

MOCK TEST PAPER

FINAL COURSE: GROUP – II

PAPER – 6B: FINANCIAL SERVICES AND CAPITAL MARKETS

*The question Paper comprises five case study questions. The candidates are required to answer any four case study questions out of five.*

CASE STUDY 1

- (1) The launch of the Vimco Flexi Cap Fund has been announced by Vimco Mutual Fund. This is the first mutual fund that the fund business has launched. The NFO for the programme began taking subscriptions on January 17, 2022, and it will finish on January 31, 2022.

The fund is managed by Varun Bhanushali, and Danish Dadlani is the exclusive fund manager for overseas investments.

The 3E approach will be used by Vimco Flexi Cap Fund to build a portfolio, according to the press release. This involves making investments in successful companies at profitable rates while keeping an efficient portfolio turnover and cost. The CEO of Vimco Asset Management, Rakesh Kumar Nahta, stated at the launch that the Vimco Flexi Cap Fund is a singular and pure equities fund in the Flexi Cap Category by design. Unlike other funds, it only seeks to invest in Indian and worldwide shares. The programme can only be a pure stock scheme because other assets like corporate debt, REITs, or derivatives are not permitted.

Its 25 stock portfolio building process ensures that investors receive the benefits of appropriate concentration and diversity, in contrast to other strategies that could be overly diversified. Additionally, because 65% of their portfolios will consist of Indian stocks, investors will be exposed to high-growth worldwide brands and will benefit from the 10% long-term capital gains tax rate after a year. This offers as a fantastic model framework for investors.

Varun Bhanushali, Equity Fund Manager of the Vimco Flexi Cap Fund, said, "We have built the Vimco fund as a simple 3-step purchase and hold strategy that shall invest in some of the world's fast-growing, capital-efficient enterprises that can compound capital over the long run." Investors will have access to high growth firms worldwide because the fund will invest 35% of its assets in foreign stocks. Due to the strategic goal of reducing portfolio turnover, we'll also try to keep voluntary dealing fees low in order to maintain reasonable overall investment costs for investors. We are ready to establish new benchmarks with our disclosures on active shares and optional dealing charges.

The Vexagone Framework, an internal proprietary investment framework that shortlists companies based on six criteria—competitiveness and pricing power, balance sheet and insolvency, reinvestment and growth, corporate governance and leadership, cash flow, and regulatory compliance—is the foundation for the stock selection.

The scheme will invest 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 the asset allocation table. The fund was presented to investors as a pure equity plan, which has the regulator fuming. According to the regulator, no programme with a significant cash allocation can be called a pure equity scheme. "The word "pure" was appropriately deleted from the website in accordance with the SEBI's directive to prevent any misunderstanding since the plan would also invest up to 35% in TREPS securities. From now on, the Vimco Flexi Cap Fund will be referred to as an equity plan "a representative for Vimco MF said.

The regulator also directed Vimco Mutual Fund to include provisions pertaining to the Vexagone Framework in the SID's investment plan section. According to the spokeswoman, the fund has incorporated the details in a notice-cum-addendum.

To comply with the regulator's order, the fund company modified the tagline to "Vexagone Tested Investments."

- (2) Vimco Mutual Fund is open to investing in index funds and other passive funds. The CEO of Vimco Mutual Fund, however, is hesitant to invest in index funds because he is concerned that tracking error could lower the returns of these funds. He also didn't understand the distinction between tracking difference and tracking error. The CFO - CA Aakash Mehta tries to persuade Mr. Nahta despite this, and he provides the following justification for the tracking error's complexity and how it differs from tracking difference:

Tracking error and tracking difference are two words associated with Index Funds that are frequently used interchangeably. But the meanings of these phrases varied significantly from one another. Tracking difference, put simply, is the performance gap between an index fund and the benchmark index that the fund is tracking.

CA Aakash used an example to clarify this and make it easier to understand. Imagine that this month's NIFTY 50 Index growth was 5%. On the other hand, during the same time frame, the NAV of an index fund that tracks the NIFTY 50 increased by 4.5%. The tracking difference of the Index Fund is this difference of -0.5% (4.5% - 5%).

A lower tracking difference than the benchmark indicates that the Index Fund has underperformed. An index fund's tracking difference isn't necessarily negative, though. The Index Fund has outperformed its benchmark if the tracking difference is positive.

It is a widely held belief that tracking error affects an index fund's performance. Tracking error, on the other hand, is a sign of how inconsistently an Index Fund performs.

The consistency of a product's tracking difference at a given period is therefore shown by tracking error. The tracking error of an index fund is defined mathematically as the annualised standard deviation of the tracking difference. He provided an example to further clarify this:

| Index Fund Returns | NIFTY 50 Returns (Benchmark) | Tracking Difference |
|--------------------|------------------------------|---------------------|
| 11%                | 12%                          | -1%                 |
| 3%                 | 5%                           | -2%                 |
| 12%                | 13%                          | -1%                 |
| 14%                | 9%                           | 5%                  |
| 8%                 | 7%                           | 1%                  |

The tracking error of the Index Fund in the aforementioned scenario is equal to the 2.83 standard deviation of the tracking difference over the 5-year timeframe. As you can see, tracking error serves as a gauge for the Index Fund's performance's fluctuation.

So, tracking error is calculated by using the following formula:

$$\text{Tracking error} = \sigma = \sqrt{\text{Var}(r_p - r_b)}$$

Where

Var = the variance

$r_p$  = return of the portfolio

$r_b$  = the return of a benchmark

- (3) High inflation has recently put strain on businesses, the government, and even the public. Rakesh Kumar Nahta, the CEO, is worried about the rising inflation that is currently devouring the Indian economy and its potential effects on the company's business, particularly equity funds, which is the most well-liked market area among its clients.

Moderate inflation benefits the equity markets, according to CFO CA Aakash Mehta, because rising prices translate into better sales and profits for businesses. However, equity market does poorly when inflation is extremely high (as it is now). The Nifty gained at a sluggish rate of 4% throughout the course of the four years from January 2010 to December 2013, while inflation was quite high and briefly surpassed 12%.

Interestingly, a high inflation rate does not instantly affect stock values. Businesses first profit from increased inventory levels and their capacity to increase prices beyond what is necessary. A delay of two to three months separates the actual effects of inflation.

CA Aakash added that the RBI had increased interest rates to fight inflation. However, the inflation has not stopped. In addition, since future cash flows will be discounted at a higher rate due to high inflation and interest rates, the current value of enterprises will be reduced.

### Questions

- (1) What is a flexicap fund? Has Vimco Flexi Cap Fund contravened any of provisions of the SEBI regulations? (5 Marks)
- (2) The CEO of Vimco Mutual Fund wants to understand the concept of tracking error with the help of a practical example. Solve the following problem by calculating the tracking error to help him understand the concept:

| Year | Index Fund ABC | Nifty 50 |
|------|----------------|----------|
| 2015 | 34.6           | 32.3     |
| 2016 | 12             | 13.5     |
| 2017 | 5.5            | 3.3      |
| 2018 | 15.2           | 12.5     |
| 2019 | 17.5           | 2.8      |

(5 Marks)

- (3) What methods are available for India's financial regulator, Reserve Bank of India to combat inflation and provide the necessary respite to the economy as well as the companies? (5 Marks)
- (4) Multiple Choice Questions: (10 Marks)
- (i) Under the ..... 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.
- (a) Liquidity Adjustment Facility
  - (b) Margin Standing Facility
  - (c) Market Stabilization Scheme
  - (d) Open Market Operations
- (ii) Which among the following is not one of the ways of measuring performance of mutual funds?
- (a) Sharpe Ratio
  - (b) Treynor Ratio
  - (c) Liquidity Ratio
  - (d) Sortino Ratio

- (iii) Which among the following is true in case of rolling returns?
- (a) It simply measures the performance of the growth option NAV from the start date to today's date, annualized.
  - (b) Measure the return from the start date to next date, from next to next-to-next date and so on and take the average of all these observations.
  - (c) measure the return from the start date to next week, from next week to next-to-next week and so on and take the average of all these observations.
  - (d) All of the above
- (iv) The CEO, Sumesh Kumar Nahta wants to know from the CFO, CA Aakash Mehta that if the equity fund is redeemed at ₹ 20 and the exit load is 2.50%, what will be the NAV of the equity fund?
- (a) 19.50
  - (b) 20.50
  - (c) 19.975
  - (d) 20.00
- (v) Front end load is also called .....
- (a) Entry Load
  - (b) Exit Load
  - (c) Both Entry and Exit Load
  - (d) Trail Commission

## CASE STUDY 2

- (a) Caustic soda makes up a significant portion of the cost of production for Pratham Limited, which manufactures items made of aluminium. Because of the rupee's recent depreciation versus the dollar, imports have suddenly become more expensive. Mr. Prabhat, the company's CEO, is concerned about how the current circumstances may affect the company's profitability. He was informed of the current position and given a detailed explanation by the company's finance team.

Inflation in India has exceeded the maximum tolerance level established by the central bank for the last eight months. This year, both domestic inflation and external depreciation versus the US dollar have reduced the value of the rupee. The Monetary Policy Committee (MPC) has found it more challenging to maintain financial stability in an unstable international environment because of the twin problems.

The rupee has fallen from 74.5 to 79.8 to the dollar this year, losing close to 7% of its value. The average increase in consumer prices over this period has been 6.8%. Why is this crucial? The domestic and foreign values of the rupee are intertwined and mutually supportive. Long-term inflation weakens the rupee by impairing India's economic development and competitiveness, and inflation brought on by a lowering exchange rate is caused by rising import costs. India is particularly susceptible to becoming stuck in this inflation exchange rate loop since it imports most of its crude oil.

Almost all industrialised and developing countries' central banks increased interest rates this year. The rupee is currently hovering close to the emotionally charged 80-mark, and the MPC may not have an option but to follow those concerns even while the rest of the world struggles with worries about an imminent recession. Given the current situation, it seems inevitable that the MPC will increase the repo rate for a fourth consecutive occasion, this time by a margin of 35 to 50 basis points (bps). A basis point is equal to one-tenth of a percentage point.

## Rupee Dynamics

There are two categories of factors that contribute to the rupee's value decline: those that primarily raise domestic costs and those that primarily have an impact on currency markets. Food, fuel, and input prices went up when the Russia-Ukraine war started, falling within the first group.

The main element influencing the currency market were rising US interest rates. As returns on US assets, which were already enticing because to their status as safe havens, a sizeable amount of capital from throughout the world was reallocated into dollar assets. As a result, the dollar rose, and the rupee fell.

The Federal Reserve may still hike rates if US inflation remains high, even though the difference between US and Indian inflation rates is narrowing. In these circumstances, a further rise in India's interest rate will help to entice foreign direct investment and, in turn, dollar inflows that will support the rupee.

## Inflation and the Rupee

Based on spending needs, each household feels a different level of inflation, but this time, broad-based inflation across food, gasoline, and services has meant the pain has been quite secular. All forex traders typically deal with the same exchange rate at any one time.

The RBI is aware that there is a significant link between inflation and currency depreciation: A monetary policy analysis from April 2022 estimated that a 5% depreciation may result in an increase in inflation of 20 basis points. The fact that the RBI routinely intervenes in currency markets to control the exchange rate shouldn't come as a surprise. This is important right now because the inflation is mostly the result of external sources.

The central bank regularly participates in the market almost every day, according to the governor of the RBI, not only to control volatility but also to moderate expectations of rupee depreciation. A stronger rupee will make imported inputs less expensive, in turn helping to moderate inflation.

## Export Strength

Given the current state of global uncertainty, predicting whether and by how much more the rupee will decline is difficult. The rupee's loss this year is among the biggest in this group when measured against other currencies. The value of currencies supported by the export of commodities, such as those of Malaysia and Brazil, decreased less because of increased commodity prices.

The currencies of countries with strong export industries, including South Korea and Thailand, fell further because of concerns that a slowdown in the West might impede economic growth. India benefits from being driven by domestic demand, but it also faces challenges due to being a net importer of goods. The likelihood of becoming trapped in the inflation-exchange rate loop increases with the dollar's upward trend. In this case, even if the RBI's rate increase does not totally break the loop, it will surely diminish its impact soon.

- (b) The company's CEO, Prabhat, is advocating for the Initial Public Offering (IPO). The finance team also believes that the time is right for an IPO and that there is a good likelihood that the transaction will be oversubscribed. If the proposed IPO is oversubscribed, the management is interested in knowing if there is an over-allotment option.

The management was informed about the Green Shoe Option (GSO) by the head of the finance team, CA Pradeep Sharma. He went on to explain that GSO functions as an over-allotment mechanism. It is a possibility to distribute shares more than those that have previously been made available to the public. It serves as a tool for price stability to give initial public offerings post-listing price stability.

## Questions

- (1) Why the inflation-forex trap leads to rate hikes? Discuss with reference to the case study and the present situation in India affecting it. (4 Marks)
- (2) XYZ Ltd. wants to make a public issue of 10,00,000 equity shares of ₹ 100 each at par. The applications are received for 15,00,000 shares. The company wants to explore the Green Shoe Option (GSO). IPO price i.e., listing price is ₹ 120.
  - (i) What is the maximum number of shares can be issued through green shoe option? (1 Mark)
  - (ii) If the market price post listing comes down to ₹ 90, what the stabilizing agent can do in this situation? (2 Marks)
  - (iii) If the market price post listing goes up to ₹ 110, what is the option before the stabilizing agent? (3 Marks)
- (3) Pratham Ltd. wants to come out with an IPO through the book building having an issue size of ₹ 15 crores. The face value is Rs. 100 per share. XYZ mutual fund wants to invest in the IPO of the company. The company has satisfied all the conditions as per regulation 6 (1) of the SEBI (ICDR) Regulations. The company wants to issue shares to anchor investors at least one day before the issue opens. How many shares can be allotted to XYZ under the mutual fund category excluding the anchor investor one? (5 Marks)
4. Multiple Choice Questions: (10 Marks)
  - (i) Which among the following tools are used by the Federal Reserve to contain inflation in India?
    - (a) Purchase of government securities
    - (b) Reducing the Discount Rate
    - (c) Reduce Reserve Requirements
    - (d) Term deposits are removed from the reserve accounts of participating institutions for the life of the term deposit
  - (ii) Which among the following reasons substantiate that rupee depreciation might cause inflation?
    - (a) Rupee depreciation discourages imports by making them costly which in turn makes the goods expensive.
    - (b) Rupee depreciation encourages imports by making them costly which in turn makes the goods expensive.
    - (c) Rupee depreciation discourages imports by making them cheaper which in turn makes the goods expensive.
    - (d) Rupee depreciation discourages exports by making them costly which in turn makes the goods expensive.
  - (iii) Which among the following is false?
    - (a) Green Shoe Option is an option to allocate shares more than the shares which have already been issued to the public.
    - (b) It is a price stability mechanism to provide prelisting price stability to an initial public offering.
    - (c) A Green Shoe option can provide additional price stability to a security issue because the underwriter can increase supply and smooth out price fluctuations.
    - (d) It is the only type of price stabilization measure permitted by the Securities and Exchange Commission (SEC) in USA.

- (iv) An anchor investor shall make an application of a value of at least ..... in the public issue.
- (a) ₹ 10 crores
  - (b) ₹ 15 crores
  - (c) ₹ 20 crores
  - (d) ₹ 25 crores
- (v) Green Shoe Option is a .....
- (a) Price stabilizing mechanism
  - (b) Over allotment option
  - (c) both (a) and (b)
  - (d) A mechanism to arrive at a fair value

### CASE STUDY 3

- (1) The SEBI permitted mutual funds to write call options using a covered call strategy in January 2019. Numerous fund companies, including PPFAS, DSP, Edelweiss, SBI, and Aditya Birla Sun Life mutual fund, have been enabling or adopting covered call strategy in several of their schemes ever since, but mainly during the past year.

In a covered call, a call option is written on a stock that is already held in the portfolio as part of an options strategy. The option premium, which is paid by the option buyer, is a source of income for the call option sellers (in this case, the fund houses).

Derivatives can be used to speculate, leverage investments, and blow up, according to a specialist. Derivatives can be used to control risk and to hedge positions, though. Just like a kitchen knife can be used to chop fruit and vegetables and stab people, derivatives may be used in a variety of ways. The viewpoint was voiced in relation to a mutual fund's recent endeavour to employ the covered call strategy.

This method enables fund managers to produce additional income, especially in a declining or sideways market, which has sparked a rise in interest among fund houses over the past year. The latter is a condition in which there are no obvious patterns and high volatility on the stock market.

To put the covered options trend into perspective, Modality Flexicap Fund entered 3347 covered call contracts in June 2022 while the market was still under sell-off pressure, resulting in gains of ₹ 2.45 crore for the month. Contrast this with the nine contracts it signed in May 2021, which resulted in a meagre net profit of ₹ 35,291.

An expert said that the benefit of covered calls increased with volatility.

Even while the Modality Flex cap Fund's gain in June 2022 was negligible in comparison to its assets under management in that month, which were around ₹ 22,300, the fund company thinks it will eventually increase the fund's yield a little. PSD Mutual Fund, which recently started using the covered call technique in its Quant Fund, has also expressed a similar opinion.

It opined that, in their flexi-cap fund, they haven't even come close to the permitted covered call limit. Additionally, the goal of adopting the method is not to make significant gains, but rather to make a few extra returns that else wouldn't have come to us.

Additionally, it's crucial to keep in mind that the fund houses' employment of a covered call technique won't alter the basic approach to investing and portfolio construction used by a scheme.

The system's operation?

A fund manager can increase returns while holding onto a stock by writing a call option when they anticipate that the price of any stock in their portfolio will drop or move sideways soon.

Take Reliance Industries Ltd. (RIL), for instance, which was included in a scheme's portfolio and purchased at the current market price of ₹ 2527. The fund manager writes (sells) a monthly call option with a strike price of ₹ 2900 because he thinks the stock won't experience a substantial uptrend soon.

No matter what the market price is on the expiration date, the buyer of the call option has the "right" to purchase the share at ₹ 2900. The fund management receives payment from the option buyer for the 'right', which is equivalent to ₹ 5.5 per share in option premium.

Let's examine the profit or loss the mutual fund scheme experiences under various market conditions.

A market price of less than or equal to ₹ 2,900 is considered scenario one.

The call option will not be exercised, and the additional return for the fund will be the option premium of ₹ 5.5 per share. RIL shares are still held by the fund manager, and call options are only exercised when the market price is higher.

In scenario two, the market price on the day of expiration is more than ₹ 2900, say ₹ 3000.

In this scenario, the call option is exercised, requiring the fund management to sell the shares to the option buyer for ₹ 2,900. (Sale price minus cost price + received option premium) = ₹ 378.5 is the real profit or loss to the sold scheme (₹ 2,900 – ₹ 2,527 + 5.5). Further, had the mutual fund not entered a covered call strategy, there could be a capital gain of ₹ 473 (3000 – 2527). So, the opportunity loss to the fund is the difference of ₹ 94.5 (₹ 473 - ₹ 378.5).

Some Coal India shares that the scheme owned were sold as part of the covered call in July 2022 with the Modality Flexi Cap fund (although at a profit to the purchase price).

### Way to mitigate risks

The covered call strategy carries several significant dangers, one of which is that it restricts the investor's ability to profit from any prospective stock price gains.

Any price increase of RIL shares above the strike price in the example above results in a missed opportunity for the fund management. However, experts think that the regulatory step might restrict the strategy's extraordinary losses.

The Nifty 50/BSE Sensex equities are the only stocks on which covered calls can be written, according to market regulator SEBI. A fund manager is also prohibited from writing options on more than 30% of the stock of any company that is held in the portfolio. Additionally, a scheme may not write a call option with a total notional value of more than 15% of the market (including the strike price and premium value).

Fund houses claim that they follow internal regulations to lower the risk associated with taking covered calls.

PSD Mutual Fund claims that to lower the risk associated with the covered call strategy, they will only write covered calls with a strike price that is 5–10% above the current stock price (on the grounds that they believe a 5–10% uptrend for an already overvalued stock is unlikely in the short run, favouring a fund manager's call).

As the uncertainty grows with additional future calls, the fund house also made clear in its communication on the covered call strategy that it will issue calls with a close to month expiration and not long dated options. In addition, we refrain from writing covered calls where there is an overall uncertainty regarding situations such as elections where outcomes cannot be predicted.

The method aids in creating extra income, but it won't be effective until the plan can write calls on substantial portions of the portfolio's holdings.

- (2) The index serves as a proxy for the whole stock market. It demonstrates the adjustments being made in the stock market. The index's movement also reflects the average returns investors earn. An index makes it easier for investors to evaluate performance because it can be used as a benchmark. For example, a straightforward comparison between the stock and the index can be done to determine

whether it is feasible to hold a particular stock.

An index is a representation of every stock exchange in India, for example, it is the Sensex of the BSE and the Nifty of the NSE. At the global level, some of the major indexes are Dow Jones, NASDAQ, FTSE etc.

When valuing stocks, future profits (such as dividends and capital gains) are discounted to arrive at the current value. So, in a nutshell, the stock market represents how a firm will do in the future. Therefore, as the index rises, it is assumed that future returns would also rise, and vice versa.

The steps for calculating the index on a specific day are as follows:

- ❖ Determine the market capitalization of each of the companies that make up the index.
- ❖ Add the individual market capitalizations of all the companies to determine the total market capitalization.
- ❖ The index value and the entire market capitalization from the previous day are needed to calculate the index for the following day, which is done as follows:

$$\text{Index Value} = \text{Index on Previous Day} \times \frac{\text{Total market capitalisation for current day}}{\text{Total capitalisation of the previous day}}$$

It should be noted that the price weighted technique can also be used to calculate indices. The weight in this case is determined by the member firms' share prices. However, the market capitalization weighted technique is used to compute practically all equity indices globally.

#### Questions:

- (1) The shares of ABC Ltd., and XYZ Ltd. are trading at Bombay Stock Exchange (BSE). From the following information, you are required to calculate the closing prices and last traded prices for both the shares as on 4<sup>th</sup> July 2022. (6 marks)

| Share A     |          |           |                      |
|-------------|----------|-----------|----------------------|
| Date        | Time     | Price (₹) | No. of shares traded |
| 4 July 2022 | 14:46:20 | 585.60    | 650                  |
| 4 July 2022 | 14:54:40 | 582.45    | 1500                 |
| 4 July 2022 | 15:00:25 | 581.95    | 1550                 |
| 4 July 2022 | 15:02:30 | 582.89    | 1650                 |
| 4 July 2022 | 15:10:25 | 580.45    | 1050                 |
| 4 July 2022 | 15:15:30 | 581.61    | 1400                 |
| 4 July 2022 | 15:20:35 | 581.62    | 900                  |
| 4 July 2022 | 15:24:25 | 584.17    | 700                  |
| 4 July 2022 | 15:26:26 | 583.84    | 1300                 |

| Share B     |          |           |                      |
|-------------|----------|-----------|----------------------|
| Date        | Time     | Price (₹) | No. of shares traded |
| 4 July 2022 | 14:09:30 | 70.80     | 650                  |
| 4 July 2022 | 14:12:50 | 75.20     | 1500                 |
| 4 July 2022 | 14:18:25 | 78.75     | 1550                 |
| 4 July 2022 | 14:20:30 | 73.25     | 1650                 |
| 4 July 2022 | 14:25:35 | 70.25     | 1050                 |

|             |          |       |      |
|-------------|----------|-------|------|
| 4 July 2022 | 14:45:10 | 74.75 | 1400 |
| 4 July 2022 | 14:55:45 | 79.65 | 900  |

- (2) Mr. Akash purchased a 3-month call option for 200 shares in ABC Ltd. at a premium of ₹ 25 per share, with an exercise price of ₹ 500. He also purchased a 3-month put option for 200 shares of the same company at a premium of ₹ 10 per share with an exercise price of ₹ 400. The market price of the shares on the date of Mr. Akash's purchase of options, is ₹ 450. Calculate the profit or loss that Mr. Akash would make if the market price fell to ₹ 325 at the end of 3 months. (5 Marks)
- (3) Does the covered call strategy in options has a meaningful impact on the income of a mutual fund. Discuss with reference to the case study and the results observed in practical situations. What are the expectations of the investors in this regard and how the mutual funds are expected to meet it?

(4 Marks)

- (4) Multiple Choice Questions (10 Marks)

- (i) Mutual Fund schemes investing in exchange traded ..... may hold the underlying goods in case of physical settlement of such contracts.
- Commodity Derivatives
  - Forex Derivatives
  - Gold Options
  - Silver Options
- (ii) Which among the following options is not true?
- Investing in options provide limited risk
  - Investing in options provide high potential reward
  - Investing in options required larger amount of capital in comparison to cash market
  - When individuals sell options, they effectively create a security that didn't exist before
- (iii) ..... separates the ownership and control of stock exchange from the trading rights of members.
- Indexation
  - Demutualization
  - Trading Mechanism
  - Governing Board
- (iv) Which among the following is not a risk management mechanism in the secondary market?
- Circuit Breaker
  - Rolling Settlement
  - Market Making System
  - Reverse Book Building
- (v) In the Indian market, most of the options are of ..... style.
- European
  - American
  - both (a) and (b)
  - Asian

## CASE STUDY 4

- (1) The Reserve Bank of India (RBI) has authorised credit rating agencies six months to lower or remove bank loan ratings that the regulator deems to have been "diluted or non-prudent support structures."

By early 2023, it's likely that hundreds of businesses will see their borrowing costs increase and their bank loan ratings fall by at least two notches as a result.

The RBI has previously expressed its concerns regarding "credit enhancement" strategies including "letters of comfort" and "letters of undertaking" delivered to the borrowing entity by promoters or the parent company, as well as supports like share pledges. Through these frameworks, corporations frequently dramatically cut their cost of financing.

The Central Bank also drew attention to the obligator co-obligator structure that many infrastructure businesses utilise to obtain money by organising projects under numerous special purpose entities (SPVs), which lacks regulatory registration under the Indian Companies Act, 2013. A financial innovation known as the "obligator co-obligator" structure has gained popularity recently and enables infrastructure developers to combine cash flow from several SPVs. If one SPV's escrow account runs out of money, money can be taken from another SPV, which will have enough money to pay off loans and avoid default.

According to RBI's July 26, 2022, note, "obligator co-obligator structure" has merely developed as a market practise without statutory basis. This "regulatory issue" is likely related to the IL&FS explosion. "Since each firm (i.e., SPV) is a separate legal entity, it is possible that there would be legal difficulties in dividing the cash flows in the case of financial hardship, a change in ownership, litigation by minority shareholders, etc. Furthermore, if one of the SPVs or companies experiences a bad development, the reputation risk will spread to the other SPVs or entities, impacting the group's cash flow as a whole. Therefore, RBI stated, "Rating companies shall not obtain rating comfort from such frameworks.

If a rating drop is not acceptable to the borrower, the rating may be withdrawn by the agencies if the borrower requests it. Rating agencies are required to make a press release at the time of the withdrawal explaining the cause. Banks prefer to provide rated loans because unrated risk necessitates setting aside additional cash from lenders.

Rating companies must complete internal procedures and change all current ratings to "standalone ratings" or "withdrawn" within the 6-month period (from July 26, 2022) specified by the RBI. For new loans with guaranteed backing, the timescale for invocation of corporate guarantees must be provided to justify a better rating.

- (2) For engaging in insider trading in the shares of IT solutions provider NIIT Technologies, SEBI has prohibited one individual from the capital markets for six months and fined him Rs 12 lakh.

In addition to this, the regulator has ordered Arvind Mehrotra to disgorge a loss saved of ₹ 1.03 lakh, plus interest, in accordance with a SEBI decision.

The markets watchdog noted in its order that Mehrotra, who held the title of President- Infrastructure Management Services (IMS) and was the business head of Asia and Australia for the company, had traded in the firm's stock while in possession of the Unpublished Price Sensitive Information (UPSI) pertaining to the dispute between the company's subsidiary and its client in the APAC region.

"Additionally, Mehrotra traded and carried out the sale of 2,500 shares of the Company on January 5, 2015 (1,000 shares), and February 24, 2015 (1,500 shares), while in possession of the pertinent UPSI", according to SEBI.

Additionally, Mehrotra requested for pre-clearance of trades in the company's stock while falsely claiming he did not have UPSI despite having it. Additionally, he didn't tell the business, or the stock exchanges the specifics of selling 2,000 NIIT shares for more than Rs 5 lakh in November 2014.

Through such actions, Mehrotra has transgressed both the model code of conduct for the prevention of insider trading and the terms of insider trading rules, the SEBI observed.

## Questions

- (1) "Credit Enhancements helps corporates to lower their cost of debt". Explain the statement in the context of the case study. (5 Marks)
- (2) How can credit rating agencies increase their quality of monitoring? (5 Marks)
- (3) What are the restrictions enforced upon the insiders in case of communication or procurement of unpublished price sensitive information? Is there any exception provided to the insiders in this respect? (5 Marks)
- (4) Multiple Choice Questions: (10 Marks)
  - (i) Credit decisions are based on .....
    - (a) Probability of default
    - (b) Tracking deviation of bond spreads
    - (c) Both (a) and (b)
    - (d) Credit risks
  - (ii) A trading plan shall not entail commencement of trading on behalf of the insider earlier than ..... from the public disclosure of the plan.
    - (a) three months
    - (b) six months
    - (c) twelve months
    - (d) fifteen months
  - (iii) Which among the following statement is true?
    - (a) An insider can trade in securities that are listed or proposed to be listed on a stock exchange when in possession of unpublished price sensitive information.
    - (b) The trading plan once approved can be revocable with the permission of the compliance officer.
    - (c) The Audit Committee shall review the compliance of the provisions of SEBI (Insider Trading) Regulations.
    - (d) The code of fair disclosure is compulsory while Code of Conduct is voluntary on the part of a company.
  - (iv) The basic objective of credit rating is to provide guidance to investors in ascertaining ..... regarding a debt instrument.
    - (a) credit risk
    - (b) strategic risk
    - (c) operations risk
    - (d) systematic risk
  - (v) The ..... shall review the trading plan to assess whether the trading plan would have any potential for violation of insider trading regulations.
    - (a) Chief Financial Officer
    - (b) Chief Operating Officer
    - (c) Compliance Officer
    - (d) Board of Directors

## CASE STUDY 5

- (1) A Private Equity (PE) company called RRK is trying to capitalise on the rise in stock values of certain businesses in which it has made large investments during their early stages of development. To help RRK in its most recent endeavour, the company recruited CA Ranjan Kumar, a financial consultant. He described current examples of how PE Companies are using block agreements to benefit from the recovery of the stock market.

He began by describing the idea of block trades.

It is a single transaction between two parties, most of whom are institutional participants, with a minimum value of ₹ ten crores. Through a different trading window, the transaction is conducted. Deals are completed within a time span of 15 minutes each during a morning and afternoon session.

In a block deal order, the following characteristics are present:

- (i) A minimum value of ₹ 10 crores may be ordered.
- (ii) "Block Deal" orders cannot be squared off or overturned, and every trade must be fulfilled by delivery.
- (iii) A share ordered during the window shall be priced within +1% to -1% of either the closing price from the previous day or the current market price, as applicable.
- (iv) The broker must instantly provide the exchange with transparent disclosure of all trade transaction information, including the name of the scrip, the clients' names (Buyer and Seller), the number of shares purchased/sold, and the trading price. The day of the block deal transaction, after the close of trading, the exchange is required to provide the public markets with all transaction-related information.

Two FIIs (foreign institutional investors), for instance, want to trade 10% of the total number of shares of a company. The risk considerations associated with this transaction are substantial because it includes trading a significant number of shares. As a result, the exchange where trade will take place gives these two investors a distinct trading window to present a block deal, with the main aim to mitigate risk.

Furthermore, he added that even as foreign investors turn bearish on Indian stocks, the sharp increase in block trades by private equity and venture capital investors that began in July with the markets experiencing a rebound amid buying by foreign institutional investors (FII) is unlikely to slow down significantly.

Some of the largest block deals have taken place in the last few months as investors have reduced their interests in listed Indian businesses by taking advantage of the stock market's recovery.

Blackstone sold significant stakes in two of its positions—a 4,000 crore stake in auto parts manufacturer Sona BLW Precision Forgings and a 2,650 crore stake in Embassy Office Parks—while private equity giant KKR sold a 9,185 crore stake in Max Healthcare in the largest PE block deal seen in the Indian stock markets to date. In recent months, several investors including Temasek and TPG have reduced their positions in publicly traded companies.

Several promoters have also joined the movement to reduce their interests. Last month, Triveni Engineering and Industries Ltd, a Triveni Turbine Ltd promoter, sold a 1,609 crore interest in the business to a number of investors, and Biocon Ltd sold a 1,220 crore stake in Syngene to raise money.

These significant transactions occurred as FIIs purchased Indian equities worth \$7.6 billion in July and August 2022 but since the second part of September 2022 these investors have once again turned into net sellers of stocks. In September 2022 FIIs sold \$1.6 billion worth of Indian stocks.

The hesitant FII buyers will likely be replaced by domestic institutional investors and even high-net-worth individuals, according to industry analysts, who predict that the momentum in block trades by investors will likely continue.

"Compared to FIIs, domestic funds and HNIs are making more blocks. A Mumbai-based investment banker who spoke on the condition of anonymity claimed that FIIs were purchasing extremely carefully.

As the 12-month post-IPO lock-in for many companies that went public last year comes to an end, the supply of huge blocks is still high. These investors will be on the lookout for the best moments to block trade their remaining shares.

"We don't believe that FII selling has much of an impact on block deals. We observed many blocks even during the first six months of the year, when FIIs were selling. According to an investment banker who also spoke on the condition of anonymity, "the majority of the supply is coming from financial sponsors, particularly corporations where IPO lock-in are ending." He continued, "There is activity in well-performing industries like financials and consumer goods, but IT is a challenging prospect right now."

- (2) In addition, RRK is considering how to fund its expanding working capital needs. CA Ranjan suggested that the company use the money market. He also informed the management of the Reserve Bank of India's impending issuing of Treasury Bills. He did, however, issue a warning to the management regarding the recent increase in cut-off yields on Treasury Bills. He provided examples from current events to support his point, which are covered in the following paragraphs:

On October 12, 2022, the Reserve Bank of India offered 91-day T-bills at a yield of 6.3145 percent, up roughly 24 basis points (bps) from the yield of 6.0783 percent the previous week. The cut-off for the 182-day and 364-day papers increased from last week's levels by 17 bps and 23 bps, respectively, to 6.7647 percent and 7.0169 percent. A bps is a one-hundredth fraction of a percentage point.

As a result, on October 13, 2022, the weighted average rate for overnight loans in the interbank call market increased to 6.20 percent. The overnight index swap rate has also increased since last week by 20 basis points. The call money rate is influenced by monetary policy and the state of banking system liquidity.

"The need for money and tighter liquidity constraints are driving up short-term rates. Recently, there was a shortfall in overnight liquidity, which led to an increase in overnight rates such as call money and tri-party repo (TREPS). CIL Mutual Portfolio Asset Management's fund manager for fixed income, Sanjeev Grover, speculated that this may have further pushed the yield curve under pressure.

According to Manish Kumar Tulsan, managing director of a Delhi based fund house with offices in New Delhi, the overnight index swap rate, the marginal standing facility, and short-term debt instrument rates have all increased because of the lack of available liquidity.

The cost of borrowing money over the course of one day is between 6.20 and 6.30 percent, while the central bank's repo rate is at 5.90 percent and the TREPS rate is now at 6.20 percent.

#### Why are funds scarce?

Dealers reported that liquidity has tightened over the past few days because of a strong increase in loan growth, RBI intervention in the foreign exchange market, and a rise in consumption in anticipation of the holiday season.

Dealers also ascribed it to lesser government spending, currency leakage, tax outflows, and more bank participation in reverse repo auctions with variable rates.

On October 10, 2022, liquidity had its first shortfall of the month. The shortfall was Rs 8,764.43 crore, according to figures on the RBI website.

"Due to the periodic increase in cash withdrawals throughout the holiday season, liquidity circumstances are becoming more restricted. Over the upcoming weeks, the liquidity gap will increase in size. Money

market rates would rise higher if the RBI doesn't offer consistent liquidity support", according to Magnus Asset Management Co. fund manager for fixed income Deepak Shah.

### Questions

- (1) 91-day Treasury Bills (T-Bills) were issued at a fixed price of ₹ 98. The face value of it was ₹ 100. You are required to calculate the Yield Rate of T-Bill and the rate of discount. (5 Marks)
- (2) ABC Ltd. wants to go through the block deal route. Guide the company through the intricacies of block deal route. (5 Marks)
- (3) Why treasury bills are the most preferred form of money market instruments resorted to by the Government of India? (5 Marks)
- (4) Multiple Choice Questions (10 marks)
  - (i) Harvest year is projected to be the ..... for the PE/VC.
    - (a) year of investment
    - (b) year of exit
    - (c) year of putting Series B funding
    - (d) year of putting Series C funding
  - (ii) Which among the following is not an exit route for a PE?
    - (a) Initial Public Offer
    - (b) Strategic Acquisition
    - (c) Secondary Sale
    - (d) Buy Back
  - (iii) ..... means that the investors pay a lower per share price than what previous investors paid, which indirectly implies that the investors have valued the VC at a lower value in the current round than the previous round.
    - (a) Upper Round
    - (b) Lower Round
    - (c) Down Round
    - (d) Side Round
  - (iv) Duration of the call money market is for a maximum duration of ..... days.
    - (a) 7 days
    - (b) 14 days
    - (c) 21 days
    - (d) 30 days
  - (v) A depositor deposits ₹ 2,00,000 in a bank. Out of that amount bank shall keep ₹ ..... as Cash Reserve Ratio as per the present norms mandated by RBI.
    - (a) 9000
    - (b) 6000
    - (c) 8000
    - (d) 7000