positions on behalf of their managed hedge funds based extensive research about the true value or future value of a security. They may also use short term trading strategies to exploit perceived mis-pricings of securities. Because securities markets are dynamic, the result of suc h trading is that market prices of securities will move toward their true value. Trading on behalf of hedge funds can thus bring price information to the securities markets, which can translate into market price efficiency. Hedge funds also provide liquidity to the capital markets by participating in the market.

Hedge funds play an important role in a financial system where various risks are distributed across a variety of innovative financial instruments. They often assume risks by serving as ready counter parties to entities that wish to hedge risks. For example, hedge funds are buyers and sellers of certain derivatives, such as securitised financial instruments, that provide a mechanism for banks and other creditors to un-bundle the risks involved in real economic activity. By actively participating in the secondary market for these instruments, hedge funds can help such entities to reduce or manage their own risks because a portion of the financial risks are shifted to investors in the form of these tradable financial instruments. By reallocating financial risks, this market activity provides the added benefit of lowering the financing costs shouldered by other sectors of the economy. The absence of hedge funds from these markets could lead to fewer risk management choices and a higher cost of capital. Hedge fund can also serve as an important risk management tool for investors by providing valuable portfolio diversification. Hedge fund strategies are typically designed to protect investment principal. Hedge funds frequently use investment instruments (e.g. derivatives) and techniques (e.g. short selling) to hedge against market risk and construct a conservative investment portfolio – one designed to preserve wealth. In addition, hedge funds investment performance can exhibit low correlation to that of traditional investments in the equity and fixed income markets. Institutional investors have used hedge funds to diversify their investments based on this historic low correlation with overall market activity.

From time to time, allegations are made by market participants about collusion among hedge funds to manipulate markets. Like all other market participants, hedge funds are covered by both criminal and civil regimes that outlaw various forms of market manipulation and abuse.

Exchange Traded Funds (ETFs)*[*B]

Exchange traded funds (ETFs) are a new variety of mutual fund that first became available in 1993. ETFs have grown rapidly and now hold nearly $80 billion in assets. ETFs are sometimes described as more “tax efficient” than traditional equity mutual funds, since in recent years, some large ETFs have made smaller distributions of realized and taxable capital gains than most mutual funds.

In the November/December 1976 issue of *Financial Analysts Journal,* Professor Nils Hakansson published a paper titled “The Purchasing Power Fund: A New Kind of Financial Intermediary.” The theoretical “Purchasing Power Fund” envisioned a new financial instrument made up of “Supershares” that provided payoffs only for a pre-specified level of market return. The underlying assets of the Purchasing Power Fund were index funds.

In the late 1980s, Leland, O’Brien, Rubenstein Associates (LOR), a firm known for developing portfolio insurance products, believed there was a demand for a simplified version of the Purchasing Power Fund as a hedge product. With the backing of large institutional investors, such as the IBM Pension Fund, LOR wanted to create a so-called “SuperTrust” based on Hakansson’s “Supershares” ideas.

In order for the SuperTrust to work, the product needed an underlying index investment that could be listed on a stock exchange and could continuously offer and redeem shares - an ETF. The U.S. Securities and Exchange Commission (SEC) had previously authorized securities that could be either open-ended or exchange-listed, but they had not authorized securities that could have both characteristics.

In 1990, LOR undertook the arduous and expensive task of petitioning the SEC to allow the creation of an ETF as the underlying security for the SuperTrust. LOR chose the S&P 500 Index as the structure and named the investment the “Index Trust SuperUnit”.

In 1990, the SEC issued the Investment Company Act Release No. 17809, the “SuperTrust Order”, that granted LOR specified exemptions from the Investment Company Act of 1940 (the Act). Specifically, the order granted exemptions from the rules regulating unit investment trusts and the SEC’s rules and regulations governing investment companies. The SEC also made exemptions to the rules governing the way securities are sold and exchanged. This order allowed the first ETF.

After additional regulatory delays, LOR introduced the SuperTrust and the Index Trust SuperUnit in 1993. The SuperTrust and the SuperUnits offered advantages over other hedge products. However, even LOR’s simplified version of Professor Hakansson’s Purchasing Power Fund turned out to be too complex for the marketplace and the SuperTrust did not get the financial backing that LOR had hoped for. Making matters worse, demand for all hedge products had fallen off dramatically. The SuperTrust was terminated in 1996.

Although LOR developed the Index Trust SuperUnit as an investment underlying a hedge product, there was some discussion of the product being valuable as a stand-alone S&P 500 Index investment. The Index Trust SuperUnit enabled investors to trade directly in the S&P 500 Index as if it were a listed corporation. Yet, the Index Trust SuperUnit was marketed and priced as a hedge product and thus was not viable on its own.

The American Stock Exchange LLC, through its subsidiary PDR Services LLC and the Standard & Poors Depository Receipt (SPDR) Trust, took advantage of the SuperTrust Order to petition for and receive a SEC Order that in 1992 authorized a stand-alone S&P 500 Index-based ETF as a unit investment trust. The SPDR Order specified some additional exemptions allowing for easier exchange of shares, a concept pioneered in the SuperTrust and explained below.

Unlike the Index Trust SuperUnit, the SPDR gained acceptance in the marketplace and became the first commercially successful ETF.

Exchange traded funds (ETFs) are a rapidly growing class of financial products. ETFs are typically organized as unit trusts. They were introduced in 1993, and by the end of 2001, they held $79 billion in assets — 2.4 percent of the total assets in equity mutual funds. The share of equity mutual fund assets held through ETFs doubled in 2000 and rose by nearly fifty percent in 2001. With several years of continued growth at this pace, the assets held through ETFs will rival the amount held in equity index funds.

In short, they are similar to index mutual funds but are traded more like a stock.

As their name implies,Exchange Traded Funds represent a basket of securities that are traded on an exchange. As with all investment products, exchange traded funds have their share of advantages and disadvantages.

Advantages of Exchange Traded Funds

Being similar to stocks, exchange traded funds offer more flexibility than a typical mutual fund.

— ETFs can be bought and sold throughout the trading day, allowing for intraday trading - which is rare with mutual funds.

— Traders have the ability to short or buy ETFs on margin.

— Low annual expenses rival the cheapest mutual funds.

— Tax efficiency - due to SEC regulations, ETF tend to beat out mutual funds when it comes to tax efficiency (if it is a non-taxable account then they are equal).

Disadvantages of ETFs

Unfortunately, exchange traded funds do have some negatives:

— Commissions - like stocks, trading exchange traded funds are an extra cost.

— Only institutions and the extremely wealthy can deal directly with the ETF. Companies must buy through a broker.

— Unlike mutual funds, ETFs don't necessarily trade at the net asset values of their underlying holdings, meaning an ETF could potentially trade above or below the value of the underlying portfolios.

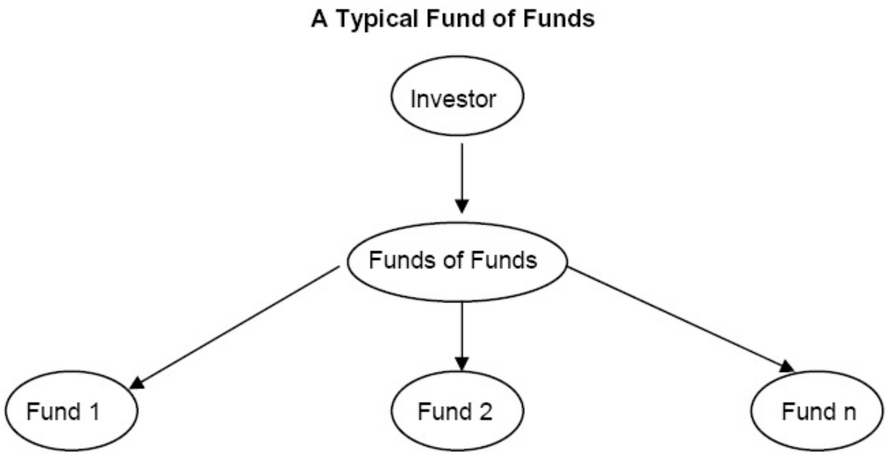
— Slippage - as with stocks, there is a bid-ask spread, meaning you might buy the ETF for 15 1/8 but can only sell it for 15 (which is basically a hidden charge).

Fund of Funds (FoFs)[*c]

Fund of funds (FoFs) is a mutual fund scheme, which invests in the schemes of same mutual funds or other mutual funds, instead of investing in securities. These funds can invest in equity oriented, debt oriented and liquid schemes or sector specific schemes. Depending on the investment style of the fund managers, fund of funds schemes can be broadly classified into:

Sector specific funds: Such type of funds invest in different sectors of the economy and thus hedge themselves against the under performance of any sector by taking the advantage from the rise in another sector.

Asset allocation funds: These funds diversify investment by holding several different asset classes at the same time. By varying the stocks to bonds proportion, the fund endeavors to endow the investors, with an appropriate asset allocation in different stages of their lives. They are also known as life cycle funds.



The various benefits of fund of funds scheme are presented below.
Diversification: As a fund of funds invests in the schemes of other funds, it provides a greater degree of diversification.
Uncomplicated: Instead of investing in different stocks/units of mutual funds and keeping a track record of all of them, it will be much easier to invest in and track only one fund, which in turn invests in other mutual funds.
Cheap: While entering into the capital markets it is difficult to diversify because of limited funds. Fund of funds provide an opportunity to go for diversification with comparatively limited amounts.
Risk: Investors can trim down the risk by choosing this route. Because of diversification, even if one stock/scheme is not performing well risk level comes down.
Expertise of Various Managers: As in the case of schemes of mutual funds, fund of funds scheme also work under the due diligence of a fund manager. This gives the scheme additional expertise as compared to other mutual funds schemes. These schemes also provide access to information which may be difficult to obtain for an investor on a case by case basis.
However, just like any other investment, fund of funds is not free from shortcomings. Few of the disadvantages are specified below.

1. **Additional Fees:** The more diversified the fund is, the greater the likelihood that the investor will incur an incentive fee on one or more of the constituent managers, regardless of overall FoF performance.[1]
2. **Associated Risks:** Risks associated with all the underlying funds get added at this level. Following are the type of risks associated with fund of funds scheme.
   — **Management Risks:** Every fund manager has a particular style of diversification. This diversification style will be in perfect correlation with the number of managers involved. The views of a manager may be altogether different from the market. As pointed out by Harry Kat that once a fund of funds reached a certain number of managers, adding more flattens the returns curve and diversifies away alpha.
   — **Operational Risks:** Due diligence of a scheme in itself gives rise to operational risks. Continuous monitoring is required for knowing about performance of the funds, any possibility of a fraud and to know about the investment style of the funds and any desirable or undesirable changes in it.

— **Qualitative Risks:** These include risks associated with the management environment of the fund such as organizational structure, infrastructure, investment process, operational issues etc.

Realizing the benefits of the scheme and the potential of the Indian mutual fund industry SEBI had decided to allow fund of funds from May 29, 2003.

Regulations in India

The fund of funds scheme was introduced in the Indian market by making suitable amendments in SEBI (Mutual Funds) (Amendment) Regulations, 2003.

Fund of Funds Schemes in India

Prudential ICICI was the first to introduce fund of funds in India in November 2003. Till the end of this financial year, total of eight fund of funds schemes have mobilized Rs.1,189 crore and have assets worth Rs.816 crore. Up to March 2003, there were about 120 fund of funds operating in the global market having assets size of approximately US $ 130 billion.

Gold Exchange Traded Funds

SEBI (Mutual Funds) (Amendment) Regulations dated January 24, 2006 permitted introduction of Gold Exchange Traded Fund schemes by Mutual Fund. Gold Exchange Traded Fund (GETF) schemes are permitted to invest primarily in

a. Gold
b. Gold related instruments i.e. such instruments having gold as underlying, as are specified by SEBI from time to time.

A gold exchange traded fund scheme is subject to the following investment restrictions:

a. the initial issue expenses in respect of any such scheme should not exceed six percent of the funds raised under that scheme;
b. the funds of any such scheme should be invested only in gold or gold related instruments in accordance with its investment objective, except to the extent necessary to meet the liquidity requirements for honouring repurchases or redemptions, as disclosed in the offer document; and
c. pending deployment of funds in accordance with clause (b), the mutual fund may invest such funds in short term deposits of scheduled commercial banks."

1. *Valuation*

   Since physical gold and other permitted instruments linked to gold are denominated in gold tonnage, it will be valued based on the market price of gold in the domestic market and will be marked to market on a daily basis. The market price of gold in the domestic market on any business day would be arrived at as under:

   Domestic price of gold = (London Bullion Market Association AM fixing in US $/ounce X conversion factor for converting ounce into kg for 0.995 fineness X rate for US$ into INR) + custom duty for import of gold + sales tax/octroi and other levies applicable.

   The Trustees reserve the right to change the source (centre) for determining the exchange rate. The AMC should record in writing the reason for change in the source for determining the exchange rate.

2. *Determination of Net Asset Value*

NAV of units under the Scheme would be calculated as shown below:

	Market or Fair Value of Scheme's investments + Current
NAV (Rs.) =	Assets Minus Current Liabilities and Provision
	No of Units outstanding under Scheme on the Valuation Date

The NAV shall be calculated up to four decimals.

3. *Recurring Expenses*

   For a GETF, the limits applicable to equity schemes as specified in SEBI Regulations shall be applicable.

4. *Benchmark for GETF*

   As there are no indices catering to the gold sector/securities linked to Gold, currently GETF shall be benchmarked against the price of Gold.

LESSON ROUND-UP

- Instruments can be classified into three categories viz. Pure, Hybrid and Derivatives.
- Share with differential rights means a share that is issued with differential rights in accordance with the provisions of section 86 of the Companies Act, 1956. The equity shares with differential rights include equity shares with differential rights as to—(a) voting; (b) dividend; and (c) otherwise.
- Owners of preference shares are entitled to a fixed dividend or dividend calculated at a fixed rate to be paid regularly before dividend can be paid in respect of equity shares.
- Debenture is a document evidencing a debt or acknowledging it and any document which fulfills either of these conditions is a debenture.
- Debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not.
- Sweat equity share is a instrument permitted to be issued by specified Indian companies, under Section 79A of Companies Act, 1956.
- A Tracking stock is a type of common stock that “tracks” or depends on the financial performance of a specific business unit or operating division of a company, rather than the operations of the company as a whole.
- GDR is a form of depository receipt or certificate created by the Overseas Depository Bank outside India denominated in dollar and issued to non-resident investors against the issue of ordinary shares or foreign currency convertible bonds of issuing company.
- Derivatives are contracts which derive their values from the value of one or more of other assets (known as underlying assets).
- Futures is contract to buy or sell an underlying financial instrument at a specified future date at a price when the contract is entered.
- An option contract conveys the right to buy or sell a specific security or commodity at specified price within a specified period of time.

FOOTNOTES

* Excerpts from SEBI Report on “Policy Options Permitting Foreign

Hedge to Access Indian Securities Market". The Report was released by SEBI for public comments on 24.05.2004.

*[a] Assume 5% hurdle rate

*[b] Extracts from SEBI Annual Report 2002-2003.

*[c] Extracts from SEBI Annual Report 2002-2003.

[1] Brown, Stephen J., Goetzmann, William N. and Liang, Bing "Fees on Fees in Fund of Funds", Working Paper 9464, National Bureau of Economic Research, January 2003.