

MOCK TEST PAPER
FINAL (NEW) COURSE: GROUP – II
PAPER – 6B: FINANCIAL SERVICES AND CAPITAL MARKETS
Solutions

ANSWER TO CASE STUDY 1

1. Flexi Cap Funds are a new category of mutual funds, which invest a minimum of 65% of its fund corpus in equity. In this fund category, the fund manager has the flexibility to take exposure to Large Cap, Mid Cap, and Small Cap segments without any restrictions. So, Flexi Cap Funds invest your funds across market capitalisation. This means fund managers have the complete control to limit or maximize exposure to a particular market cap segment based.

According to the market regulator SEBI, any equity programme having a significant cash allocation can be called a pure equity scheme.

The Vimco Flexi Cap Fund invested 65-100% in Indian stocks, 0-35% in foreign securities, and 0-35% in tri-party repo (TREPS) through Clearing Corporation of India, according to its asset allocation plan. Furthermore, the fund was presented to investors as a pure equity plan, which made the regulator angry.

Therefore, as a corrective measure, the word "pure" was appropriately deleted from the company's website in accordance with the SEBI's directive to prevent any misunderstanding since the plan would also invest up to 35% in TREPS securities.

As per Regulation 58 of the SEBI (Mutual Funds) Regulations, 1996, the mutual fund, the asset management company, the trustee, custodian, sponsor of the mutual fund shall make such disclosures or submit such documents as they may be called upon to do so by the Board.

Furthermore, as per Regulation 59 of the said regulations, a mutual fund and asset management company shall within one month from the close of each half year, that is on 31st March and on 30th September, host a soft copy of its unaudited financial results on their website.

Also, a mutual fund and asset management company shall publish an advertisement disclosing the hosting of such financial results on their website, in at least one English daily newspaper having nationwide circulation and, in a newspaper, having wide circulation published in the language of the region where the Head Office of the mutual fund is situated.

And, more importantly, the trustee shall be bound to make such disclosures to the unitholders as are essential to keep them informed about any information which may have an adverse bearing on their investments.

2. Calculation of Tracking Error

$$\begin{aligned} &= \sqrt{\text{Var}(r_p - r_b)} \\ &= \sqrt{(34.6 - 32.3)^2 + (12 - 13.5)^2 + (5.5 - 3.3)^2 + (15.2 - 12.5)^2 + (17.5 - 2.8)^2 / 5 - 1} \\ &= \sqrt{5.29 + 2.25 + 4.84 + 7.29 + 216.09 / 4} \\ &= 7.68 \end{aligned}$$

3. The Reserve Bank of India (RBI) has many weapons in its arsenal to combat inflation and to provide the necessary respite to the economy as well as the companies. These are discussed in the following paragraphs:
 - (i) Increase in Cash Reserve Ratio (CRR) - RBI may increase the CRR to control inflation if it thinks that there is large amount of money supply in the economy.
 - (ii) Increase in Statutory Liquidity Ratio (SLR) - SLR is also a very powerful tool to control liquidity in the economy. An increase in SLR is used as an inflation control measure to control price rise.
 - (iii) Market Stabilization Scheme - Under the market stabilization scheme, the Government of India borrows from the RBI and issues treasury bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows. Now, with the introduction of Liquidity Adjustment Facility (LAF) i.e., Repo and Reverse Repo mechanism, bank rate has become dormant as an instrument of monetary policy.
 - (iv) Open Market Operations - Open Market Operation is basically a tactic employed by the RBI to control the liquidity in the economic system. When the RBI feels there is excess liquidity in the market, it resorts to sale of securities thereby reducing excess rupee flowing in the Indian economy thereby controlling inflation.
4.
 - (i) (c)
 - (ii) (c)
 - (iii) (d)
 - (iv) (b)

Redemption Price = $\text{NAV} / (1 + \text{Exit Load})$

Or, $20 = \text{NAV} / (1 + 0.025)$

So, NAV = Rs. 20.5

 - (v) (a)

ANSWER TO CASE STUDY 2

1. The value of the rupee has decreased this year due to both internal inflation and foreign devaluation against the US dollar. The twin issues have made it more difficult for the MPC to maintain financial stability in an unstable global environment.

The rupee has lost almost 7% of its value this year so far, going from 74.5 to 79.8 to the dollar. Consumer prices have increased by 6.8% on average during this time. The rupee's local and international values are connected and mutually reinforcing. Inflation that persists for an extended length of time lowers the rupee by harming India's economic growth and competitiveness, and inflation that results from a declining exchange rate is brought on by increasing import costs. India, which imports most of its crude oil, is particularly vulnerable to getting caught in this inflation exchange rate loop.

The RBI, thus, recognises a strong correlation between inflation and rupee depreciation. According to a monetary policy study from April 2022, a 5% depreciation might cause inflation to increase by 20 basis points. It should come as no surprise that the RBI frequently intervenes in currency markets to control the exchange rate. This is crucial currently because external factors are largely to blame for the inflation. So, this leaves no choice for RBI but to hike rates.
2.
 - (i) Maximum number of shares that can be issued through the green shoe option

$$= 10,00,000 \times 15\% = 1,50,000$$

- (ii) If the market price post listing comes down to Rs. 90, the stabilizing agent will purchase shares from the market to boost up the demand for the shares. This will induce the investors to start purchasing the shares of XYZ Ltd. and consequently, the market price of shares will go up. So, basically, green shoe option is a price stabilizing mechanism. The shares borrowed from the promoters will then be returned to them.
- (iii) If the market price post listing goes up to Rs. 110, the stabilizing agent will do the same thing as discussed in point (ii) above. However, if the post listing market price goes above Rs. 120, the best course of action for the stabilizing agent is to wait for 30 days after the date of listing and then take steps to allot further shares. The shares borrowed from the promoters will then be returned to them.
3. As per regulations 32 (1) (c) of the SEBI (ICDR) Regulations, 2018, in an issue made through the book building process under sub-regulation (1) of regulation 6, not more than fifty per cent shall be allocated to qualified institutional buyers out of which five per cent shall be allocated to mutual funds.
- Furthermore, according to regulation 32 (3) of the said regulations, in an issue made through the book building process, the issuer may allocate up to sixty per cent of the portion available for allocation to qualified institutional buyers to anchor investors.
- Keeping in view the above-mentioned regulations, the number of shares that should be allotted to the mutual fund excluding the Anchor Investor category assuming that it is the only investor in the category is
- = 5% of (40% of 50% of 15,00,00,000)
- = Rs. 15,00,000/Rs 100 per share
- = 15,000 shares
4. (i) (d)
- (ii) (a)
- (iii) (b)
- (iv) (a)
- (v) (c)

ANSWERS TO CASE STUDY: 3

1. The weighted average price of all deals performed during the final 30 minutes of a continuous trading session is used by the BSE to calculate the closing price of stocks.

The last traded price of the security during the continuous trading session is used as the official closing price if no trade has been registered in the previous 30 minutes.

Hence, last traded price of shares of ABC Ltd. is Rs. 583.84 and last traded price of shares of XYZ Ltd. is 79.65.

Closing prices of the shares of ABC Ltd. or Share A is computed as follows:

Time	Price (Rs.) (1)	No. of shares traded (2)	Total Value (Rs) (1 x 2)
15:00:25	581.95	1550	902022.5
15:02:30	582.89	1650	961768.5
15:10:25	580.45	1050	609472.5
15:15:30	581.61	1400	814254

15:20:35	581.62	900	523458
15:24:25	584.17	700	408919
15:26:26	583.84	1300	758992
	Total	8550	4978886.5

Closing Price = Rs. $4978886.5/8550 = 582.33$

Closing Price of Shares of XYZ Ltd. or share B is as follows:

Since no activity in the shares of XYZ Ltd. has been observed in the previous 30 minutes, the last traded price of the scrip during the ongoing trading session can be considered the official closing price. Consequently, the closing price of share B is Rs. 79.65.

2. Since the market price at the end of 3 months fell to Rs. 325 which is below the exercise price under the call option, the call option will not be exercised. Only put option is viable.

The gain per share = Rs. 400 – Rs. 325 = Rs. 75

Total gain per 200 shares = 200 shares x Rs. 75 = Rs. 15000

Cost of premium paid = (Rs. 25 x 200 shares) + (Rs. 10 x 200 shares) = Rs. 5000 + Rs. 2000 = Rs. 7000

So, net gain = Rs. 15000 - Rs. 7000 = Rs. 8000

3. The covered call strategy in options surely seems to help in generating additional income, but it will be meaningful only if the scheme is able to write call in large holding of the portfolio. It also depends upon premium amount which is dependent on various factors such as strike price, the period until the expiry date, volatility, corporate actions and earnings, and expectations of the sector.

In terms of a covered call strategy, a retail investor must largely see whether there is a transparent communication from the fund house on its usage than evaluating the nitty-gritty of covered call taken by the fund manager.

However, it has been observed that there is no uniformity among mutual fund houses in terms of disclosures on covered calls. Some mutual funds take the initiative to disclose every information to the investors including communicating to them when the call went wrong.

Furthermore, as an investor, one should check 'detailed portfolio disclosures' or factsheets to obtain details on the covered call entered into by the scheme, apart from direct communication from the fund house.

4. (i) (a)
(ii) (c)
(iii) (b)
(iv) (d)
(v) (a)

ANSWERS TO CASE STUDY: 4

1. Credit enhancement is a strategy for improving the credit risk profile of a business, usually to obtain better terms for repaying debt.

In the financial industry, credit enhancement may be used to reduce the risks to investors of certain structured financial products.

A business that engages in credit enhancement is providing reassurance to a lender that it will honor its obligation. This can be achieved in various ways:

- ◆ By providing additional collateral
- ◆ By obtaining insurance guaranteeing payment
- ◆ By arranging for a third-party guarantee

The company might also increase its cash reserves or take other internal measures to demonstrate its ability to pay its debts. Credit enhancement reduces the credit risk/default risk of the company's debt and thus can make it eligible for a lower interest rate.

The 'credit enhancement' mechanisms like "letter of comfort" and "letter of undertaking" given by promoters or parent firm to the borrowing entity as well as supports like pledge of shares have helped corporates to significantly lower their cost of debt. The reason is that these measures have convinced the credit rating agencies about the credit worthiness of the companies and thereby giving higher ratings to them. This, in turn, reduces the cost of debt or borrowing of these companies as demand for such securities are more and investors are more willing to invest in those companies which have higher credit rating.

2. The Reserve Bank of India has asked rating agencies to enhance the quality of monitoring rated entities through means like social media and corporate filings, and not just depend on information given by companies. The Banking regulator emphasized on the need to pick up signal and work on them before defaults happen.

There was also nudging from the banking regulator to use intelligent information systems be it machine learning and Artificial Intelligence (AI) that could capture social media alerts and trends useful for rating purpose. This issue may also be discussed at the panel of market regulators comprising SEBI, IRDAI, PFRDA, among others, for improving the quality of oversight.

During the meeting, held through video conference, Credit Rating Agencies (CRAs) presented assessment of the macroeconomic situation and outlook on various sectors including the financial sector. They also shared perspectives on the overall financial health of the entities rated by the CRAs and major factors that affect credit ratings in current context, according to an RBI statement.

RBI also gave feedback on ways to further strengthen the rating processes and engagement with key stakeholders. Rating agencies also expressed concerns over rising share of companies in "not cooperating" categories. RBI want these entities to be taken off from monitoring after remaining in this category for 6-12 months.

3. As per regulation 3 of the SEBI (Prohibition of Insider Trading) Regulations, 2015, no insider shall communicate, provide, or allow access to any unpublished price sensitive information, relating to a company or securities listed or proposed to be listed, to any person including other insiders except where such communication is in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.

Further, no person shall procure from or cause the communication by any insider of unpublished price sensitive information, relating to a company or securities listed or proposed to be listed, except in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.

The board of directors of a listed company shall make a policy for determination of "legitimate purposes" as a part of "Codes of Fair Disclosure and Conduct" formulated under regulation 8 of the said regulations.

Any person in receipt of unpublished price sensitive information pursuant to a "legitimate purpose" shall be considered an "insider" for purposes of these regulations and due notice shall be given to such

persons to maintain confidentiality of such unpublished price sensitive information in compliance with these regulations.

Notwithstanding anything contained in this regulation, an unpublished price sensitive information may be communicated, provided, allowed access to, or procured, in connection with a transaction that would: –

- (i) entail an obligation to make an open offer under the takeover regulations where the board of directors of the listed company is of informed opinion that sharing of such information is in the best interests of the company.
 - (ii) not attract the obligation to make an open offer under the takeover regulations but where the board of directors of the listed company is of informed opinion that sharing of such information is in the best interests of the company and the information that constitute unpublished price sensitive information is disseminated to be made generally available at least two trading days prior to the proposed transaction being effected in such form as the board of directors may determine to be adequate and fair to cover all relevant and material facts.
4. (i) (c)
(ii) (b)
(iii) (c)
(iv) (a)
(v) (c)

ANSWERS TO CASE STUDY: 5

1. Yield Rate on Treasury Bill = $(\text{Face Value} - \text{Purchase Price} / \text{Purchase Price}) \times (364 / \text{Maturity Period}) \times 100$

$$\begin{aligned}\text{So, Yield Rate on Treasury Bill} &= (100 - 98/98) \times (364/91) \times 100 \\ &= 8.16\%\end{aligned}$$

Also, the rate of discount = $100 - 98 = 2\%$

Note: In case of TBs, for the calculation of yield, a year is normally assumed to be of 364 days.

2. The block deal window is provided for buyers and sellers to execute trades for many shares. Such deals are usually negotiated before their execution.

SEBI would provide two block deal windows -- morning and afternoon -- of 15 minutes duration each.

The minimum order size for execution of trades in the block deal window is Rs 10 crore.

The morning window would operate from 8:45 am to 9:00 am and the reference price for execution of block deals in this window would be the previous day's closing price of the stock.

With regard to afternoon window, the regulator said it would operate from 2:05 pm to 2:20 pm. The pricing would be based on the volume weighted average market price (VWAP) of the trades executed in the stock in the cash segment between 1:45 pm to 2:00 pm.

According to a SEBI circular, between the period 2:00 pm and 2:05 pm, stock exchanges shall calculate and disseminate necessary information regarding the VWAP applicable for the execution of block deals in the Afternoon block deal window.

The transaction price of a share should be within plus or minus 1 per cent of the previous day's closing.

According to Sebi, every trade executed in the block deal windows must result in delivery and would not be squared off or reversed.

The stock exchanges would disseminate the information on block deals such as the name of the scrip, name of the client, quantity of shares bought or sold, traded price, among others, to the general public on the same day, after the market hours.

SEBI asked exchanges to ensure that all appropriate trading and settlement practices as well as surveillance and risk containment measures, as applicable to the normal trading segment, are made applicable and implemented in respect of the block deal windows as well.

3. A short-term treasury bill helps the government raise funds to meet its current obligations, which are more than its annual revenue generation. Its issue is aimed at reducing total fiscal deficit in an economy, and in regulating the total currency in circulation at any given point of time.

The Reserve Bank of India (RBI) also issues such treasury bills under its Open Market Operations (OMO) strategy to regulate the inflation level and spending/borrowing habits of individuals. During times of economic boom leading to high and persistent inflation rates in the country, high value treasury bills are issued to the public, which, thereby, reduces aggregate money supply in an economy. It effectively curbs the surging demand rates, an in turn, high prices hurting the poorer sections of the society.

Alternatively, a contradictory OMO regime is undertaken by the RBI during times of recession and economic slowdown through a reduction in treasury bill circulation and reduced discounted value of the respective bonds. It disincentivises individuals into channelling their resources on this sector, thereby boosting cash flows to the stock markets instead, ensuring a boost in the productivity of most companies. Such a rise in productivity has a positive impact on the GDP and aggregate demand level in an economy.

Hence, a treasury bill is an integral monetary tool used by the RBI to regulate the total money supply in an economy, along with its fundraising usage.

4.
 - (i) (b)
 - (ii) (d)
 - (iii) (c)
 - (iv) (b)
 - (v) (a) [Calculated at the present Cash Reserve Ratio (CRR) rate of 4.5%]