Workbook for

NISM – Series – II – B: Registrars and Transfer Agents (Mutual Funds) Certification Examination
Workbook
for
NISM-Series-II-B: Registrars to an Issue and Share Transfer Agents – Mutual Fund Certification Examination

National Institute of Securities Markets
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In pursuance of the announcement made by the Finance Minister in his Budget Speech in February 2005, Securities and Exchange Board of India (SEBI) has established the National Institute of Securities Markets (NISM) in Mumbai.

SEBI, by establishing NISM, has articulated the desire expressed by the Indian government to promote securities market education and research.

Towards accomplishing the desire of Government of India and vision of SEBI, NISM has launched an effort to deliver financial and securities education at various levels and across various segments in India and abroad. To implement its objectives, NISM has established six distinct schools to cater the educational needs of various constituencies such as investor, issuers, intermediaries, regulatory staff, policy makers, academia and future professionals of securities markets.

NISM brings out various publications on securities markets with a view to enhance knowledge levels of participants in the securities industry.

NISM is mandated to implement certification examinations for professionals employed in various segments of the Indian securities markets.
Acknowledgement

This workbook has been developed by NISM in cooperation with the Examination Committee for Registrar and Transfer Agent Examinations consisting of representatives of Registrars and Transfer Agent Association of India (RAIN). NISM gratefully acknowledges the contribution of all committee members.

About the Authors

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About the Certification Examination for Registrars and Transfer Agents – Mutual Funds

The examination seeks to create a common minimum knowledge benchmark for persons working in Registrars to an Issue and Share Transfer Agents (R&T agent) organizations in the mutual fund R&T function, in order to enable better quality investor service, operational process efficiency and risk controls.

Examination Objectives
On successful completion of the examination the candidate should:

- Know the basics of securities and securities markets
- Understand broadly the role and functions of the R&T Agents in the mutual fund issuance and transaction process.
- Know the regulatory environment in which the R&T Agents operate in India.

Assessment Structure
The examination consists of 100 questions of 1 mark each and should be completed in 2 hours. The passing score on the examination is 50%. There shall be negative marking of 25% of the marks assigned to a question.

Examination Structure
The exam covers knowledge competencies related to the basics of securities and markets and those related to the processing of mutual fund offerings and subsequent operations.

How to register and take the examination
To find out more and register for the examination please visit .nism.ac.
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1. Introduction to Securities

1.1. Introduction to Equity and Debt

A firm requires money to conduct its operations. The funding of a business can be of two dominant forms:

- Contribution by owners
- Loans from outsiders

Businesses are typically created by promoters, who bring in the initial funds, to create and nurture a business. Later as the business grows bigger, the need for money can be met by asking for more contributions to the business from outsiders.

Capital used in running a business can be primarily classified based on:

- The contributors of funds
- The period for which money is contributed
- The cost of the funds to the firm
- The rights that accrue to the contributors of the funds

Contributors

Fund brought in by promoters and owners of the business is called equity capital. Equity capital can be brought in at the start of a business or at a later date as the business grows. Equity capital also can be contributed by outside investors. To enable such contribution, the business offers equity shares to outside investors, who become share holders.
Funds brought in as loan is called debt capital. Those that contribute debt capital are called as lenders to the business. Lenders can be individuals or institutions including banks. To enable such lending, a business issues debt instruments to investors, or obtains term loans by mortgaging the assets of the company.

**Time Period**

The period for which capital is brought in may vary. Equity capital cannot be taken out of the firm unless the firm is liquidated. Such capital is for perpetuity.

Debt has to be repaid by the company after a certain period. The period of repayment may be short-term (less than one year) or long-term (usually up to 10 years) and is decided at the time such capital is brought in.

**Cost of Capital**

The business has to pay a price for using equity or debt capital. The cost may be fixed at the time the money is brought in and may constitute an obligation for the company. Debt instruments usually pay a periodic interest at a pre-determined rate.

The cost of capital may vary depending on the earnings of the company, as is the case with equity capital.

**Rights of the Contributors**

The contributors of capital enjoy certain rights and obligations depending upon the type of capital that they have brought in. Equity
investors enjoy rights such as ownership and voting rights and rights to share the profits of the company. Debt investors have the right to receive periodic interest and return of the capital on the expiry of the fixed period. The contributors of debt capital may have their rights secured against the assets of the company.

1.2. Features of Equity Capital

Those who contribute equity capital to the company buy equity shares, when they are issued by the company. They are called equity shareholders of the company.

Limited liability

Equity capital is issued with limited liability. This means, if the creditors to a business are not able to recover their dues, equity shareholders will not be asked to pay up. The liability of equity shareholders in a company is limited to their contribution made or on any amount unpaid which they have agreed to pay.

Face value

The total equity capital required by a company is divided into smaller denomination called the face value or par value of the equity shares. For example, if a company has an equity capital of Rs 10,00,000, this can be divided into:

- one lakh shares with a face value of Rs 10; or
- two lakh shares with a face value of Rs 5; or
- ten lakh shares with a face value of Re 1.

Equity shares were earlier issued as certificates; now they are invariably issued in electronic/dematerialised form.
The par value or face value of the shares can be changed subsequently, if the company so desires. This is called a split or a consolidation of shares. If a share with a face value of Rs 10 is divided into two shares with par values of Rs 5 each, it is called a split. If 5 shares of Rs 2 face value each are clubbed into one share of Rs 10, it is called a consolidation of shares.

**Authorised capital**

The maximum amount of equity capital that a company will have is defined in the Memorandum of Association (MoA) of the company and is called its authorised capital. The authorised capital of a company can be increased or reduced subsequently by the company.

**Issued capital**

The company may issue a portion of its authorised capital as and when it requires capital. The capital may be issued to the promoters, public or to specified investors. The portion of authorised capital that has been issued to investors is called issued capital. Capital can be raised at various times as and when the company requires it, provided the sum of all capital issued is less than or equal to the authorised capital of the company.

The capital may be issued by the company either at its face value or at a premium (higher than the face value) or at a discount (lower than the face value). The issued capital will take into account only the face value of the shares issued. The remaining portion paid by the investor is accounted under the share premium account (liability
side of the balance sheet) or share discount account (asset side of the balance sheet).

**Paid-up capital**

When investors subscribe to the capital issued by a company, they may be required to pay the entire price at the time of issue or in tranches (instalments) as application money, allotment money and call money. The portion of the issued capital that has been fully paid-up by the allottees is the paid-up capital of the company.

A company decides that the maximum equity capital it needs is Rs20 cr. In the initial stages, the need is Rs.10cr. It issues equity shares of Rs.10 face value, at par. Investors are required to pay Rs.5 per share with application, Rs.2 on allotment, and balance Rs.3 after it has been called. What is the authorised, issued and paid-up capital of the company, before the issue, after application, after allotment and after the call?

**Before the issue:**
Authorised capital: Rs 20 Cr

**After application:**
Authorised capital: Rs 20 Cr
Issued capital: Rs 10 Cr
Paid up capital: Rs 5 Cr
After allotment:
Authorised capital: Rs 20 Cr
Issued capital: Rs 10 Cr
Paid up capital: Rs 7 Cr

After first call:
Authorised capital: Rs. 20 Cr
Issued capital: Rs 10 Cr
Paid up capital: Rs 10 Cr

Thus it can be seen that the paid up capital is always less than or equal to issued capital; issued capital is always less than or equal to authorised capital. Authorised capital is the maximum amount that can be issued or paid up.

Ownership rights
Equity represents ownership of the company. Equity shareholders are part-owners of the company. The extent of their ownership is defined by their portion of the shares held in issued capital.

For example, if a company has an issued capital of Rs.10 Cr made up of 1cr shares of Rs.10 each, an investor who holds 10 lakh equity shares is a part-owner with 10% stake in the company.

Equity shareholders have the right to participate in the management of the company. They can do this through voting rights. Each equity share carries one vote. Major decisions of the company require
resolutions to be passed, which have to be voted by a majority or more of the equity shareholders.

Equity capital entitles its contributors to participate in the residual profits of the company. After meeting all expenses and provisions, whatever is the profit that remains in the books belongs to equity share holders.

**Liquidity and return**

Equity shares are first issued by a company. They are then listed on the stock exchange, where they can be transferred from one investor to another. Such transactions are between existing shareholders, and therefore do not result in change in the capital structure of the company. Equity capital is for perpetuity. It cannot be redeemed and the company does not have to repay it.

The return from equity capital is in the form of dividends from the profits of the company and appreciation in the value of the holdings. There is no guarantee of dividends or capital appreciation on equity capital.

1.3. **Features of Debt Capital**

Debt capital refers to the borrowings of a company. Those contributing equity capital are owners of the company; those that contribute debt capital are lenders or creditors of the company.

Debt is raised by companies by issuing securities such as debentures, bonds and commercial paper to the lenders. The terms at which the borrowing is being made, such as, the period, the interest and other features are mentioned in the document (or
certificate) that represents the debt security. Debt securities are also issued in electronic form.

Debt is raised by the company for a fixed period after which it has to be repaid. The period of borrowing will vary depending upon the need of the company.

The company has to pay periodic interest for the sum they have borrowed as decided at the time of the borrowing. Interest is usually a percentage of the par value of the debt instrument. The interest that the company has to pay will depend upon the risk of default associated with the company and the credit policy followed by the bank.

The lenders may have the right against the assets of the company if the company fails to pay interest and/or return the principal amount borrowed. Lending can also be unsecured, where such rights do not exist. Debt instruments may be listed on a stock exchange, in which case investors can buy or sell them. Debt instruments provide predefined income at specific intervals and the redemption proceeds on maturity.

1.4. Hybrid Structures

Companies may raise capital in a form that combines the features of both debt and equity. These are called hybrid instruments.

Convertible debentures

Convertible debentures pay interest like any other debt instrument till the date of conversion into equity shares. The terms of conversion,
such as the number of equity shares that each debenture will be converted into and the price at which conversion will take place will be mentioned at the time of the issue of the debt instrument.

**Preference shares**
Preference shares resemble debt instruments because they offer pre-determined rate of dividend. However, they do not have a fixed maturity period or a right over the assets of the company. They have a preference in the payment of dividend over ordinary equity shares and in the return of capital, if the company is wound up.
Key Points

1. The capital structure of the company comprises of equity and debt in varying proportions.

2. Equity and debt capital differ on the rights and obligations for the investor and the company.

3. The equity capital of a company is divided into denominations called face value or par value. The denomination is usually Rs 10, Rs 5, Rs 2, and Re 1.

4. The memorandum and articles of association define the upper limit on the equity capital that a company can raise. This is called the authorised capital of the company.

5. The issued capital is that portion of the authorised capital that has been issued and the paid up capital is that portion of the issued capital that has been paid up by the allottees.

6. Equity capital implies ownership and higher risk for investors. For the company it is higher cost capital but without the obligation of repayment.

7. Debt capital implies regular return and security for the investor. For the company there is an obligation to make periodic interest payments and to repay the capital on maturity.

8. Hybrid products are created that have a combination of the features of equity and debt capital.
Quick Recap

Fill in the Blanks

1. _______ is for perpetuity from the point of view of the company.
2. Equity capital gives returns from _______ and _________ for the investor.
3. The denomination in which equity capital is issued is called_______
4. Debt capital has fixed ________
5. The interest that a company will have to pay on the debt raised will depend upon its ________.

State True or False

1. Companies prefer equity capital because it is less expensive.
2. The Authorised capital of the company can be raised if the company wants to increase the capital once it is fixed.
3. The paid-up capital of a company can be higher than its issued capital.
4. Debt capital is always raised for short-term periods.
5. Debt instruments are listed and traded on the secondary markets.
Answers:

Fill in the Blanks:

1- Equity capital
2- Dividends
Capital Appreciation
3- Face or Par Value
4- Maturity
5- Default Risk

True or False:

1- True
2- True
3- False
4- False
5- True
2. Characteristics of Equity Shares

2.1 Investors in Equity Shares

A company raises equity capital to meet its need for long-term funds for expansion or continuing operations of the company. Equity capital does not impose any liability on the company in terms of returns or repayment. However, when a company issues equity capital, the investors also get control and ownership. Their ownership rights depend on the proportion of issued capital that they hold.

A company can raise capital from different categories of investors. Different categories of investors have different requirements in terms of returns, risk and management control.

Promoters

Promoters are the group of investors who set up the company and bring in the initial capital required to start the business. This is the risk capital that allows the business to leverage and to protect it from fluctuations in earnings. At this stage the entire control of the company is with the promoters. They bring in additional capital as and when required.

As the capital needs of the business grow, promoters find that they cannot meet the company’s need for funds. Equity is then issued to eligible investors such as institutions and retail public investors.

Promoters usually retain the majority shareholding in the company so that they can continue to control its affairs even after their stakes
are diluted. The stage at which the promoters bring in the initial capital is the riskiest as the business is in the nascent stage and has a high risk of failure.

**Institutional Investors**

Institutional investors include financial institutions, venture capital companies, mutual funds and foreign financial institutions, banks among others. These are professional investors who have the ability to evaluate the business proposition, the risks associated with it and the expected returns.

The company may allot shares to such investors through a private placement of shares where the regulatory requirements are much less as compared to a public issue of shares. The risks and returns will depend upon the stage at which the institutional investors bring in capital.

Some like venture capital firms may be willing to bring in capital for companies in the start-up stage or even later while others like financial institutions invest in more established firms. Institutional investors such as venture capital firms may be actively involved in the management of the company while others like mutual funds may be more passive investors who are more interested in the returns that their investment can generate rather than in the management of the company.

Apart from the attractiveness of the business proposition, institutional investors would also be interested in factors such as exit options, since many of them may hold a significant proportion of the equity capital. Many institutional investors like venture capitalists,
encourage a company to offer its shares to the public investors as an exit option for themselves.

**Public Investors**

When the equity shares are held by promoters and a few investors, it is said to be closely held. Such companies are also private companies, which are not required to disclose too much of information about themselves to the public.

When a company offers its equity shares to the public at large, it moves from being a privately held company, to a publicly held company, which agrees to disclose periodic information about its operations and business to the public.

Investors, other than promoters, participate in the equity of a company when a company comes out with a public issue of shares. A public issue of shares requires regulatory compliance with SEBI’s guidelines and regulations governing listing of the shares on a stock exchange.

Public investors in shares may be retail investors, high net worth individuals (HNI) or institutional investors. Retail investors, and to a great extent HNIs, are more interested in the returns that they can generate from their investment from capital appreciation in the value of the shares and dividend rather than in the control and management of the company. They hardly exercise their voting rights.

Large stake holders and institutional shareholders actively participate in the affairs of the company. Some large institutional investors are
also given a seat on the board of the company. Regulations require extensive and timely disclosures of all information that affects the interests of the public investors in a company.

2.2 Features of Equity Share Capital

Equity share capital has distinct features which define its risk and return. These features determine the suitability of raising equity capital for the company over other sources of financing such as debt. For the investors, the risk and return in the equity investment determine whether such investment is appropriate for their needs.

Ownership rights

Issuing ordinary equity capital implies that the company is giving ownership rights to the shareholders. Investors are given voting rights which allow them to vote on important decisions taken by the company. The voting rights are in proportion to the number of shares held by the investor and allow them to express their views by voting for or against a proposal.

Ownership rights in a company also mean that the investors who hold equity shares are entitled to participate in the residual profits of the company. This participation will be in the form of dividends that are periodically declared by the company. The company may also allot bonus shares to its shareholders from the reserves of the company.
**Equity capital is for perpetuity**

A company is not required to return the equity capital to the investor. Investors who do not want to hold the capital of the company can sell the shares in the stock market to other investors who may want to buy the shares. This is, however, possible only if the shares are listed on a stock exchange. The company does not redeem or repay the amount invested to the investor in equity shares.

**Returns are not fixed**

Investment in equity shares does not come with a guarantee of income or security for the investor. The income for the investor from equity is from dividends and capital appreciation. Neither of these is guaranteed by the company or any other entity.

At the time of the issue of shares the company does not commit to pay a periodic dividend to the investor or a pre-fixed date for payment of dividend, if any. The investor cannot take any action against the company if dividends are not declared or if the share value depreciates.

The profits made by the company, after all contractual and regulatory payments have been made, are for the benefit of its equity shareholders. These profits are either distributed to the investors as dividend or retained as reserves which add to the net worth of the company and the inherent value of its equity shares.
2.3 Risks in Equity Investing

No fixed return
The return in the form of dividend from equity is not pre-defined either in terms of the percentage of dividend or the date on which the payment will be made. Dividend is paid if the company makes sufficient profits and the management of the company feels it is appropriate for some of the profits to be distributed among the shareholders.

In case the company makes losses or the profits made by the company is ploughed back for the expansion and other operations of the company, the shareholders may not get a dividend.

The other source of return for the holder of equity shares is the appreciation in the price of the share in the secondary market. This constitutes the major portion of the return for the equity investor. If the company's performance is bad or if the stock markets are going through a downturn, the value of the shares may actually depreciate leading to a loss for the investor. There is no guarantee that the principal amount invested in equity shares will remain intact.

No fixed tenor
Equity shares are issued for perpetuity. This means that there is no period of maturity after which the money will be returned to the shareholders. Investors who want to exit their investments may do so by selling the shares on the stock exchange to other investors.
The investor who is selling all his shares ceases to be a shareholder of the company. The shares are transferred to the buyer who now gets all the rights and obligations associated with it. Transactions between investors on the secondary market do not increase or decrease the share capital of the company. The risk to the shareholder arises if the shares are illiquid and not easily sold at its market value or if the shares are unlisted. The investor’s investment may get stuck without an exit option.

**No collateral security**

Equity capital is not secured by the assets of the company. The cash and assets of the company are first applied to settle the claims of the lenders and creditors. The claims of the equity shareholders always rank last in order of preference. During the normal course of operations of the company, dividends are payable to the equity shareholders only after the expenses, interest and taxes are provided for. In the event of liquidation of the company, the equity shareholders are only entitled to a refund of capital after the claims of all the other creditors are satisfied from the auction sale of the company’s assets.

**2.4 Dividend from Equity Shares**

Equity shareholders are entitled to share in the residual profits of the company. One way to do this is through the dividend that the company may periodically declare.

Dividend declared by a company is not pre-fixed in terms of the percentage of the dividend or the period when it will be declared. Dividends are declared by the company when there is sufficient
profits that can distributed among the shareholders. The board of directors of the company will take a decision on the dividend to be declared. Shareholders approve such dividend proposed by the board, in an annual general meeting.

Dividend is declared as a percentage of the face value of the shares. A 40% dividend declared by company will translate into a dividend of Rs 4 for a share with a face or par value of Rs 10 (10*40/100), Rs 2 for a share with a face value of Rs 5 (5*40/100).

Dividend for a company is usually declared at the end of a year which is called the final dividend. Companies may also declare dividends during the year. This is called interim dividend.

Dividend income received on equity shares is exempt from tax for the investor at this time. The company is however required to pay a dividend distribution tax on the dividend.

The dividend declared by a company is a percentage of the face value of its shares. When the dividend received by an investor is compared to the market price of the share, it is called the dividend yield of the share.

For example, a company declares a dividend of 60% on its shares which have a face value of Rs 2. The market price of the share is Rs 80. The dividend yield is the dividend amount, which is Rs 1.2 (Rs 2*60/100) as a ratio of the market price which is Rs 80. The dividend yield is therefore 1.2/80*100= 1.5%.
The dividend yield of a share is inversely related to its share price. If the price of equity shares moves up, the dividend yield comes down, and vice versa.

2.5 Preference Shares

When we talk of shares of a company we usually refer to the ordinary shares of a company. A company may also raise equity capital with varying rights and entitlements. These are called preference shares because they may offer certain special features or benefits to the investor. Some benefits that investors in ordinary equity capital have, such as, voting rights, may instead not be available to preference share holders. Preference shares are usually given preference over equity shares in the payment of dividends and the repayment of capital if the company is wound up.

Dividend is paid to the preference share holder at a fixed rate mentioned at the time of the issue of the shares. The terms of issue may allow the preference share holders to participate in the residual profits too in some defined ratio. These are called participating preference shares.

Preference shareholders are paid dividend only if the company has sufficient profits. The unpaid dividend may be carried forward to the following year(s) and paid if there are profits to pay the dividends, if the terms of issue of the shares so allow. Such shares are called cumulative preference shares.
The returns for the preference shares are only from the dividend the company pays. These shares are usually not listed and there is not much scope for capital appreciation. This is because these shares do not participate in the profits of the company. Their value is not affected by the over-performance or under-performance of the company.

Though preference shares are similar to debentures, they differ on the following points:

- A preference share holder is a shareholder of the company. A debenture holder is a creditor of the company.
- A debenture is usually secured on the assets of the company. A preference share is not secured since it is not a borrowing.
- The coupon interest on the debenture is an expense to be paid by the company before calculating the profits on which tax has to be paid. Dividends on preference shares are paid from the residual profits of the company after all external liabilities, including tax, have been paid.

2.6 Rights Issue of Shares

A company may raise equity capital from its investors at various times, provided it is within the authorised capital limits of the company. Whenever a company makes a fresh issue of shares, it has an impact on the existing shareholders since their proportionate holding in the shares of the company gets diluted.
For example, a company may have 10 lakh shares of Rs.10 each, amounting to an issued and paid-up capital of Rs. 1cr. If it issues another 10 lakh shares, to increase its capital, the proportion held by existing shareholders will come down by half, as the issued and paid up capital has doubled. This is called as dilution of holdings. To prevent this, section 81 of the Company's Act requires that a company which wants to raise more capital through an issue of shares must first offer them to the existing shareholders. Such an offer of shares is called a rights issue.

The rights shares are offered to the existing investors in a proportion as approved by the board of a company. For example, the company may choose to issue rights at 1 for 1, to double its capital. This means each existing shareholders will get one equity share for every one equity share that they already hold.

The issued and paid up capital will double, but proportionate holdings will not change. Ratio of rights issues need not always be one. They can be 1:2, 2:3, 2:5 and so on, depending on the decision of the board of the company.

Investors have to subscribe to a rights issue, by paying for and buying the equity shares being offered. The rights issue is kept open for a fixed period during which investors subscribe to the shares or can also sell/renounce their right entitlement.

A rights issue of shares must follow all SEBI’s regulation on issue of shares. The company must issue a letter of offer giving details of the issue including the purpose for which funds are being raised. The
draft letter of offer must be filed with SEBI at least 30 days prior to filing the same with the designated stock exchange.

An abridged letter of offer must be dispatched to all investors at least one week before the issue opens. Investors can also apply on a plain paper if they do not receive the application form. The investors are given the option to receive the shares in dematerialised form.

A company cannot withdraw a rights issue after announcing it. If the company does so, it will not make an application for listing any securities within a minimum period of 12 months from such withdrawal.
Key Points

1. Equity capital may be raised from the promoters, institutions and the public at various points in time.

2. Ordinary equity shares give ownership rights to the investor. This includes voting rights and the right to participate in the residual profits of the company.

3. Equity capital is for perpetuity. This means the company does not have to repay the capital that is raised from investors.

4. Investors can however exit from the investment by selling the shares in the secondary market to other investors.

5. Returns from equity are in the form of dividend and capital gains when the shares are sold in the secondary markets.

6. Investors receive dividends only if there are profits and the company decides to distribute them. Dividends are declared as a percentage of the face or par value of the shares.

7. The dividend yield of a share compares the dividend paid to the market price of the share.

8. The risk in equity investing arises from the fact that returns from equity are not fixed and the secondary market for the shares may be illiquid making it difficult for the investor to exit.

9. Preference shares give the investor a fixed rate of dividend and priority over ordinary equity shareholders in repayment of capital if the company goes into liquidation.

10. Rights shares are further shares issued to existing shareholders in proportion to their existing holding.
Quick Recap

Fill in the Blanks

1. _____ rights give the equity investor a say in the management of the company.
2. A 20% dividend declared on face value of Rs 10 and market price of Rs 120 translates into a dividend payout of Rs. _____.
3. When market price goes up dividend yield goes______.
4. Cumulative preference shareholders can carry forward ______
5. The price of at which rights shares are issued are decided by ________

State True or False

1. Retail investors usually participate in the equity of a company at its inception stage.
2. A company may not declare a dividend even if there are profits.
3. Preference share holders get preference over debenture holders in the payment of dividend.
4. Preference share holders and debenture holders are creditors of the company.
5. Rights shares, if subscribed to, maintains the investors proportionate holding of the investor in the company.
Answers:

Fill in the blanks:

1- Voting
2- Rs 2
3- Down
4- Unpaid dividend
5- Company

State True or False:

1- False
2- True
3- False
4- False
5- True
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3. Other Securities

Companies can raise capital using equity and debt instruments. The basic features of these instruments can be modified to suit the specific requirements of the borrowers or lenders. Such modifications bring advantages such as wider participation, better management of cash flows and better return prospects.

3.1 Warrants

Warrants are securities usually issued by companies along with a debenture to make the debt issue more attractive to the investors. Warrants give the investors in the debentures, the right to buy shares of the company in the future.

Warrants are usually attached to a debenture issue of the company to make the debenture more attractive. The number of shares that the warrant entitles the holder to subscribe to, the price at which such shares can be bought and the period during which the warrant can be exercised are specified at the time of the issue.

Warrants will be exercised if the share price at the time of exercise is higher than the price at which the investors have the option to buy the shares. For example, assume a warrant enables an investor to buy an equity share of a company at Rs.100. The warrant will be exercised if, when it is due to be exercised, the price of the share in the markets is more than Rs.100. If the market price is less than Rs.100, the investor can always buy from the market, rather than use the option to buy the same share at a higher price. When warrants
are exercised they result in additional shares being issued by the company and a dilution in the stake of the existing shareholders.

Warrants may be traded on the stock exchange as a security separate from the debenture with which it was issued. Warrants usually have a longer lifetime (usually in years) as compared to option contracts which they closely resemble.

Warrants may be used by promoters to increase their stake in the company. SEBI requires that shares issued to promoters as a result of exercising the option on the warrant will have a lock-in of three years from the date the shares are allotted.

### 3.2 Convertible Debentures

Convertible debentures are debt instruments that can be converted into equity shares of the company at a future date. The security has features of both debt and equity. It pays periodic coupon interest just like any other debt instrument.

At the time of redemption of the debenture, the investors can choose to receive shares of the company instead of cash.

The issuer specifies the details of the conversion at the time of making the issue. This will include:

- The date on which the conversion will be made
- The ratio of conversion i.e. the number of shares that the investor will be eligible to get for each debenture
- The price at which the shares will be allotted to the investor on conversion. Usually this is at a discount to the market price
- The proportion of the debenture that will be converted into equity shares.

Debentures may be fully convertible debentures (FCD) where the entire face value of the debenture is converted into equity shares or they may be partly convertible debentures (PCD) where a portion of the debenture is converted into equity. The non convertible portion will continue to remain as debentures and will be repaid in cash on redemption.

The advantage to the issuer of convertible debenture lies in the fact that convertible debentures usually have a lower coupon rate than pure debt instruments. This is because the yield to the investor in such debenture is not from the coupon alone but also the possibility of capital appreciation in the investment once the debentures are converted into equity. Moreover, the issuer does not have to repay the debt on maturity since shares are issued in lieu of repayment. The disadvantage to this is that holding of the existing shareholders get diluted when fresh shares are issued on conversion.

The investors in a convertible debenture have the advantage of equity and debt features. They earn coupon income in the initial stages, usually when the company’s project is in its nascent stage. Once the debenture is converted into shares, the investor may benefit from the appreciation in the value of the shares.
An issue of convertible debentures by way of a public issue will have to abide by the regulations of SEBI. The guidelines also require that the investors be given the option of not converting the debenture into shares, if the price at which conversion is to be made is not defined at the time of the issue.

3.2.1 Depository Receipts

Depository receipts (DRs) are financial instruments that represent shares of a local company but are listed and traded on a stock exchange outside the country. DRs are issued in foreign currency, usually dollars.

To issue a DR, a specific quantity underlying equity shares of a company are lodged with a custodian bank, which authorises the issue of depository receipts against the shares. Depending on the country of issue and conditions of issue, the DRs can be converted into equity shares.

DRs are called American Depository Receipts (ADRs) if they are listed on a stock exchange in the USA such as the New York stock exchange. If the DRs are listed on a stock exchange outside the US, they are called Global Depository Receipts (GDRs). The listing requirements of stock exchanges can be different in terms of size of the company, state of its finances, shareholding pattern and disclosure requirements.

When DRs are issued in India and listed on stock exchanges here with foreign stocks as underlying shares, these are called Indian Depository Receipts (IDRs)
The shares of a company that form the basis of an ADR/GDR/IDR issue may be existing shares i.e. shares that have already been issued by the company. These shareholders now offer the shares at an agreed price for conversion into DRs. Such a DR issue is called a sponsored issue.

The company can also issue fresh shares which form the underlying for the DR issue. The funds raised abroad have to be repatriated into India within a specified period, depending on the exchange control regulations that will be applicable.

The company whose shares are traded as DRs gets a wider investor base from the international markets. Investors in international markets get to invest in shares of company that they may otherwise have been unable to do because of restrictions on foreign investor holdings. Investors get to invest in international stocks on domestic exchanges. Holding DRs gives investors the right to dividends and capital appreciation from the underlying shares, but not voting rights.

The steps in issuing DRs are the following.

- The company has to comply with the listing requirements of the stock exchange where they propose to get the DRs listed.
- The company appoints a depository bank which will hold the stock and issue DRs against it.
- If it is a sponsored issue, the stocks from existing shareholders are acquired and delivered to the local custodian of the depository bank. Else the company
issues fresh shares against which the DRs will be issued.

- Each DR will represent certain number of underlying shares of the company.

Once the custodian confirms that the shares have been received by them, the depository bank in the foreign country will issue the depository receipts to the brokers to trade in the chosen stock exchange where the DRs have been listed. DRs may feature two-way fungibility, subject to regulatory provisions. This means that shares can be bought in the local market and converted into DRs to be traded in the foreign market. Similarly, DRs can be bought and converted into the underlying shares which are traded on the domestic stock exchange.

SEBI has laid down the guidelines to be followed by companies for IDRs. This includes the limit on the money raised by a company in India, a one year lock-in on the conversion of IDRs to shares, the availability of IDRs to only resident Indian investors and not to FIIs.

3.3 Foreign Currency Convertible Debenture (FCCB)

FCCBs are a foreign currency (usually dollar) denominated debt raised by companies in international markets but which have the option of converting into equity shares of the company before they mature.

The payment of interest and repayment of principal is in foreign currency. The conversion price is usually set at a premium to the
current market price of the shares. FCCB allow companies to raise debt at lower rates abroad. Also the time taken to raise FCCBs may be lower than what takes to raise pure debt abroad.

An Indian company that is not eligible to raise equity capital in the domestic market is not eligible to make an FCCB issue either. Unlisted companies that have raised capital via FCCB in foreign markets are required to list the shares on the domestic markets within a stipulated time frame.

FCCBs are regulated by RBI notifications under the Foreign Exchange Management Act (FEMA). The Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism), 1993 lays down the guidelines for such issues.

The issue of FCCBs should be within the limits specified by RBI from time to time. Public issue of FCCB will be managed by a lead manager in the international markets. Private placement of FCCBs is made to banks, financial institutions, foreign collaborators, foreign equity holders holding at least 5% stake.

The maturity of FCCB will be not less than five years. Proceeds from FCCB shall not be used for stock market activities or real estate. If it is to be used for financing capital expenditure, it can be retained abroad.

The expenses shall be limited to 4% of the issue size in case of public issue and 2% in the case of private placement. Within 30 days of the issue a report has to be furnished with RBI giving details of the
amount of FCCBs issued, the name of the investors outside India to whom the FCCBs were issued and the amount and the proceeds that have been repatriated into India.
Key Points

1. Instruments can be created with features of equity and debt to suit the specific needs of the borrower and lender.

2. Warrants give the investor the option to buy shares of the company in future. They are traded separately in the market.

3. Convertible debentures come with the feature that they can be converted into shares of the company at a future date.

4. The price and conversion ratio are decided at the time of the issue. Till conversion, the debenture will pay coupon interest like other debt instruments.

5. The issue of convertible debentures is regulated by SEBI's norms for issue, price and lock-in.

6. Depository receipts are instruments that represent underlying shares of a local company but listed on a foreign stock exchange. The issue has to meet the requirements of the stock exchange where it proposes to list the DRs.

7. An Indian Depository Receipt (IDR) is listed on an Indian stock exchange and represents the shares of a foreign company. An IDR issue has to meet the specifications laid down by SEBI.

8. DRs can be converted into the underlying shares and vice versa.

9. FCCBs are issued as convertible debentures abroad, with the debt component in foreign currency and the equity on conversion, into Indian equity shares.
Quick Recap

Fill in the Blanks
1. Warrants are usually issued along with _________.
2. Warrants resemble __________.
3. The non-convertible portion of a partly convertible debenture is ________ on maturity.
4. The stocks which underlie a DR issue are held by a __________.
5. Holders of DRs do not have _______ rights.

State True or False
1. Warrants have to be compulsorily exercised by the holder on the specified date.
2. Convertible debentures may be fully or partly converted into equity shares.
3. A convertible debenture issue does not have to be credit rated since it is going to be converted into shares.
4. Investors in convertible debentures may be given the option of not converting the holding into shares.
5. A sponsored DR issue has existing shareholders offering their shares for conversion into DRs.
Answers:

Fill in the blanks:

1-Debentures
2-Call Options
3- Repaid in cash
4- Depository Bank/ (Local Custodian)
5- Voting

State True or False:

1- False
2- True
3- False
4- True
5- True
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4 Debt Securities

4.1 Features of a Debt Security

A debt security denotes a contract between the issuer (company) and the lender (investor) which allows the issuer to borrow a sum of money at pre-determined terms.

These terms are referred to as the features of a bond and include the principal, coupon and the maturity of the bond. In Indian securities markets, a debt instrument denoting the borrowing of a government or public sector organizations is called a bond and the borrowings by the private corporate sector is called debenture. The terms bonds and debentures are usually used interchangeably these days.

The principal is the amount which is being borrowed by the issuer. Each debenture represents a portion of this principal amount borrowed. The face value or par value of the debenture is the amount of the principal that is due on each debenture. The face value of a debenture is usually Rs100.

The coupon is the rate of interest to be paid by the borrower to the lender. This is a percentage that is applied to the face value or par value of the bond. The periodicity (annual, semi-annual, or quarterly.) with which the interest will be paid is also agreed upon.

The maturity of a bond refers to the date on which the contract requires the borrower to repay the principal amount. Once the bond is redeemed or repaid, it is extinguished and ceases to exist.
Each of these features of a bond can be modified to create instruments that meet the specific requirements of the borrower or the lender. A plain vanilla bond will have a fixed term to maturity with coupon being paid at pre-defined periods and the principal amount is repaid on maturity. The bond is usually issued at its face value, say Rs100 and redeemed at par, the same Rs100.

The simple variations to this structure could be a slightly varied issue price, higher or lower than par and a slightly altered redemption price, higher or lower than par. In some cases, the frequency of the interest payment could vary, from monthly, to quarterly and annual. All these variations still come under the plain vanilla definition of a bond, where the interest is paid at a fixed rate periodically, and principal returned when the bond is retired. There are however many ways in which bonds are differently structured, by tweaking their features.

4.2 Varying Coupon Structures

Zero Coupon Bond
In such a bond, no coupons are paid. The bond is instead issued at a discount to its face value, at which it will be redeemed. There are no intermittent payments of interest. When such a bond is issued for a very long tenor, the issue price is at a steep discount to the redemption value. Such a zero coupon bond is also called a deep discount bond.

The effective interest earned by the buyer is the difference between the face value and the discounted price at which the bond is bought. There are also instances of zero coupon bonds being issued at par,
and redeemed with interest at a premium. The essential feature of this type of bonds is the absence of periodic interest payments.

**Floating Rate Bonds**

Instead of a pre-determined rate at which coupons are paid, it is possible to structure bonds, where the rate of interest is re-set periodically, based on a benchmark rate. Such bonds whose coupon rate is not fixed, but reset with reference to a benchmark rate, are called floating rate bonds.

For example, a company can issue a 5 year floating rate bond, with the rates being re-set semi-annually with reference to the 1-year yield on central government securities and a 50 basis point mark-up. In this bond, every six months, the 1-year benchmark rate on government securities is ascertained.

The coupon rate the company would pay for the next six months is this benchmark rate, plus 50 basis points. The coupon on a floating rate bond thus varies along with the benchmark rate, and is reset periodically.

The other names, by which floating rate bonds are known, are variable rate bonds and adjustable rate bonds. These terms are generally used in the case of bonds whose coupon rates are reset at longer time intervals of a year and above. These bonds are common in the housing loan markets.
Other Variations

Some of other structures are: (a) deferred interest bonds, where the borrower could defer the payment of coupons in the initial 1 to 3 year period; (b) Step-up bonds, where the coupon is stepped up periodically, so that the interest burden in the initial years is lower, and increases over time.

4.3 Other Types of Bonds

Callable Bonds

Bonds that allow the issuer to alter the tenor of a bond, by redeeming it prior to the original maturity date, are called callable bonds. The call option provides the issuer the option to redeem a bond, if interest rates decline, and re-issue the bonds at a lower rate. The investor, however, loses the opportunity to stay invested in a high coupon bond, when interest rates have dropped.

Puttable Bonds

Bonds that provide the investor with the right to seek redemption from the issuer, prior to the maturity date, are called puttable bonds. A put option provides the investor the right to sell a low coupon-paying bond to the issuer, and invest in higher coupon paying bonds, if interest rates move up. The issuer will have to re-issue the put bonds at higher coupons.

Amortising Bonds

The structure of some bonds may be such that the principal is not repaid at the end/maturity, but over the life of the bond. A bond in which payments that are made by the borrower includes both interest and principal, is called an amortising bond. Auto loans, consumer
loans and home loans are examples of amortising bonds. The maturity of the amortising bond refers only to the last payment in the amortising schedule, because the principal is repaid over time i.e. redemption in more than one instalment.

**Asset-backed Securities**

Asset backed securities represent a class of fixed income products, created out of pooling together assets, and creating bonds that represent participation in the cash flows from the asset pool. For example, select housing loans of a loan originator (say, a housing finance company) can be pooled, and bonds can be created, which represent a claim on the repayments made by home loan borrowers. Such bonds are called mortgage–backed securities. In some markets like India, these bonds are known as structured obligations (SO). Assets with regular streams of cash flows are ideally suited for creating asset-backed securities.

### 4.4 Classification of Debt Instruments

**Issuers in Bond Markets**

There are two broad ways in which bond markets can be segmented.

- Based on the type of borrower, we can segment the market between the bonds issued by governments, and those issued by non-government agencies like banks, corporations and other such entities.

- Based on the tenor of the instrument, we can segment the bond markets as short-term, medium term and long term.
These are not mutually exclusive segments. The government issues bonds to meet its requirements for various periods as does the private sector. Each issued bond has an issuer and a tenor.

Government Securities comprises the central government bonds, and quasi-government bonds issued by local governments, state governments and municipal bodies. Government securities do not have credit or default risk.

Corporate bond markets comprise predominantly of short-term commercial papers and long-term bonds. Another segment comprises of short term paper issued by banks, in the form of certificates of deposit. The rate at which this segment borrows depends upon the credit quality of the borrower. The credit or default risk of the borrower is defined by the credit rating of the bond. Higher the credit rating lower is the risk of default.

Companies also raise fixed deposits from the retail investors to meet their borrowing requirements. Such deposits are for a fixed term and carry a pre-defined interest rate. The interest can either be paid periodically, such as annual, semi-annual, or quarterly or it is paid cumulatively at the end of the term along with the repayment of the principal.

Company deposits are credit rated but unsecured borrowings of companies and as such pay a higher interest rate on the deposit. Since these are deposits and not a security, there is no liquidity in such fixed deposits. The investors hold the deposits to maturity.
Treasury Bills
The government borrows for periods such as 91 days, 182 days and 364 days using these instruments. Treasury bills are issued through an auction process which is managed by the RBI. Banks, mutual funds, insurance companies, provident funds, primary dealers and FIs bid in these auctions. The treasury bills are usually issued as zero-coupon bonds.

CBLO
A Collateralised Borrowing and Lending Obligation (CBLO) is created using government securities as collateral and held with the Clearing Corporation of India Ltd. (CCIL) to enable borrowing. It is a discounted instrument available for maturities from one day to up to one year. Banks use the CBLO to borrow from mutual funds and insurance companies.

Certificates of Deposit (CD)
Banks use CDs to meet their short-term needs for funds. CDs are different from deposits because they involve creation of paper. This makes the CD transferable before maturity. Secondary market activity in CDs are however low.

Commercial Paper (CP)
CPs are short-term papers issued by companies to meet their working capital requirements. They can be issued for various maturities of up to 364 days. The popular CP is the 90-day CP. CPs are unsecured credit-rated borrowings with a limited secondary market.
Government Securities

Government securities, also called treasury bonds, are predominantly issued to fund the fiscal deficit of the government. Treasury bonds also set benchmark for pricing corporate paper of varying maturities. All other borrowers in the system borrow at a spread over this benchmark rate on government securities.

The instruments used in this segment are many, including fixed coupon bonds, commonly referred to as dated securities, treasury bills, floating rate bonds, zero coupon bonds and inflation index bonds.

Treasury Bonds may have tenors ranging from a year to 30 years.

Corporate Bonds

The market for corporate debt securities is dominated by private placements with large institutional investors. Public issue of corporate debt securities are regulated by SEBI’s guidelines for the same. The guidelines require the issue to be credit-rated, appointment of a debenture trustee, creation of debenture redemption reserve and creation of a charge on the assets of the company.

The secondary market for long-term bonds is concentrated in the government securities segment. In this segment too, trading primarily happens in the benchmark securities. Trades in the government securities segment as well as the corporate bond segment are reported to the exchanges.
4.5 Yield from Debt Instruments

The returns to an investor in bonds, is primarily made up of the coupon payments. However, if the investor acquires or sells the bond at a price that is different from the par value the returns can vary from the coupon. Therefore, the coupon rate of the bond is not an indicator of the returns on the bond, but merely helps in computing what cash flows would accrue periodically, to the investor.

We use the term ‘yield’, rather than ‘coupon rate’, to denote the returns to the investor.

Current Yield

Current yield simply compares the coupon of a bond with its market price. For example, if a bond paying an annual coupon of 12% is trading in the markets for Rs. 109.50, we compute the current yield as:

\[ \frac{12}{109.5} = 10.95\% \]

Yield to Maturity (YTM)

Yield to maturity (YTM) is a popular and extensively used method for computing the return on a bond investment. Every bond is made up of a set of cash flows that accrue at various points in time, from the time the bond is acquired, until it is sold or redeemed.

We can then use the very well known principle in finance, to value the bond: the price at which a series of future cash flows should sell is the sum of the discounted value of these cash flows. The rate
which equates the discounted value of the cash flows with the price of the bond is the yield to maturity of the bond.

4.5.1 Credit Rating

The biggest risk faced by investors in debt securities is the possibility of the lender not honouring their commitment on payment of interest on the borrowing and repayment of the principal on maturity of the instruments.

The ability of the borrower to meet its obligation will depend upon factors internal and external to the business. Lenders therefore evaluate these factors associated with the borrower before entering into the transaction. The decision of a lender on whether or not to lend to a borrower and at what cost would be determined by the risk associated with the borrower. This risk of the possibility of a default on obligations by the borrower is called the credit risk of the borrower.

The credit risk of a borrower is evaluated by credit rating agencies. Credit rating agencies have to be registered with SEBI and abide by the regulation laid down in SEBI (Credit Rating) Regulations, 1999 in the conduct of such evaluations.

The credit rating agencies consider all the qualitative and quantitative factors that impact the business of the borrower and consequently their ability to meet their financial obligations. The appraisal is done by industry experts and the information collected not only from the borrower but from other sources as well. Based on their appraisal, the rating committee of the credit rating agency will assign a rating to the borrowing. Rating is therefore an exercise that
converts into a symbol the ability and willingness of the company to service the instrument proposed to be issued.

The credit rating assigned to an instrument is not static but is dynamic. This means that the credit risk associated with a borrowing may change over time. Credit rating agencies are required by SEBI to constantly monitor factors that affect the status of the instrument and to reassign a rating if the credit quality of the instrument improves or deteriorates.

The rating symbols usually used by rating agencies are described in the table below:

<table>
<thead>
<tr>
<th>Rating Symbol</th>
<th>Instrument</th>
<th>Description</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA,LAAA, P1,A1+, FAAA</td>
<td>Long-term, Short-term, Fixed Deposit</td>
<td>Investment Grade</td>
<td>Highest Safety</td>
</tr>
<tr>
<td>AA,LAA, P2,A1, FAA</td>
<td>Long-term, Short-term, Fixed Deposit</td>
<td>Investment Grade</td>
<td>High Safety</td>
</tr>
<tr>
<td>A,LA, P3,A2, FA</td>
<td>Long-term, Short-term, Fixed Deposit</td>
<td>Investment Grade</td>
<td>Adequate Safety</td>
</tr>
<tr>
<td>BBB,LBBB, A3</td>
<td>Long-term, Short-term</td>
<td>Investment Grade</td>
<td>Moderate Safety</td>
</tr>
<tr>
<td>BB,LB, A4</td>
<td>Long-term, Short-term</td>
<td>Speculative Grade</td>
<td>Inadequate Safety</td>
</tr>
<tr>
<td>FB</td>
<td>Fixed Deposit</td>
<td>B, LB</td>
<td>Long-term</td>
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<tr>
<td>P4</td>
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<tr>
<td></td>
<td>Fixed Deposit</td>
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</tr>
<tr>
<td>C,LC</td>
<td>Long-term</td>
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<tr>
<td>FC</td>
<td>Fixed Deposit</td>
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<td>D,LD</td>
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<td></td>
<td>Short-term</td>
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<tr>
<td>P5,A5</td>
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<td>NM</td>
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<td>Short-term</td>
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</tr>
</tbody>
</table>

(Rating symbols used by CRISIL, ICRA)
Key Concepts

1. The three basic features of a debt instrument are the principal amount that has to be repaid, a coupon interest that has to be paid on the principal amount till it is repaid and a maturity period at which the debt or the principal amount is repaid.

2. The three features of a debt instrument can be modified to create instruments such as zero coupon bonds and bonds with put and call options.

3. Debt markets can be segmented based on the issuer as government bonds and corporate debentures and based on maturity as long and short term bonds.

4. Issuers use different types of instruments to raise debt in the short-term and long-term markets.

5. The yield from a bond can be calculated either as the current yield which relates the coupon income to the market price of the bond or as the YTM which is the internal rate of the bond that would accrue if the bond is held until maturity.

6. The interest that is paid on a debt instrument depends on the credit risk associated with it and the term of borrowing.

7. The credit risk associated with a bond is measured by an exercise called credit rating undertaken by credit rating agencies such as Crisil and Icra, Care and Fitch.
Quick Recap

Fill in the Blanks

1. ________ of a bond refers to the interest payable on a bond.
2. Bonds are segmented as long and short term based on their ______.
3. Call and put options modify the _______ of the bond.
4. The government uses ______________ to borrow for the short-term.
5. A bond with a higher credit rating will pay ______ interest rates.

State True or False

1. Bonds with sinking fund provisions alter the maturity of the bond.
2. A ceiling limits the minimum interest that an investor will receive from a floating rate bond.
3. All government securities are tax-free bonds.
5. Fixed deposits raised by companies are unsecured but rated borrowings.
6. CPs are mostly issued to banks because the stamp duty is lower.
7. The corporate bond market is dominated by public issues of bonds.
8. The prices of bonds are directly related to interest rate movements.
9. The YTM of a bond is the yield that investors will earn on holding a bond to maturity.
10. The credit rating assigned to a bond will change with a change in the financial viability of the borrower.
Answers:

Fill in the Blanks:

1- Coupon
2- Term to maturity
3- Maturity
4- Treasury Bills
5 - Lower

State True or False:

1-True
2-False
3- False
4- False
5-True
6-True
7-False
8- False
9- True
10- True
A mutual fund is an investment option, where investors contribute small amounts of money. These contributions are pooled together to make it a large sum. This sum is then invested in various securities.

When we say 'mutual fund' we are referring to the money contributed by the investors. When we say 'portfolio' we are referring to the securities in which the investments have been made.

A mutual fund thus enables investors to participate in securities markets and invest in equity shares, bonds and such instruments by pooling their money together. A mutual fund will state its objective up front. This indicates how the money will be invested and how the portfolio will be constructed. Investors choose a fund, which matches their own objectives.

For example, an equity fund may state that its objective is to invest in equity shares to generate long term growth. An investor, who likes to invest in a portfolio of equity shares, will buy the units of this fund. A liquid fund may state that its objective is to provide steady return from investing in money markets over the short term. Investors having a short term surplus may decide to invest it in such a fund.

5.1 **Collective Investment Vehicle**

A mutual fund is a collective investment vehicle. Usually a mutual fund product is first described by its investment objective. Investors
then invest their money in the product. The money is pooled together and is invested according to the stated objective.

Example
HDFC Income Fund is a debt fund that invests pre-dominantly in debt instruments, with the objective of generating regular income for its investors.

DSP BR Top 100 Equity Fund is a fund that seeks to generate capital appreciation from a portfolio of equity shares of the 100 largest listed companies.

Fund managers invest the pool of money into securities such as equity and debt, according to the stated investment objective of the fund. The risk and return of the fund depend on the investment portfolio of the fund. The benefits from the investment portfolio accrue to those that contribute to the pool. There is thus mutuality in the contribution and the benefit. Hence the name 'mutual' fund.

When a mutual fund pools money from several investors, each investor does not contribute the same sum of money. Depending on their needs and preferences, investors put in money into the fund. Therefore each investor’s share in the pool of funds is not equal.

5.2 Proportionate Share of Benefits
The benefits from the fund accrue to all investors in proportion to their share in the pool.
Example

Three investors invest Rs 10,000, Rs 20,000 and Rs 30,000 respectively in a mutual fund. So the pooled sum is Rs 60,000. The money is invested and gains Rs 12000 over time. This means, the pool is now worth Rs 72,000. The value of the investors’ holding in the mutual fund also goes up proportionately (in the ratio of 1:2:3) to Rs 12,000, Rs 24,000 and Rs 36,000 respectively.

Investors can contribute into a fund or redeem and take away their contributions, depending on the nature of the pool. In a closed end fund, investors tend to stay until maturity. If a fund is open-ended, investors can come in and move out at will. Therefore, there is the need to standardize the contributions of investors to be able to objectively measure their share in the fund.

5.3 Units Vs Shares

When investors subscribe to a mutual fund, they buy a share in the pool of funds. This share is called a unit of the mutual fund scheme. The investment in a mutual fund is represented to the investor in units.

A mutual fund investor is called a unit holder just as an investor in equity shares is called a share holder. The ownership of the fund is jointly held by all the unit holders. Just as investors in equity hold shares of a company, mutual fund investors hold units of the fund. Each unit has a face value. This is typically Rs 10 per unit for most mutual funds.
Equity shares are offered to investors for the first time in an IPO (Initial public offering). Mutual funds are offered for the first time to investors in an NFO (New fund offer).

Subsequently equity shares are bought and sold on the stock exchange.

Mutual fund units can usually be bought and sold through the fund itself. Funds enable continuous transactions at their offices and at investor service centres. Sometimes mutual funds are listed and can be bought and sold on the stock exchange.

**Unit Capital**

Investments are made in rupee terms by the investor. But the fund will always record this investment in terms of number of units. Number of units = Invested amount/price per unit.

For example,
If the value of a unit is Rs 10, and 2000 units have been sold at Rs 10 each, the value of the pool is $10 \times 2000 = Rs 20,000$.

For example,
If the price of 1 unit is Rs 10.225, and amount invested is Rs 20,000, the number of units issued against this investment is $20,000/10.225 = 1955.99$ units.
Units can thus be denoted also as a fractional value. Unit capital is a term used to denote the corpus of a fund. This is nothing but the total face value of ALL the units issued by a fund.

For example, if a fund has issued 10,000 units so far, its unit capital is $10,000 \times 10 \text{(FV)} = Rs \ 1,00,000$.

According to the SEBI Regulations, each mutual fund scheme has to have a separate account. Therefore the unit capital of each scheme is maintained to reflect its current corpus.

5.4 Assets under Management (AUM)
A portfolio is a collection of securities. These securities can be equity shares, bonds, debentures, deposits, money market instruments, derivatives and the like. Mutual funds can invest only in marketable securities, or securities that can be traded in a market and therefore have a market price.

The value of the fund’s portfolio changes with changes in market value of the securities that have been bought. The portfolio is updated every day, to represent its current market value. This process is called ‘marking to market’.

The market value of the portfolio is known as the assets under management (AUM) of the fund. The value of the portfolio changes every time there is a change in market price of the securities that a mutual fund holds.
Consider this table:

<table>
<thead>
<tr>
<th>Security</th>
<th>No of shares</th>
<th>Market Price Day 1 (Rs)</th>
<th>Market Value Day 1 (Rs)</th>
<th>Market Price Day 2 (Rs)</th>
<th>Market Value Day 2 (Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>L&amp;T</td>
<td>1000</td>
<td>2500</td>
<td>2500000</td>
<td>2700</td>
<td>2700000</td>
</tr>
<tr>
<td>Finolex</td>
<td>2000</td>
<td>50</td>
<td>100000</td>
<td>53</td>
<td>106000</td>
</tr>
<tr>
<td>Sun Pharma</td>
<td>1000</td>
<td>1400</td>
<td>1400000</td>
<td>1300</td>
<td>1300000</td>
</tr>
<tr>
<td>ICICI Bank</td>
<td>1000</td>
<td>750</td>
<td>750000</td>
<td>700</td>
<td>700000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>4750000</strong></td>
<td></td>
<td><strong>4806000</strong></td>
</tr>
<tr>
<td><strong>Number of Units</strong></td>
<td></td>
<td></td>
<td><strong>475000</strong></td>
<td></td>
<td><strong>475000</strong></td>
</tr>
<tr>
<td><strong>Value per unit (Rs)</strong></td>
<td></td>
<td></td>
<td><strong>10</strong></td>
<td></td>
<td><strong>10.12</strong></td>
</tr>
</tbody>
</table>

As the market price of the shares changes, the value of the portfolio has changed from Rs 47.5 lakh to Rs 48.06 lakh. Therefore if the units had been issued at Rs. 10 each, there would be 475,000 units. Their market value will now be 4806,000 / 475,000, which is Rs. 10.12 per units. The value per unit is higher than 10 because the value of the portfolio have also moved up.

The value of the investors' unit holdings also changes along with the market value of the portfolio. The current market value per unit is called the net asset value (NAV). NAV can move up or down, depending upon whether the value of the portfolio has moved up or down.
If value of the portfolio falls from 4750000 to 4500000, when the prices of the shares held in the portfolio fall, this will led to the NAV per unit falling from Rs.10 to Rs.9.47. Thus the current value of a unit depends on the value of the portfolio of the fund, and can go up and down with changes in the market value of the portfolio.

5.5 Fund Recurring Expenses (FRE)

The activities associated with portfolio management involve costs and fees. These expenses are charged to the fund. Regulations cover what kind of costs can be charged to the fund and also prescribe limits on these expenses. These expenses are called fund recurring expenses (FRE).

FRE is usually represented as a percentage of AUM. These expenses are charged to the AUM of the fund on a daily accrual basis.

FRE, for instance, if calculated at 2.5% of the AUM it is divided by 365 to get the daily accrual. The value of the portfolio is re-calculated daily and represented as market value (AUM). The expenses (FRE) are accrued everyday and charged to AUM.

5.6 Net Assets

Net assets refer to the net value of the portfolio, after charging the daily FRE. When we divide the net assets of a fund by the number of units issued, we get net asset value (NAV) per unit. Net assets of a mutual fund may change with the change in the market value of the portfolio or change in the expenses charged to the fund.
When the net assets of a fund are divided by the number of units in the fund, we get the market value per unit, which is called the net asset value (NAV) per unit. NAV thus includes both market value and expenses charged to the fund.

Mutual funds declare the NAV of all their schemes every business day. Mutual fund NAVs are published in newspapers as well as on the website of AMFI (.amfiindia.).

5.7 Assets and Liabilities in a Mutual Fund Portfolio

When we refer to total assets, we are referring to the market value of the mutual fund portfolio. A mutual fund rarely holds any other long-term asset in its balance sheet. There may be few receivables and accrued income, which are current assets. These are added to the portfolio value to get the total assets of the fund. Similarly on the liability side, a mutual fund does not have long-term liabilities. The assets are fully funded by the unit capital contributed by the investors. Therefore when we refer to liabilities, we are referring to current liabilities, in terms of payables that may be due.

The expenses associated with managing the portfolio are accrued as current liabilities and are paid as they become due. Therefore net assets of a fund refer to the market value of the portfolio, plus accrued incomes, less any current liabilities and accrued expenses. Net asset value (NAV) is a per unit representation of the net assets of a fund. NAV is a very frequently used term in the mutual fund industry. It refers to the current value per unit, deriving out of the current value of the mutual fund portfolio.
Example 1

The market value of a fund’s portfolio is Rs 700 Crore. If the current liabilities are Rs.50 Crore, what are the net assets?

Net assets = Portfolio value less liabilities
= 700 – 50
= Rs 650 Crore

Example 2

Assume that the net assets of a fund are Rs 750 Crore. The unit capital (face value Rs10) is Rs 250 Crore. What is the NAV?

Number of units = Unit capital/Face value
= 250/10
= 25 Crore units
NAV = Net asset /number of units
= 750/25
= Rs 30 per unit

Example 3

If a fund’s NAV was Rs 15 and the number of units was 100 Crore, what are its net assets?

Net Assets = NAV x Number of units
= 15 x 100
= Rs 1500 Crore
5.8 Advantages of Mutual Funds

The following are the advantages of mutual funds to investors:

- Portfolio diversification from securities spread over various companies, industries, issuers and maturities. The portfolio will not be affected by the bad performance of one or few of the securities.

- Low transaction cost from economies of scale. Since the fund invests large sums of money, the transaction cost comes down. Small amounts of investors get benefits of the large pool.

- Professional managers who are employed by mutual funds offer their expertise in managing the investors’ funds, given their knowledge of markets and securities, according to the investment objective of the scheme.

- Portfolio diversification and the professional management of funds offer reduction in risk for the investor. The investment is always in a managed portfolio and not a single stock or sector.

- Investors can choose their investment to suit their particular needs and preferences. Minimum investment is low for most funds. Investors can choose from dividend and growth options. Mutual fund transactions are flexible and easy to conduct.

- Mutual funds structure the portfolio in such a way that they are able to provide liquidity to the investor. Investors can take their money out when they need it.
Key Points

1. Mutual funds are collective investment vehicles that pool together investors' funds and invest them in securities according to stated investment objectives.

2. An investor’s holding in a mutual fund is denoted in units. The face value of the units is usually Rs 10.

3. The value of the unit goes up or down depending on the value of the underlying securities.

4. The AUM of the fund is the market value of its portfolio. This less the FRE and current liabilities of the fund is the Net Assets of the fund.

5. The FRE of a fund are expressed as a percentage of its AUM. The expenses that can be included and the limit are specified by regulations.

6. The expenses are charged to the fund on a daily basis.

7. The NAV of a unit is the per unit representation of the net assets of the fund.

8. Mutual funds give the advantages of lower risk from diversification and professional management, lower costs and convenience and flexibility to the investor.
Quick Recap

Fill in the Blanks
1. The securities that a fund invests in depend upon its ________.
2. Marking to market is the process of valuing the security at ________
3. The type of expenses that can be charged to a fund and the limit is decided by ________.
4. A mutual fund cannot have ________ liabilities on its balance sheet.
5. Mutual funds have lower risks because of ________ & ________.

State True or False
1. Units of a mutual fund have a similar connotation as shares of a company.
2. The unit capital of a fund is the number of units issued x NAV of the fund.
3. The funds of each scheme are maintained in a separate bank account.
4. The value of a unit cannot go below its face value.
5. FRE is charged to the fund at the end of the financial year.
Answers:

Fill in the Blanks:

1- Investment objective
2- Market price
3- SEBI
4- Long-term
5- Portfolio diversification & Professional management

State True or False:

1- True
2- False
3- True
4- False
5- False
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The existence of an efficient and stable financial system is essential to make the securities market vibrant, wide reaching and effective. An efficient capital market ensures that resources are priced and allocated correctly in an economy. Institutions and mechanisms that enable this must be supported by regulatory structures that will streamline and enable the proper functioning of the securities markets. The purpose of securities regulation should be to have markets that are fair, transparent and efficient and ensure protection of the investor’s interests.

In India the prime regulators are the Reserve Bank of India (RBI), the Securities Exchange Board of India (SEBI), the Ministry of Corporate Affairs and the Department of Economic Affairs (DEA). Both RBI and SEBI have been set up through Acts of the Parliament which define their role and responsibilities.

SEBI is the apex regulator of the securities market and also responsible for its orderly growth and protection of the investor’s interests. The RBI, as the manager of public debt, is responsible for the primary issue of government securities, all contracts involving such securities and money market instruments. Other regulators such as the Insurance Regulatory Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority have been set up with the specific mandate to regulate the functioning and growth of particular industries.
6.1 **SEBI’s Role**

The preamble of SEBI provides for “The establishment of a Board to protect the interests of investors in securities and to promote the development of and to regulate the securities market.” The objective of SEBI is therefore to facilitate the growth and development of the capital markets in terms of mechanisms, participants and securities and to ensure the protection of the investors in the securities market.

The SEBI Act entrusts the responsibility of inspection, investigation and enforcement of the activities, systems and mechanisms of the institutions and intermediaries of the securities market. SEBI has been assigned the powers of recognizing and regulating the functions of a stock market under the Securities Contracts Regulation Act (SCRA).

The requirements for granting recognition to a stock exchange include representation of SEBI on the board of the stock exchange and an undertaking to make and amend their rules only with the prior approval of SEBI. The stock exchanges have to furnish periodic reports to the regulator and submit bye-laws for SEBI’s approval. Stock exchanges are required to send monitoring reports daily and for every settlement. SEBI has set up surveillance mechanisms, both internal and at stock exchanges, to deal with unfair trade practices. Measures such as circuit filters, price bands and caps have led to enhanced safety in the market.

An integrated surveillance mechanism which tracks the activities of the stock exchanges, the brokers, depository, R&T agents, custodians and clearing agents aim at timely identification of
fraudulent activities. SEBI and the central government have over-
riding powers under the SCRA in all matters relating to the stock
markets.

Regulating market intermediaries through registration and
supervision is a primary function of the securities market regulator.
Market intermediaries such as brokers, sub-brokers, R&T agents,
depositories, custodians, bankers, merchant bankers, portfolio
managers and underwriters have to get themselves registered under
the respective regulations of SEBI.

The regulations specify the net worth, experience, infrastructure and
other requirements necessary for an intermediary to be eligible for
registration. The registration given, if found eligible, has been made
permanent subject to certain conditions under the Securities and
Exchange Board of India (Intermediaries) Regulations, 2008
discussed later in this chapter.

SEBI makes routine inspections of the intermediaries functioning in
the securities markets to ensure compliance with prescribed
standards. It can also order investigations into the operations of any
of the constituents of the securities market for activities such as price
manipulation, artificial volume creation, insider trading, violation of
the takeover code or any other regulation, public issue related
malpractice or other unfair practices. Investigation is based on
SEBI’s surveillance activities or those of the stock exchange. A
preliminary probe is conducted after which, if necessary, a full-
fledged investigation is undertaken.
SEBI has the powers to call for information, summon persons for interrogation, examine witnesses and conduct search and seizure. If the investigations so require, SEBI is also empowered to penalize violators. The penalty could take the form of suspension, monetary penalties and prosecution.

SEBI also has the mandate to ensure the streamlined functioning of the primary markets. It has laid out the eligibility, norms and rules to be followed for the public issue of securities in the Disclosure and Investor Protection Guidelines.

The guidelines specify the minimum net worth requirements for an issuer, the minimum public holding to be maintained and the lock-in on the holdings of the promoters. SEBI has also specified the roles and responsibilities of intermediaries in the primary markets such as the merchant bankers, underwriters, R&T agents and brokers in the guidelines for each intermediary.

These guidelines impose minimum disclosure requirements on the issuer to ensure that investors have all the relevant information before making the investment. The listing agreement that companies enter into with the stock exchange has clauses for continuous and timely flow of relevant information to the investors, corporate governance and investor protection. SEBI investigates and penalizes the non-conformance to the guidelines by the issuers and intermediaries.

SEBI’s has laid down regulations to prevent insider trading and unfair trade practices which are detrimental to the interests of the investor.
Insider trading refers to the dealing in securities by persons connected with a company having material information that is not available to the public.

Such persons include the directors and employees of the company, associates such as bankers and tax consultants or government employees who get sensitive information. The SEBI (Prohibition of Insider Trading Regulations), 1992 seeks to prevent insider trading which erodes the confidence of the common investor in the securities markets.

SEBI’s guidelines require companies to have comprehensive code of conduct to prevent such activity. This includes appointing a compliance officer to enforce it, ensuring periodic disclosure of holding by all persons considered as insiders and ensuring data confidentiality and adherence to the requirements of the listing agreement on flow of price sensitive information.

If an insider trading charge is proved through SEBI’s investigations, the penalties include monetary penalties, criminal prosecution, prohibiting persons from securities markets and declaring transactions as void.

6.2 Investor Education and Protection Fund (IEPF)

The IEPF is a fund created by the Ministry of Corporate Affairs for promoting investors’ awareness and protecting their interests. The fund is created out of contributions from the central government, state government, companies and institutions.
Apart from this, unpaid dividends, matured debentures and deposits, application and call money due for refund and interest on them shall form part of the fund provided such money has remained unpaid and unclaimed for a period of seven years from the date they were due for payment.

The fund shall conduct investor education programs through the media and seminars. It will fund investor education projects of institutions and organizations engaged in the same and which applies for resources to conduct such programs.

6.3 **SEBI Regulations for Registrars and Transfer Agents**

Registrar and Transfer (R&T) agents are identified as ‘intermediaries’ by the SEBI Act and are regulated by SEBI. They have to abide by the regulations and guidelines of the regulator. The primary regulations that govern the functioning of the R&T agents are as follows:

2. Securities and Exchange Board of India (Intermediaries) Regulations, 2008
3. Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996
Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993

The SEBI (Registrars to an Issue and Transfer Agents) Regulations came into effect in 1993 and amended periodically. These regulations govern the constitution, capital adequacy, obligations and responsibilities inspection and reporting norms that the R&T agent has to abide by. The broad heads under these regulations are:

a) Application for Registration: An application has to be made in the prescribed format to SEBI for registration as an R&T agent. An entity can take on assignments as a registrar and/or transfer agent only after obtaining the certificate from SEBI. The application can be for registration as a category I intermediary which allows the applicant to act as registrar and transfer agent or category II which allows the applicant to act as registrar or transfer agent. The application shall be evaluated on the basis of:
   a. Available infrastructure
   b. Past experience
   c. Capital adequacy
   d. Integrity of partners and promoters

b) Capital Adequacy: The net worth requirement for a category I applicant is Rs.6 lacs and for a category II applicant Rs. 3 lacs. Net worth for the purpose of this regulation is defined as paid-up capital and free reserves in case of a body corporate and in case of partnerships and proprietorship it is value of the capital contributed and free reserves.
c) Obligations and Responsibilities: The regulations require an R&T agent shall:

a. Abide by the code of conduct
b. Not act as R&T agent for an associate company
c. Maintain proper books and accounts and records
d. Appoint a compliance officer to ensure compliance with the regulations

d) Inspection of R&T agent’s operations: The regulator, SEBI, may inspect the operations of an agent either on receiving a complaint from an investor or otherwise to ensure compliance with the regulations. The R&T agent is required to give all information and cooperation to enable the inspection.

e) Cancellation/Suspension of Certificate: SEBI may suspend or even cancel the registration granted to an R&T agent in case of non-compliance with the provisions of the regulations. Such a penalty will be imposed only after holding an enquiry into the facts of the case and issuing a show cause notice to the R&T agent.

Securities and Exchange Board of India (Intermediaries) Regulations, 2008

SEBI overseas and regulates the functioning of intermediaries such as brokers, R&T agents, Merchant bankers, Depository participants and Bankers, under specific regulations and guidelines issued by the regulator. The Securities and Exchange Board of India (Intermediaries) Regulations, 2008 consolidates the common
requirements which apply to all intermediaries and will apply to all intermediaries. The salient features of the Regulations are as under:

(a) The Regulations put in place a comprehensive regulation which will apply to all intermediaries. The common requirements such as grant of registration, general obligations, common code of conduct, common procedure for action in case of default and miscellaneous provisions have been provided in the approved Intermediaries Regulations.

(b) Application for registration: An applicant may file application in the prescribed format along with additional information as required under the relevant regulations along with the requisite fees. Such application may be made through the respective stock exchange, clearing corporation or depository participants if the intermediary is to be associated with these institutions. These institutions will examine the eligibility and other criterion before forwarding the application to SEBI.

The existing intermediaries who have already been registered under the relevant regulations have to file the disclosure in the specified Form. The disclosures shall be made public by uploading the information on the website specified by SEBI.

If a registered intermediary wants to operate as an intermediary in a new category, they need to file for registration by giving additional shortened forms disclosing the specific requirements of the new category as per the relevant regulations.
(c) The application will be considered based on factors such as eligibility criteria, activities in the securities market of persons associated with the applicant and whether the applicant can be considered ‘Fit and Proper’ based on integrity, competence, including financial net worth, and past history.

(d) The registration granted to intermediaries has been made permanent subject to the compliance of the SEBI Act, regulations, updation of relevant disclosures and payment of fees.

(e) Intermediaries are required under the regulation to:

- Appoint a compliance officer who will give a report to the regulator on adherence to all obligations responsibilities and eligibility criteria.
- Redress investor grievance within 45 days from receipt of such complaint and to maintain records of the same.
- Make complete disclosure of interest before making any recommendation to invest in any security to a client.
- Abide by the specified code of conduct in terms of protecting investors’ interests, disclosing all information, maintaining high levels of service, have adequate infrastructure, exercise due diligence in all activities.

(f) SEBI can undertake inspection of the books and records of an intermediary, after giving due notice, in the interest of investors. The intermediary is required to give all cooperation in this exercise.

(g) The certificate granted to an intermediary may be revoked if it fails to comply with the requirement of the regulations or any other
guidelines issued from time to time. A show cause notice is issued to
the intermediary before such action is taken.

(h) While common requirements will be governed by the new
Regulations, the intermediary-specific requirements will continue to
be as per the relevant regulations applicable to individual intermediaries.

**Securities and Exchange Board of India (Depositories and
Participants) Regulations, 1996**

R&T agents are a category of intermediaries who are allowed to be
participants of a depository under the SEBI (Depositories and
Participants) Regulations, 1996. R&T agents have to abide by the
regulations for their activities in this capacity. The application as
participant must be made in accordance with the regulations and the
certificate shall be granted if the depository concerned and SEBI are
satisfied as to the eligibility and competence of the R&T agent.
Under the regulations, the participant:

a) Undertakes to pay the fees, maintain records, address investor
complaints within the specified time and comply with all requirements
subject to which the certificate was granted.

b) Undertakes to abide by the code of conduct for participants which
require them to

a. Do all activities in such a way that investors’ interest are
   protected

b. Address investor complaints promptly

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c. Co-operate with the regulator in case of any enquiry or inspection.
d. Have mechanisms in place, such as the maker-checker concept, to ensure there are checks and balances in all the transactions.
e. Maintain records and data carefully.
f. Have good corporate governance policies in place.

c) The participant shall agree to:

a. Enter into agreements with the beneficiary owners according to the bye-laws of the depository.
b. Separate accounts shall be opened for each beneficial owner and the accounts shall be managed separately.
c. They must have continuous electronic connectivity with the depository.
d. The participants must have good accounting systems and procedures in place. Records should be maintained as required and periodic reports sent to SEBI.
e. They must maintain records of all transactions between the investors and the participants—dematerialisation, rematerialisation, records of instructions and approvals.
f. Integrity of data should be ensured and it should be protected from damage, loss or misuse. Records should be maintained depository-wise if the participant is associated with more than one depository.
Key Points

1. SEBI and RBI along with the Ministry of Corporate Affairs and Department of Economic Affairs regulate the functioning and participants of the securities markets.

2. SEBI is responsible for the orderly development of capital markets and the protection of investors’ interests.

3. SEBI undertakes registration of intermediaries, surveillance of market activities, inspection and investigation and enforcement of penalties for violations.

4. The Disclosure and Investor Protection guidelines of SEBI lay down the norms and rules for the primary markets.

5. SEBI has the authority to grant recognition to stock exchanges and oversee trading and settlement mechanisms, surveillance of the stock exchange participants, approving the bye-laws and listing agreement of the stock exchange and inspection of the records of the intermediaries.


7. The IEPF has been set up by the central government to educate and protect investors.

8. The IEPF is funded by government grants and funds from unpaid dividend, mature deposits and debentures, application money.
Quick Recap

Fill in the Blanks
1. The Apex regulator of the securities markets is ________.
2. The RBI is responsible for the issue of ________.
3. Powers to regulate stock exchange were given to SEBI by____
4. SEBI insists on the _________ of market participants under the specific regulations.
5. Insider trading is controlled by the regulations of __________.
6. The IEPF is funded by unpaid dividends remaining unclaimed for at least_________.

State True or False
1. SEBI’s guidelines apply to government securities.
2. IRDA regulates the activities of the insurance industry only.
3. The protection of investor interest is a secondary objective of SEBI.
4. Stock exchanges have been given complete powers to regulate and are not controlled by SEBI.
5. SEBI has the power to enforce penalties.
Answers:

Fill in the blanks:

1- SEBI,
2- Government securities,
3- SCRA,
4- Registration,
5- SEBI,
6- Seven years

State True or False

1- False
2- True
3- False
4- False
5- True
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Mutual funds may be structured either as a company in which investors hold shares or as a trust in which investors are the beneficiaries. In the USA, where mutual funds first began, they are set up as investment companies. In the UK, open-ended funds are created in the form of unit trusts while closed-end funds are set up as investment trusts or companies.

In India, mutual funds are created as trusts. The investors are the beneficial owners of the investments held by the trust. The structure to be followed by mutual funds in India is laid down in SEBI (Mutual Fund) Regulations, 1996. Mutual funds in India follow a three-tier structure of sponsor, trust and asset management company (AMC).

The sponsor promotes the fund and sets up the AMC. The mutual fund itself is structured as a trust. It is managed by trustees in the beneficial interest of the unit holders. Trustees appoint an asset management company (AMC) to manage the funds.
7.1 Sponsor

The sponsor is the promoter of a mutual fund, who sets up the trust and the AMC, appoints the custodian, board of trustees and the board of directors of the AMC. The sponsor seeks regulatory approval for the mutual fund.

SEBI has laid down the eligibility criteria for a sponsor. A sponsor should:

- have at least five years experience in the financial services industry.
- have a good financial track record for at least three years prior to registration of the fund. (Positive net worth is essential).
- contribute at least 40\% of the capital of the asset management company (AMC).

Sponsors can be Indian companies, banks or financial institutions, foreign entities or a joint venture between the two.

Examples

ICICI Prudential Mutual Fund has been set up by ICICI Bank and Prudential Plc, as a joint venture. Both sponsors have contributed to the capital of the AMC.

Mutual funds like Reliance Mutual Fund and HDFC Mutual Fund are sponsored fully by Indian entities. Funds like JP Morgan Mutual Fund and Fidelity Mutual Fund are sponsored fully by foreign entities.
7.2 Trustees
The mutual fund itself is set up as a trust. Trustees are appointed by the sponsor with SEBI approval, to act on behalf of the investors. Trustees act as the protectors of the unit holders' interests and are the primary guardians of the unit holders' funds and assets.

The trust deed is executed by the sponsor in favour of the trustees and it deals with the establishment of the trust, the authority and responsibility of the trustees towards the unit holders and the AMC.

Trustees can be appointed as a Board of trustees, or formed as a trustee company by the sponsor. The board of such trustee company oversees the mutual fund.

The trustees have the fiduciary responsibility of protecting the beneficiaries of the trust, namely the investors in the mutual fund. At least two-thirds of the members of the board of trustees have to be independent of the sponsor. The board of trustees has to meet at least six times in a year. Trustees are paid a fee for their services.

SEBI regulations for trustees govern the appointment and functions of the trustees. There are aspects of general and specific due diligence to be exercised by trustees, to oversee the working of the AMC and the management of the mutual fund.

7.3 Asset Management Company (AMC)
Asset Management Company (AMC) is the investment manager of the mutual fund. The AMC is set up by the sponsor, and registered
with SEBI. AMCs can be structured as public or private limited companies. Most AMCs in India are private limited companies. The capital of the AMC is contributed by the sponsor and its associates.

AMCs specialise in investment management. They manage money for a fee, usually determined as a percentage of the assets under management (AUM).

AMCs are appointed by trustees to manage the mutual fund. But AMCs do not have any access to the investors' money.

AMCs are the face of mutual funds. They set up offices, employ staff, create and market products, mobilise funds through distributors, manage the money and report the portfolio performance to trustees and investors.

AMC is appointed to manage a mutual fund by the trustees of the fund, in consultation with the sponsor and with the approval of SEBI. The rights and obligations of the AMC are specified in the Investment Management agreement signed between the trustees and the AMC. SEBI regulations for AMCs require that:

- AMCs should have a net worth of at least Rs 10 Crore at all times.
- At least 50% of members of the board of an AMC have to be independent.
- The AMC of one mutual fund cannot be an AMC or trustee of another fund.

AMCs cannot engage in any business other than that of financial advisory and investment management. Statutory disclosures regarding AMC operations should be periodically submitted to SEBI.

### 7.4 Constituents

AMCs focus on managing the portfolio of the mutual fund. The functional divisions in a typical AMC can be classified as, fund management, operations, sales and marketing, customer service, compliance, finance and accounts.

They out-source several operations and functions to other constituents. The core function is fund management, which cannot be out-sourced.

AMCs have their direct sales teams, and also appoint distributors to sell their products. Portions of the operations functions such as investor records, fund accounting and valuation are out-sourced.

Mutual fund constituents (except custodians) are appointed by the AMC with approval of the trustees.

All constituents have to be registered with SEBI. Constituents are paid fees for their services.
The following table lists the various constituents and their roles:

<table>
<thead>
<tr>
<th>Constituent</th>
<th>Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>Custodian</td>
<td>Hold funds and securities</td>
</tr>
<tr>
<td>R&amp;T Agent</td>
<td>Keep and service investors’ records</td>
</tr>
<tr>
<td>Banks</td>
<td>Enable collection and payment</td>
</tr>
<tr>
<td>Auditor</td>
<td>Audit scheme accounts</td>
</tr>
<tr>
<td>Distributors</td>
<td>Distribute fund products to investors</td>
</tr>
<tr>
<td>Brokers</td>
<td>Execute transactions in securities</td>
</tr>
</tbody>
</table>

Core functions in these areas are done in-house, while other functions are outsourced to constituents. Some funds choose to do some of these functions in-house. For example, Franklin Templeton Mutual Fund services its investors on its own.

### 7.5 Custodians

Custodians hold the cash and securities of the mutual fund and are responsible for their safekeeping. They hold actual custody of the assets of the mutual fund.

Custodians are appointed by the sponsor. They represent the only constituent not directly appointed by the AMC. Custodians should be independent of the sponsor. That is, a sponsor cannot be a custodian of the fund as well.

**Example**

ICICI Bank is a sponsor of ICICI Prudential Mutual Fund. It is also a custodian bank. But it cannot offer its custody services to ICICI Prudential Mutual fund, because it is also the sponsor of the fund.
Custodians settle the securities transactions of the mutual fund. This function involves:

- Delivering and accepting securities and cash, to complete transactions made in the investment portfolio of the mutual fund.
- Tracking and completing corporate actions and payouts such as rights, bonus, offer for sale, buy back offers, dividends, interest and redemptions on the securities held by the fund.
- Coordinating with the Depository Participants (DPs) who hold the securities account of the mutual fund schemes.

Some custodians also offer fund accounting and valuation services to mutual funds.

7.6 Registrar and Transfer Agents

Registrar and transfer agents (R&T agents) are primarily responsible for providing services to the investors. They accept and process investor transactions. R&T agents are paid a fee for their services.

They also operate investor service centres (ISCs) which act as the official points for accepting investor transactions with a fund.

R&T functions include:

- Issuing and redeeming units and updating the unit capital account.
- Enabling investor transactions such as purchase, redemption and switches.
- Creating, maintaining and updating investor records.
- Banking the payment instruments (cheques and drafts) given by investors and notifying the AMC.
- Processing payouts to investors in the form of dividends and redemptions.
- Sending statutory and periodic information to investors.

7.7 Other Constituents

Banks provide collection services to mutual funds. Investor cheques and drafts are collected into the mutual fund scheme accounts by banks. Auditors audit the books of the mutual fund. There are separate auditors for the AMC’s accounts. Brokers execute the buy and sell transactions of the fund managers.

Distributors

AMCs appoint distributors who sell the mutual fund units to investors on behalf of the mutual fund. Distributors may work for more than one mutual fund. There is no exclusivity in mutual fund distribution. A distributor may also appoint sub-brokers for the purpose of distributing units.

The sponsor or an associate may act as a distributor for the fund with which they are associated. For example, ICICI Bank is the sponsor of ICICI Prudential Mutual Fund also one of its distributors.

Distributors may be individuals or institutions such as banks, Non-Banking Finance Companies (NBFCs) or broking and distribution companies. Individual distributors form the largest geographical network.
7.8 Regulation of Mutual Funds

Mutual funds in India are regulated by SEBI (Mutual Funds) Regulations, 1996. SEBI regulations define the activities of the mutual fund on aspects relating to registration, management, products, investments, accounting, valuation, investor services and investor protection. Mutual fund investors have recourse to the trustees, AMC and SEBI, in that order, for the redressal of their complaints.

Mutual funds in India are subject to the SEBI (Mutual Fund) Regulations, 1996. Some key aspects of SEBI (MF) Regulations are:

- Mutual funds have to obtain SEBI approval before they set up their business.

- AMCs have to be registered with SEBI before they get into the business of investment management.

- The constitution and management of the mutual fund, AMC and custodian have to be according to the regulations.

- All mutual fund constituents such as custodians, R&T agents, bankers and brokers have to seek SEBI registration before they work for mutual funds.

- Mutual fund products’ offer documents have to be created in a standard format and filed with SEBI for approval before being offered to investors.

- Investment objectives, accounting and valuation of the portfolio have to be as per SEBI regulations.

- Mutual funds have to submit periodic reports and are subject to SEBI inspection and audit.

- Mutual funds also have an industry association called the Association of Mutual Funds in India (AMFI).

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Key Points

1. Mutual funds in India are created as trusts and have a three tier structure of sponsor, trust and AMC.

2. The investors are the beneficial owners of the assets held in the trust promoted by the sponsor and managed by the AMC for a fee.

3. A mutual fund may be sponsored by a bank, financial institution or companies whether foreign or Indian or a joint venture.

4. The trustees are responsible for protecting the interest of the investor in the mutual fund.

5. The AMC is the invest manager of the mutual fund. The AMC handles the business of creating a mutual fund product, marketing it, collecting funds, investing the funds according to the investment objective of the fund and manage the assets.

6. The AMC delegates several operations of managing the mutual funds to other constituents such R&T agents, Custodians, Brokers and Distributors appointed by them.

7. All the constituents used must be registered with SEBI under the relevant guidelines. They are paid a fee for their services.

8. The R&T agent maintains the records of the investor and is responsible for the operational aspects of buying and redeeming units and other transactions initiated by the investors.

9. Distributors are the conduit between the fund and the investors. They usually deal with more than one fund.
Quick Recap

Fill in the Blanks

1. The _______ are responsible for protecting the interest of the investors in the mutual fund.
2. At least _______ trustees must be independent of the sponsor.
3. The functioning of the AMC is overseen by the _______.
4. An AMC must have a minimum net worth of __________.
5. The remuneration of the constituents of a mutual fund is in the form of _______

State True or False

1. The sponsor contributes to the capital of the AMC.
2. The trustees can be organized either as a trustee company or a Board of trustees.
3. The funds of the investor are held in the AMCs account to enable them to invest and manage it.
4. An AMC can manage the funds of more than one mutual fund.
5. The sponsor of a fund can act as its custodian if it has the required experience and SEBI registration.
Answers:

Fill in the blanks:

1-Trustees
2-2/3rds
3-Trustees
4-Rs 10 Crores at all times
5-Fees

State True or False:

1-True
2-True
3-False
4-False
5-False
8. Mutual Fund Products

The term ‘scheme’ or ‘plan’ usually indicates the various products a mutual fund offers. The term ‘fund’ is also used to refer to a mutual fund product. When we say mutual fund, we are not referring to a particular product.

For example, HDFC mutual fund is not a single product, but represents all the schemes and products under that umbrella.

HDFC Top 200 Fund, on the other hand, refers to a specific product of HDFC mutual fund, which is an equity scheme, investing in the top 200 stocks in the equity market.

The mutual fund is an umbrella entity, and there are several funds/schemes/plans with distinct objectives underneath this entity. Investors invest in a specific fund/scheme/plan. The products offered by a mutual fund are known as schemes, or funds.

8.1 Product Differentiation

Mutual funds offer a range of products to investors. These products are designed to meet the varying needs of investors.
Investors who are willing to take higher risks for higher level of return tend to choose equity products. Investors who seek regular income and a lower level of risk tend to choose debt products.

The investing horizon also tends to influence the choice of products. Long term investors may choose equity, while investors with short to medium term horizons choose debt and debt-oriented products.

Investors also tend to take a view on the market and investment opportunities. When they anticipate an appreciation in equity for example, they prefer equity products over debt products.

To meet the diverse needs of investors, mutual funds offer a range of equity, debt and hybrid products. They also deploy different investment strategies to achieve their investment objectives.

A mutual fund is created when investors pool their money. In practice, the product is first defined. The money is pooled later, based on this definition.

8.2 Open-ended Funds
An open-ended fund gets its name from the fact that it does not have a maturity date. The end date of the fund is open. An open-ended fund offers units to investors for the first time during the new fund offer (NFO).

Investors can buy (purchase) and sell (redeem) units of an open-ended fund, at the mutual fund offices or their investor service
centres (ISCs) on a continuous basis. The prices at which purchase and redemption transactions take place in a mutual fund are based on the net asset value (NAV) of the fund.

The unit capital of an open-ended fund is therefore not fixed, but varies according to the purchase and redemption transactions of investors. An open-ended fund can restrict the purchase and redemption of units only under special circumstances.

8.3 Closed-end Funds

Closed-end funds run for a specific period. On the specified maturity date, all units are redeemed and the scheme comes to a close. Closed-end funds are offered in an NFO but are closed for further purchases after the NFO.

The units may be listed on a stock exchange to provide liquidity. Investors buy and sell the units among themselves, at the price prevailing in the stock market. Thus the size of a listed closed-end fund is kept constant, as buying and selling happens in the secondary market, without recourse to the fund itself. The units may trade on the exchange at a discount or premium to the NAV depending upon investors' perception. The units of a closed-end fund tend to usually trade at a discount.

Some closed-end funds offer redemption of units as to provide liquidity to the investors. Several closed-end funds do not list, but provide redemption facility to investors. Normally investors do not redeem their units before the maturity date with the fund. In some cases they may do so after paying exit charges to leave the fund.
mid-way. In these cases, there is a change in the unit capital of the fund.

8.4 Product Creation Process

The AMC describes the portfolio. This description is then given a product name. An offer document is created with the product details. The offer document is approved by the trustees and SEBI. The product is open for subscription to investors as a New Fund Offer (NFO).

After the money is collected, fund managers begin to construct the portfolio. Investors are allotted units against their investment.

A mutual fund product is basically defined in terms of the investment portfolio. The portfolio features of a mutual fund product are defined in terms of:

- Which is the asset class the portfolio will invest in? Equities? Debt? Both?
- What are the limits on investing in the chosen asset classes?
- Will it invest in the entire range or choose some niche – like small cap equity or short term debt?
- What will the portfolio be managed for – growth, income, both?
- Will the portfolio use specific strategies?
- What is the benchmark to compare the performance of the portfolio with?
A mutual fund product can also be understood in terms of its operational features relating to investor participation. These are:

- What are the types of investors eligible to buy the units?
- How can the investor buy the units?
- What is the price of the units?
- What are the rules of entering and exiting the portfolio?
- What are the income streams the investor can expect?
- What will be the tax implication of these income streams?

Mutual fund products typically combine different portfolio and operational features.

8.5 Offer document, Addendum and KIM

SEBI requires that AMCs provide relevant and complete information to help the investor take an informed decision to invest in mutual funds. All such information is provided in the offer document of the scheme.

The Offer Document (OD) is available free of cost at any of the ISCs or AMC offices. The OD has to be in the format prescribed by SEBI. According to the regulations, with effect from June 1, 2008 the information has to be provided in two parts.

Statement of Additional Information (SAI)

The SAI contains information common to all schemes of a mutual fund. It is filed with SEBI as a one-time filing.
The information includes:

- Details of the Sponsor, trustee, AMC and other constituents.
- Condensed financial information of all the schemes of the mutual fund.
- Rights of unit holders, investor grievance redressal.
- Investment valuation norms.
- Other common information.

The SAI has to be updated every financial year. Any material changes have to be incorporated immediately.

**Scheme Information Document (SID)**

Information about the mutual fund scheme is provided in the Scheme Information Document (SID). This includes:

- Name and type of scheme.
- Issue dates - open, close and re-issue.
- Names of sponsor, trustee, AMC and other constituents.
- Summary of the scheme features
- Fees and expenses of the scheme.
- Performance, in case of an existing scheme.
- Mandatory disclosures and disclaimers.

The SID has to be updated every financial year if there is no change in the material factors. If there is a change in the fundamental attributes, the SID has to be revised immediately. For other changes, the AMC issues an addendum which is attached to the existing SID.
Every Addendum has to be approved by trustees, and displayed prominently at the Investor Service Centres (ISCs). AMCs generally send the copy of the addendum to the ISCs for the information of investors.

The information in the addendum is included in the SAI or SID as the case may be, when they are revised and reprinted every year. Until then, all the issued addenda have to be attached to the older version of the SAI/SID.

Key information memorandum (KIM) is a synopsis of important information contained in the SID. It also contains information that is useful for filling up the application form. The application form is appended to the KIM. According to regulation, both application form and KIM have to be printed together and made available to the investor. The format for the KIM is prescribed by SEBI.

8.6 Categorisation of Products

Funds can be classified based on where they invest in, what objectives they pursue and the amount of risk they assume in the investment portfolio. Investors tend to choose mutual fund products based on their investment objective, time horizon, market outlook and risk appetite.

Mutual funds offer a range of products, keeping in mind these diverse needs of investors. Products are defined in terms of where they will invest, what objectives they will pursue, and the kind of risk they feature.

Several products offer a combination of these factors. For example, a liquid fund focuses on short term debt markets, is for investors with
short investment horizon, and features a low level of risk. It thus serves multiple investor objectives. Some products may be focused on a single objective. For example, a sector fund is focused on a specific sector, and is suitable to an investor who has a view on the sector and likes to implement that view by buying the sector fund.

**Investment categories**

Funds can be classified depending on investment category (also called asset class) they focus on. For example, equity funds invest in equity shares; debt funds invest in debt securities; money market funds invest in money market securities; commodity funds invest in commodity-linked securities; real estate funds invest in property-linked securities; and gold funds invest in gold-linked securities.

**Investment Objective**

The objective of funds can be used to classify them. For example, growth funds seek capital appreciation and therefore invest in equity; income funds invest with the objective of generating regular income and seek debt securities; and monthly income plans seek to derive regular income with some growth and have a bit of equity along with debt.

**Investment Risk**

Funds can be grouped according to the risk associated with the investment objective and portfolio. Equity funds have a greater degree of risk as compared to a debt funds. Liquid funds are the least risky, as they invest in very short-term securities.
8.7 Debt Funds

Debt funds invest predominantly in debt securities. Debt securities have a fixed term and pay a specific rate of interest. There are several types of debt funds that invest in various segments of the debt market. Debt securities are broadly classified as short term securities (money market securities) and long term securities (bonds, debentures). Very short term debt securities provide a steady but low level of return. Longer term debt securities have the potential to provide a higher level of return, but their price can fluctuate.

In debt markets, there is also categorisation based on default risk. This is usually denoted by credit rating. A debt security with a higher credit rating like AAA, has lower risk of default than say, BBB rating.

Liquid or Money Market Funds

Very short term debt funds are also called as liquid funds or money market funds. They invest in short term debt instruments. Liquid funds invest in debt securities with less than one year to maturity such as treasury bills, commercial papers and certificate of deposits.

Since liquid funds have very short-term maturity, the risk of NAV fluctuation is low. Liquid funds provide safety of principal and liquidity. Examples: Kotak Liquid Fund, Principal Liquid Fund.
Short Term Debt Funds
Debt funds that invest in securities with slightly longer term than liquid funds are called short term debt funds. Examples: ICICI Prudential Short Term Fund, Reliance Short Term Fund.

Income Funds
Debt funds that invest pre-dominantly in a wide range bonds are called income funds. Income funds predominantly in invest in medium-term and long-term debt instruments that are issued by the government, companies, banks and financial institutions.

There is a higher risk of default in these funds as compared to gilt funds, since they invest in securities issued by non-government agencies that carry the risk of default. They have a higher interest rate risk than money market funds since they invest in longer-term securities. These funds aim at providing regular income rather than capital appreciation. Examples: Reliance Income Fund, Templeton India Income Builder Fund.

Gilt Funds
Funds that invest in government securities are also called gilt funds. Gilt funds invest in government securities of medium and long-term maturities. These funds do not have the risk of default since the issuer of the instruments is the government.

Gilt funds have a high degree of interest rate risk, depending on their maturity. If interest rates go up, the value of a debt security goes down. This response to changes in interest rates is called interest
rate risk. Higher the maturity profile, higher the interest rate risk. Examples: ICICI Prudential Gilt Fund, Principal Gilt Fund.

**Floating Rate Funds**

Floating rate debt funds are those that invest in a class of debt instruments, whose interest rates are not fixed, but change depending on a market benchmark. Examples: Templeton India Floating Rate Fund, ICICI Prudential Short Term Floating Rate Fund.

**High-yield Debt Funds**

These funds seek higher interest income by investing in debt instruments that have lower credit ratings and therefore higher risk of default. Lower the credit rating, higher the interest a borrower pays. These high-yield funds are also called as junk bond funds.

**Fixed maturity plans (FMPs)**

Fixed maturity plans (FMPs) are closed-end funds that invest in debt instruments with maturities that match the term of the scheme. The debt securities are redeemed on maturity and paid to investors. An FMP structure eliminates the interest rate risk for investors if the fund is held by them until maturity. These funds usually have a shorter term.

Typically FMPs are issued for maturity periods of 91 days, 190 days, 390 days and 750 days. Funds issue FMPs in a series, offering one fund after another has matured.
Consider the following table for comparison of debt funds:

<table>
<thead>
<tr>
<th></th>
<th>Return</th>
<th>Risk</th>
<th>Liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid fund</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Gilt fund</td>
<td>Medium</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Income fund</td>
<td>Medium</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>High yield fund</td>
<td>High</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>FMPs</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

The risk in a gilt fund comes from interest rate changes; there is no credit risk. FMPs hold lower risks only for investors holding the fund until maturity.

8.8 **Equity Funds**

Equity funds invest in equity shares issued by companies. The risk of such funds is higher than that of debt funds. However, the risk levels can differ depending upon the investment strategies adopted by the fund manager. Equity funds can be classified by their investment strategy as diversified, aggressive, growth, value and sector funds.

The equity market is made up of large number of equity stocks. These equity stocks can be classified according to the industry they belong to, or their size. There are several types of equity funds. Each one is defined to invest in some segment of the equity market.
**Diversified Equity Funds**
These are funds that can invest in the broad equity markets, without any restrictions. These funds also feature a lower risk, compared to equity funds that invest in a specific sector or category of equity markets.
Examples: HDFC Equity Fund, HSBC Equity Fund.

**Large Cap Funds**
These are funds that focus on the equity shares of large sized companies. Large companies are usually well established, and the shares are easy to buy and sell. Large cap companies also feature lower risk, due to their long performance track record and history.
Examples: Franklin India Blue-chip Fund, Kotak 30 Fund.

**Mid Cap Funds**
These are funds that focus on equity shares of medium sized companies. These are usually the second rung companies in the market and bought for their potential to become big. Risk of failures especially during the turn in business cycles, can also be high.
Examples: Sundaram BNP Paribas Select Mid Cap Fund

**Small Cap Funds**
These are funds that focus on equity shares of small companies, many of them typically new and upcoming companies. They are bought for their future potential, but they can be difficult to buy and sell in large quantity.
Examples: DSPBR Small and Mid Cap Fund
Sector Funds

These are funds that focus on companies in a particular sector, appealing to investors who think that the performance of stocks in this sector would be better than that of the broad market.

Examples: Reliance Banking Fund, JM Pharma Fund

8.9 Strategy-based Classification

A mutual fund may invest in equity or debt markets. But the portfolio may be managed with a certain strategy to create a differentiation.

Some equity funds follow a stock selection strategy, which they think will bring about superior performance. These may include investing in turn-around stocks or special situations. Some equity funds may be created to capture a certain theme, such as infrastructure. This may require investing across a set of sectors that benefit from that theme. These can also be called multi-sector funds or thematic funds.

Some equity funds are created with the intention of generating dividend income for the investors. There are equity funds that are created with strategic intent in their names, such as an opportunity fund, a flexi-cap fund, a core-and-satellite fund, indicating how they are likely to create their portfolio.

Some funds are managed passively, selecting the same stocks in a given index, in the same proportion. They do not actively choose stocks and sectors. These are index funds. They can also be issued
as Exchange traded funds (ETFs) that list on the stock exchange and can be bought or sold on the stock exchange.

Debt funds invest in fixed income paying securities. These securities come with their defined interest income, which is paid unless there is a default. But their market value does not remain constant. Since mutual fund products have to be ‘marked to market’, the NAV of the debt funds also changes. For debt funds that invest in long term securities, the interest income and NAV fluctuation is higher, while for the short term funds, both are lower. Therefore debt fund strategies focus on balancing these factors.

Some debt funds have a proportion of their portfolio invested in long term securities, to get advantage of any appreciation in value. They balance the short term and long term securities depending on their view of the markets. Such funds are known as flexible or dynamic debt funds.

Some debt funds pre-dominantly invest in short term securities, but hold a smaller proportion of funds in the long term. This is to enable earning the higher return of a long-term debt, while at the same time, not exposing the portfolio to risks from long-term debt.

**Equity Linked Saving Schemes (ELSS)**

Some diversified equity funds that are specially designated as equity linked saving schemes (ELSS) give tax benefits to the investors on their investment. Investment up to Rs. 100,000 in a year in such funds can be deducted from taxable income of individual investors, as per Section 80C of the Income Tax Act. ELSS hold at least 80%
of their portfolio in equity securities. Such funds have a lock-in period of 3 years from the date of investment.

8.10 Hybrid Funds

Funds that have a combination of asset classes such as debt and equity in their portfolio are called hybrid funds. Some mutual fund products invest in both equity and debt markets. The objective is to bring to the investor the benefit of strategically investing in both markets, in a single product.

There are three broad types of hybrid funds:

- Predominantly debt-oriented hybrids
- Predominantly equity-oriented hybrids
- Dynamic asset allocation hybrids

Predominantly Debt-oriented Hybrids

These funds invest mostly in the debt market, but invest 5% to 35% in equity. The investor gets some growth benefits of equity along with income from debt investments. Some of these funds are packaged as ‘monthly income funds’ and ‘children’s investment funds’.

The objective in these funds is to generate income from the debt portfolio, without taking on the risk of equity. The allocation to equity is kept lower, to enable growth and a small increase in return, without the high risk of fluctuation in NAV that comes with equity. Many of these schemes also feature a periodic payout of dividend.
Predominantly Equity-oriented Hybrids

These funds invest in the equity market, but invest up to 35% in debt, so that some income is generated. Such hybrids are also called balanced funds.

Balanced funds are suitable to those investors who seek the growth opportunity in equity investment, but do not have a very high risk appetite. The exposure to debt balances out the risks, and enables a combination of growth and lower risk. The proportions in equity and debt are managed tactically by the fund managers based on their view of the markets.

Dynamic Asset Allocation Funds

These funds have the flexibility to invest in a 0-100% range in equity or debt markets. They switch out of equity markets if the risks are high, and invest in debt. They switch back into equity when markets move up again. Depending on the view of the fund managers, the switch between equity and debt is done. Therefore the portfolio of the scheme can swing between a high allocation to equity and a high allocation to debt.

Instead of the investor doing the switches – incurring costs and taxes, the fund does it within the portfolio. Sometimes quantitative models are used as triggers for deciding the switch. The change in allocation is then done on auto-mode.
8.11 Other Types of Funds

Foreign security funds invest in securities of other markets. These are also called international funds. The government has also permitted Indian investors to invest in international markets through such mutual funds.

Commodity funds abroad invest directly in commodities such as precious metals, edible oils or grains or through futures contracts. Indian commodity funds predominantly invest in commodity companies as direct investments have not been permitted.

Real estate funds invest in real estate directly or lend to real estate developers or buy securities of housing companies and sectors related to housing and property. They can also invest in debt instruments issued by housing projects.

Fund of Funds (FoF) invest in other mutual funds. Its portfolio is made up of other fund schemes that are combined to serve the given investment objective. FoFs may invest in money market instruments directly, to manage their cash flows. An FoF involves two layers of fund management fees.
Key Points

1. A mutual fund offers various products designed to suit the varying needs of investors for investment horizon, return and risk.

2. Open-ended funds allow investors to invest and exit from their investment in the mutual fund at any time at NAV related prices.

   Closed-end funds have a fixed maturity date.

3. Information about the scheme is provided in the offer document which is divided into two parts. The Statement of additional information (SAI) contains information common to the fund. The Scheme Information Document (SID) contains information specific to the scheme.

4. The KIM is the condensed version of the offer document and has to accompany every application form.

5. Debt funds can be categorized on the basis of the segment of the debt market in which they invest in.

6. Equity funds can be segmented based on the investment strategies adopted and the segment of the equity market in which the fund invests in.

7. Hybrid funds have portfolios that have exposure to both equity and debt in varying proportions.

8. There are mutual funds that invest in markets such as real estate, gold, foreign securities and units of other mutual fund schemes.
Quick Recap

Fill in the Blanks

1. The units of an open-ended fund are available for purchase continuously at _______
2. Investors buy closed-end funds during _______
3. A mutual fund product is created by _______
4. Information in the _________ is common to all schemes of a mutual fund.
5. A Scheme information Document is revised _______ for changes in material information.
6. Mutual fund products can be categorized based on ________, ________, and ________.
7. Liquid funds invest in debt securities with _________ to maturity.
8. Gilt funds do not have _______ risk.
9. High yield debt funds are high ______ funds.
10. Large cap funds have low _______ risk.
11. ETFs are _______ funds.
12. Debt funds that invest in _________ debt securities have higher interest income and higher NAV fluctuations.
13. Dynamic asset allocation funds can have ______% exposure to equity or debt.
14. ELSS schemes are required to hold at least ____% of assets in equity.
State True or False

1. Scheme refers to a product offered by a mutual fund
2. Once the money is pooled from the investors, the fund defines the investment objective and strategy of the scheme.
3. The NAV of the existing investors in an open-ended scheme comes down when an investor redeems units.
4. Closed-end funds may be listed on the stock exchange to provide liquidity to investors.
5. A mutual fund requires the approval of the trustees only before the scheme is offered to the public.
6. The format of the KIM is decided by each fund.
7. Liquid funds have stable NAVs because they invest in very short-term paper.
8. Income funds have higher interest rate risk because they invest in non-government securities too.
9. FMPs are low risk funds for all investors.
10. Mid and small cap funds invest in the shares of middle and small sized companies for the future growth potential
11. Sector funds are highly diversified funds.
12. Real estate funds cannot invest directly in property.
Answers:

Fill in the blanks:

1- NAV based prices,
2- NFO,
3- AMC,
4- Statement of Additional Information,
5- Immediately,
6- Objective, Strategy, Risk,
7- less than one year,
8- Default,
9- Risk,
10- Liquidity,
11- Passive,
12- Long-term,
13- 0-100%,
14- 80%.

State True or False

1- True 2- False 3- False
4- True 5- False 6- False
7- True 8- False 9- False
10- True 11- False 12- False
Mutual funds offer returns to investors in two forms – dividends and capital gains. When a mutual fund pays out a dividend, investors earn a dividend income, taxed under that head in their hands.

On the other hand, if investors earn a gain out of the sale of their units, such gains are subject to different tax treatment as capital gains.

As the portfolio value changes, the fund's NAV also changes. Investors can redeem their units at any time, at a price that is based on the NAV. If investors redeem their units at a price that is higher than their purchase price, they earn a capital gain.

As the value of the portfolio changes over time, and there is an appreciation in the NAV, the mutual fund can decide to pay out some of the profits made. These payouts are called dividends. If dividend is paid out, the AUM of the fund will drop to that extent, because that amount of assets have been liquidated, and the cash has been paid out.

In the following example, the market value has appreciated to Rs 12 per unit. When Re 1 is paid out as dividend the NAV drops by the same amount to Rs 11. This is because, the net assets have come down after the payout, but the number of units in the fund has not changed.
The tax treatment for capital gains and dividends is different. Capital gains are taxed as short term capital gains (STCG) if the investor has held the investment for a period less than 1 year.

If the holding period is for more than 1 year, the gain is taxed as long term capital gain (LTCG).

Dividends on the other hand, are completely exempt from tax in the hands of the investor. They are however subject to Dividend Distribution Tax (DDT) which is paid directly by the mutual fund before it distributes dividends to the investor.

The tax treatment for equity oriented funds and other funds are also different. An equity oriented fund is one that has invested not less than 65% of its funds in equity shares.

Any fund that has less than 65% in equity is not an equity-oriented fund, and receives a different tax treatment. Liquid funds, debt funds and debt-oriented hybrids fall in this category.

### 9.1 Taxation of Capital Gains

Short term capital gains (STCG) for equity-oriented funds are taxed at 15%. In case of all other funds, STCG is taxed at the applicable rate of tax. That is, the STCG will be added to the taxable income of...
the investors and taxed normally, at the rate applicable to their level of taxable income.

Long term capital gains (LTCG) are exempt from tax in the case of equity-oriented funds. In the case of all other funds they are taxed at 10% without indexation or 20% after indexation. Indexation refers to recalculating the purchase price, after adjusting for inflation index, as published by the Income Tax authorities.

Securities Transaction Tax (STT) refers to the tax that has to be paid at the time of redemption, in the case of equity-oriented schemes, at the rate specified by the IT authorities. At present, the applicable rate is 0.25%

9.2 Dividends and DDT
Mutual fund dividends are exempt from taxation. The treatment of dividends paid by equity-oriented schemes, other schemes and liquid funds varies. Dividends of equity oriented mutual funds are exempt from tax and dividend distribution tax (DDT). All other funds are subject to DDT.

DDT is paid directly by the mutual fund. Before dividends are paid out, the applicable DDT is deducted from the distributable surplus and the dividends are paid to investors. There is no impact on the rate of dividend that investors get, but the net assets of the fund will reduce to the extent of dividend and DDT.
The rate of DDT that applies to individual investors (including Hindu Undivided Families (HUF)) is lower (12.5%) than that applies to all other types of investors (20%).

Institutional investors are taxed at a higher rate compared to individuals for all non-equity oriented funds, except liquid funds. All liquid funds (defined as funds that have more than 90% of assets invested in instruments with less than 1 year maturity) are subject to higher rate of DDT (25%).

9.3 Investment Options
Mutual funds offer investors three options:
- Growth option - enables booking the capital gains.
- Dividend option - pays out dividends to investors.
- Dividend reinvestment option - dividend is not paid out, but reinvested back in the scheme.

<table>
<thead>
<tr>
<th>NAV</th>
<th>Dividend Option</th>
<th>Growth Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Initial Corpus</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>(b) Current Market Value</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>(c) Dividends paid</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>(d) Balance AUM (b - c)</td>
<td>500</td>
<td>600</td>
</tr>
<tr>
<td>Post-dividend NAV</td>
<td>10</td>
<td>12</td>
</tr>
</tbody>
</table>

AUM is different after dividend, so NAV is also different.
The underlying portfolio is the same, but the tax implication to the investors can be in the form of dividend or capital gain, depending on the option they choose.

The units and the AUM are bifurcated for purposes of computing NAV. The NAV of the dividend and growth options will be different. An investor's choice between dividend and growth options depends on several factors such as need for income, tax status and time period.

Those who need income, choose the dividend option. Those investors who have a longer term investment horizon and are looking for growth, choose the growth option.

The tax status of the investor is important because of the difference in the tax treatment of dividends and capital gains. A retired investor who does not have taxable income may choose a growth. If he chose the dividend option, the dividend payout will be subject to DDT.

All mutual funds feature dividend and growth options in virtually all their schemes. Therefore every NAV published by the fund will have to be identified along with the option it belongs to. In mutual fund communications on scheme performance, the growth option NAV is usually used.

When the number of options is increased due to the presence of institutional options, where the FRE is different, the NAV is also different for each of these options. That is why in certain schemes, there is a long list of NAVs.
Key Points

1. The returns from mutual funds may from dividend or capital appreciation.

2. Dividends are paid out of the realized profits of the fund and as such reduce the NAV to the extent of the payout.

3. Capital gains accrue to the investor only when the units are sold and not merely on appreciation.

4. Dividend Distribution Tax is paid by debt funds on the dividends before it is distributed. The rate of DDT depends on the type of fund and type of investor.

5. Dividends from all funds are exempt from tax in the hands of the investor.

6. For equity funds, short-term capital gains are taxed at 15% and long term capital gains are exempt from tax.

7. For debt funds, short-term capital gains are taxed at the investor’s marginal tax rate and long-term gains are taxed at 10% without indexation and 20% with indexation benefits.

8. Investors choose between growth, dividend and re-investment options based on their need and the tax implications.

9. The NAV for the growth and dividend options of a scheme will be different.
Quick Recap

Fill in the Blanks

1. Dividends from mutual funds are __________.
2. An equity oriented scheme has at least _____% of assets in equity.
3. Short-term capital gains from equity funds are taxed at _____%.
4. STT is paid at the time of redemption from ________ funds.
5. _______ funds are exempt from dividend distribution tax.
6. Liquid funds have more than ____% invested in instruments with maturities of less than one year.
7. The number of units held by an investor goes up in ______ option.
8. In communications made by the mutual fund the NAV of the _____ option is used.

State True or False

1. All short-term gains are taxed at 15%.
2. Long-term capital gains from all funds are exempt from tax.
3. Institutional investors pay higher DDT at 20%.
4. Liquid funds pay higher DDT at 25%.
5. The NAV in a re-investment option comes down after payment of dividend.
6. Tax implications affect the choice of an investor between the various options offered by a mutual fund.
7. The NAV of the dividend and dividend re-investment option will be different.

8. Mutual funds may offer separate plans within a scheme which have different expense ratios.
Answers:

Fill in the blanks:

1- Exempt from tax in the hands of the investor
2- 65%
3-15%
4- Equity
5- Equity
6-90%
7- Reinvestment
8- Growth

State True or False:

1- False
2- False
3- True
4- True
5- True
6-True
7-False
8-True
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10. Operational Concepts

10.1 New Fund Offer (NFO)

A mutual product begins its life on the NFO start date. Investors can begin to invest in the fund from this date. The NFO close date is defined in the offer document. During the NFO period (open date to close date) the fund are purchased at the NFO price.

Allotment

Once the NFO closes, there is a 'no transaction period' (usually 5 days). During this period, the investors’ account folio details are created, cheques are banked, bounced cheques are returned, and the final list of unit holders who form the register of investors for the just closed NFO is created.

Once allotment is completed, investors are sent their statements of account, showing their investment in the fund and the number of units. This process of allotment has to be completed within 5 days from the NFO close date.

Inception Date

The fund begins to declare its NAV from the next day of allotment. The date of allotment is the inception date of the fund, when its NAV is set at face value. Transactions in the fund can begin from the next day when the first NAV of the fund will be declared.

On-going Offer

On-going or continuous offer indicates that transactions are resumed in a fund after the allotment is over. NAV is declared every day and
purchases and redemptions can happen at NAV related prices during the on-going offer period. If the fund is open-ended, fresh units can be purchased and allotted units can be redeemed at prices linked to the NAV on an on-going basis. If the fund has a closed end, then no new purchases happen.

Redemptions may happen after the allotment date according to the terms of the fund offer. A closed end fund has fixed term at the end of which all units are redeemed.

Ongoing purchases and redemptions have to be based on NAV. Consider a simple example. An investor buys 1 unit in a scheme during NFO at Rs 10. There is a 10% appreciation in portfolio after that. Therefore, NAV goes up to Rs 11. What happens if a new investor is allowed to buy another unit at Rs 10? The total assets of the fund will be Rs 21, and NAV drops to $21/2 = Rs 10.50$ per unit.

The NAV has fallen to Rs 10.5, because another unit was purchased at Rs 10. If the new unit was purchased at Rs 11, total net assets would be Rs 22 and the NAV unchanged at Rs 11 per unit. To be fair to both investors, the price charged to investors for buying or selling units has to be based on NAV.

10.2 Transaction Cycle

The operating cycle of a mutual fund can be summarized as below:

- Investor transaction is accepted by ISCs/AMC
- Transaction is intimated to R&T back office
- NAV is applied to the transaction
- Units are added (purchase) or reduced (redemption) in the folio of investors
- Inflow and outflow resulting from transactions is reported to the AMC Treasury
- Units issued and redeemed for the day are consolidated
- Unit capital is updated for increase/decrease from the transactions
- Unit capital is communicated to AMC fund accounts
- Portfolio is valued by fund accounts/custodian
- NAV computation is done using the portfolio value and updated unit capital
- NAV is communicated to R&T for applying to investor transactions

When investor transactions are received at the ISC during a business day, the applicable NAV of that transaction is not known. The AMC (or its custodian) computes the NAV at the end of the day, after the markets have closed.

NAV is calculated as:

\[
\frac{\text{Market value of the portfolio} - \text{Expenses and liabilities}}{\text{Number of units outstanding}}
\]

The number in the denominator can be provided by the R&T agent, only after processing the purchase and sales transactions, for which they need the applicable NAV. Therefore transactions can be processed only the next day based on NAV of previous day. After
processing the transactions, the updated unit capital is communicated to the AMC.

NAV of Day T thus includes portfolio value of Day T (Numerator) and the unit capital of day T minus 1 (Denominator). Valuation process must be completed such that NAV is computed and updated by 9.00 PM on the AMFI site (regulatory requirement).

All transactions are captured by R&T by day-end for next day’s reports to fund house for cash flow projection. NAV (Day T) = (Market value of scheme’s investments + current assets – current liabilities as on Day T) / (No. of units outstanding as on Day T-1).

Other things remaining constant, any increase in outstanding units in the denominator without a corresponding increase in the numerator representing the investment of funds received, will depress the NAV.

10.3  **Time Stamping**

Market fluctuations can cause the NAV to be volatile. In such situations, investors will be anxious about transacting at the correct NAV. In a product like a liquid fund, there is a risk of losing interest on the investment, or paying a price that is different from market levels, if the NAV is not appropriate.

It is therefore very critical to record the time at which a transaction was received and use this information to determine the applicable NAV for a transaction. SEBI has imposed electronic time stamping
as a mandatory requirement for financial transactions related to mutual funds, for the same reason.

The time stamping guidelines defined by SEBI have to be complied with at all official points of acceptance of investor transactions. Mutual fund offices and designated investor service centres (ISCs) are official points of acceptance.

The time stamping machine captures the time of receipt of a transaction at the ISC. The machine records a required number of impressions, usually three. A document that has to be time-stamped is passed through a slot in the machine. The location code, machine identifier, date, time (hh:mm) and running serial number are generated in every time stamp.

All financial transactions are processed in the R&T system as per the applicable NAV according to the recorded time stamp on the document. As per the SEBI Regulations, a document evidencing purchase and its corresponding payment instrument should have the same time stamp serial number. That is, an application form and the accompanying cheque should have identical time stamping impressions.

**Time stamping of transactions**

In case of purchase transactions, the three impressions are affixed on

- the application form or transaction slip,
-  the back of the payment instrument, and
-  the acknowledgement.

In case of a purchase accompanied by an electronic fund transfer, fax copy of the form and of the transfer instruction, are time-stamped. It may be noted that an AMC may instruct the R&T not to accept and time-stamp investor requests received by fax.

Some transactions such as redemption, switches and transfers are not accompanied by a payment instrument. For such transactions all three impressions of the time stamp are affixed on the transaction request itself. If such a document requires an acknowledgement, two time stamps are affixed on the document and the third on the acknowledgement.

Non-financial transactions are not accompanied by a payment instrument. For such transactions all three impressions of the time stamp are affixed on the transaction request itself.

**Risk Controls in Time Stamping**

The time stamp impression has to be affixed on a blank space in a document. Care has to be taken to ensure that the time stamping impression does not overwrite anything in the documents. Since the time stamp impression is used for determining applicable NAV, it has to be clear, legible and readable.

Since the AMC offices are official points of acceptance, they also receive transactions and time stamp them. The applicable NAV is
based on the time stamp made at the AMC office. Therefore, for document control purposes the ISCs only time stamp the cover sheet received from the AMC.

Offices of distributors are not official points of acceptance. Therefore, they cannot time stamp the transactions received at their offices. Each transaction request received at the ISC in a bunch from distributors should be individually time stamped. The NAV on these transactions is applied as per the time stamp on each individual transaction request. This is irrespective of the time of receipt of the bunch.

Applications for fresh purchases or additional purchases should always be accompanied by a payment instrument. Since the time stamp on the application and the instrument should be identical, it should be ensured that both are received together.

If at the time of carrying out basic checks, a document is found to be incomplete the transaction request should not be time stamped. It should be returned over the counter for corrections. If an error is found in a transaction request that has been accepted and time-stamped, it should not be returned (even if the transaction is found unacceptable). AMCs may provide specific instructions for such situations.

The following are time stamping machine maintenance procedures that are to be followed at the ISC:
In order to ensure that all the machines at the ISC are in workable condition, they have to be tested every day as per a laid down process.

The machine should remain locked at all times except when replacement of ribbon or ink cartridge is required. The key should be kept in the custody of the ISC head.

A machine log should be maintained at a branch level. The log should be used to record instances of the machine having been opened. This includes replacement of cartridge and break down.

Every morning, the first time stamp serial number should be verified with that of the last time stamp serial number of the previous day, to ensure that it is continuous.

Daily control reports are generated by all official points of acceptance, indicating the first, last and the time stamp serial number at cut-off time, for transactions received during the day.

10.4 Applicable NAV

The applicable NAV for a financial transaction is according to the time stamp. This eliminates uncertainty associated with financial transactions and brings in uniformity in their treatment.

The applicable NAV for a mutual fund transaction will depend upon:

- The day of the transaction
- The time of the transaction
- The type of scheme
The day of the transaction matters because markets and funds do not work every day. Both may not be open on a given transaction day. If it is not a business day for the fund, there would be no NAV on that date. Liquid funds publish NAV every calendar day, as the change in NAV is only made up of interest accrual.

The time of the transaction is stamped on the transaction documents. The applicable NAV will depend on the time of receiving the transaction. Cut-off time has been prescribed by SEBI for various categories of funds and transactions.

Applicable NAV for liquid funds varies from other funds. Liquid fund remittances may be made electronically and deployed on the same day. Therefore they have an earlier cut-off time.

The cut off time for liquid funds is 2 pm. If the funds can be deployed the same day, the investor can be given the previous day's NAV. The applicable NAV for liquid funds is the NAV of the day prior to the business day of realisation of funds.

The applicable NAV for transactions received on a business day, depend on the cut-off time, as summarized in the table below:
<table>
<thead>
<tr>
<th>Transaction</th>
<th>Cut-off</th>
<th>Applicable NAV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid purchases</td>
<td>Before 2 pm</td>
<td>NAV on clear funds</td>
</tr>
<tr>
<td>Liquid purchases</td>
<td>After 2 pm</td>
<td>NAV on clear funds</td>
</tr>
<tr>
<td>Liquid redemptions</td>
<td>Before 3.00 pm</td>
<td>Today's NAV</td>
</tr>
<tr>
<td>Liquid redemptions</td>
<td>After 3.00 pm</td>
<td>Next business day NAV</td>
</tr>
<tr>
<td>Non-Liquid purchases</td>
<td>Before 3.00 pm</td>
<td>Today's NAV</td>
</tr>
<tr>
<td>Non-Liquid redemptions</td>
<td>Before 3.00 pm</td>
<td>Today's NAV</td>
</tr>
<tr>
<td>Non-Liquid purchases and</td>
<td>After 3.00 pm</td>
<td>Next business day NAV</td>
</tr>
<tr>
<td>redemptions</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Key Points

1. The investors buy units at the NFO price only during the NFO.
2. The process of allotment of units has to be completed within 30 days from the closure of the NFO.
3. On-going purchase and sales from an open-ended fund is made at NAV based prices from the day after the inception date.
4. The transactions of an investor are processed on the next day of receipt using the previous day's NAV.
5. Transactions are done at the applicable NAV for the transaction.
6. The applicable NAV depends upon the day and time of submitting the transaction request and the type of scheme.
7. A time stamp must be affixed on the transaction slip/application form, payment instrument and acknowledgement slip.
8. Since the applicable NAV would depend upon the time that the application is received, time stamping procedures have to be adhered to strictly.
9. The applicable NAV for purchase transaction in liquid funds is the NAV of the day prior to the business day on which funds are realized. The cut off time is 12.00 pm
10. For all other transaction for all schemes, the applicable NAV is the NAV of the business day on which the request is received provided it is received before the cut off time of 3.00pm.
Quick Recap

Fill in the Blanks

1. During the NFO the investors buy units at ________.
2. The inception date of a fund is the ________.
3. The portfolio of a fund is valued by ________.
4. The updated NAV for a day has to be made available on AMFI’s website by ________ every day.
5. Details of the unit capital required for calculating NAV is provided by ________.
6. The official points of acceptance of mutual fund applications are ________ and ________.
7. The cut-off time for liquid fund redemptions is ________.
8. The applicable NAV for a purchase transaction of an equity fund received on a business day at 12.05pm is the NAV of ________.

State True or False

1. During the “No Transactions” period, a fund allows only redemptions but no fresh purchases.
2. The NAV calculated for a particular day uses the portfolio value of that day but the unit capital of the previous day.
3. The time stamp put at the distributor’s end can be used to decide the applicable NAV.
4. The time stamp should be affixed on the application form as well as on the payment instrument and should have the same time details if the transaction has to be processed.
5. For transactions such as switches and redemptions, three time stamps are fixed on the transaction slip.

6. For equity fund purchase transactions the day of transaction is the day on which the funds are cleared for investment.

7. NAV is calculated for all calendar days for all schemes.
Answers:

Fill in the Blanks:

1- NFO Price
2- Allotment date
3- Fund accounts/Custodian
4- 9.00pm
5- R&T agent
6- AMC offices, ISC
7- 3.00pm
8- The same day

State True or False

1- False
2- True
3- False
4- True
5- True
6- False
7- False
11. Investors in Mutual Funds

There are two broad categories of investors in a mutual fund: individual investors and institutional investors. The investment process and the documentation details are different for both these categories.

Investors above 18 years of age are classified as resident individuals. An individual investor who is under 18 years of age is called a minor.

Unless specifically mentioned as non-resident, all individual investors are assumed to be resident. A resident is an Indian citizen, who has stayed in India for at least 182 days in a financial year.

An individual investor, who is residing outside India, is called an NRI (Non Resident Indian). Such individuals can either be Indian citizens or a Person of Indian Origin (PIO). A PIO is one whose spouse, parent or grandparent is an Indian citizen or an NRI. Foreign nationals who are neither NRIs nor PIOs are not eligible to invest in Indian mutual funds.

Hindu undivided family is an Indian structure where the pool of money belonging to a family is managed by a senior male member of the family, identified as ‘karta’. Transactions on behalf of HUF are done by the karta, in his name. He indicates that he is acting on behalf of HUF, by writing the "HUF" alongside his name.
11.1 Investor Information

Individual investors investing in mutual funds are required to provide the following information when they invest in mutual funds:

Name

Name of the investor is used to identify the person in whose name the investment has been made. In a mutual fund, the beneficiary is the person who is holding the folio.

Signature

Signature is the identity of the investor in the records of the mutual fund. It is verified for every transaction. All valid transactions should carry the signature of the investor.

Joint holders

An application can have three joint holders. They may decide to hold their investments jointly or on either or survivor basis. All joint holder signatures are captured in the R&T system.

Address for correspondence

The address of the investor is to enable physical identification of the investor’s location. Therefore, post box numbers are not accepted. In case of an NRI investor, overseas address is required. Address of the first holder is the address for correspondence in the investor records.
11.2 PAN and KYC Norms

Permanent Account Number (PAN) is an identification number issued by the Income Tax authorities. PAN has been notified as the single identification number for all financial market transactions.

All mutual fund investors, irrespective of the amount they are investing, should provide a copy of their PAN card with their applications. For first time investors, PAN copy is verified against the original.

In order to ensure that illegal funds are not routed into Indian markets, the government has promulgated the Prevention of Money Laundering Act (PMLA). According to this Act, the identity of those entering into financial transactions must be known and verified. The procedure to do this is now known as KYC (Know Your Customer) norms.

KYC norms apply to opening bank accounts, trading accounts, demat accounts and all such financial relationships. Proof of identity of the customer, and proof of residence are verified to comply with KYC norms.

In case of mutual funds, the investor is required to complete the KYC formalities with an identified service provider (currently CVL - CSDL Ventures Ltd). KYC application forms have to be filled up and handed in, after verification with originals, at designated acceptance points.
KYC once completed, is valid across mutual funds. Investors have to submit photocopy of KYC acknowledgement along with application forms.

11.3 Other categories
Minors are investors whose age is less than 18 years on the date of investment. If the application is made in the name of the minor, date of birth has to be compulsorily provided.

Minors are not authorised to enter into contracts on their own behalf, or issue cheques to third parties. Therefore the financial transactions of minors are conducted on their behalf by their guardian.

Guardians have to provide all details, as if they were investing in the mutual fund themselves. Guardian's PAN is provided. Guardians also sign the application and payment instruments on behalf of minors.

NRIs and PoA
RBI regulates the foreign currency coming into and going out of India. The Foreign Exchange Management Act (FEMA) is the regulation that applies for all transactions that involve foreign currency. There is no specific RBI permission required for NRIs investing in mutual funds.

NRI investors have to use payment instruments that clearly show the sources of their funds. If the investment was made from an NRE (Non Resident External) account, they will be able to repatriate the funds on redemption. NRE accounts are foreign currency accounts.
Investments made from NRO (Non Resident Ordinary) accounts cannot be redeemed and repatriated abroad. NRO accounts are rupee accounts.

If NRIs use a foreign currency demand draft or direct remittance from their overseas bank to invest, they will have to provide a Foreign Inward Remittance Certificate (FIRC) from their banker. This proves that the source of funds was in foreign currency, and the proceeds can be repatriated on redemption.

Individual investors can empower someone they trust, to do transactions on their behalf. This is done by executing a Power of Attorney (PoA). This facility is mostly used by NRIs who are unable to manage their mutual fund transactions staying in a foreign country.

Since minors cannot enter into valid contracts, there is no question of a PoA for a minor. The guardian plays a role similar to a PoA holder acting on behalf of the minor.

A Power of Attorney has two parties – the grantor who is the primary investor who grants the rights; and the Attorney (or holder of PoA) who is authorised to execute an agreed set of actions on behalf of the grantor.

PoA holders usually exercise all the rights of an investor in a mutual fund. They can do normal transactions such as purchase and
redisemption of units. They also operate the bank account of the investor. The rights of the PoA holder are defined in the PoA.

The grantor’s signature is recorded in the folio for purposes of verification. The grantor can continue to operate the account even after giving a PoA.

Mutual fund investors can nominate someone to receive the investment proceeds in the event of their death. Nominees can be minors, in which case, the details of guardian will also have to be provided.

First holders cannot be guardians of a minor nominee. This amounts to investors nominating themselves.

PoA holders are usually not authorised to change the nomination details in an investor’s folio. They also cannot be a nominee of the original investor.

11.4 Institutional Investors

The following are various types of institutional investors who invest in mutual funds:

Private and Public Companies

These are companies set up under the Indian Companies Act, and have the Memorandum of Association (MoA) and Articles of Association (AoA) which lay out what their objectives and functions are. They are governed by their Board of Directors.
Partnership Firms
These are firms set up by individuals who are partners coming together under a partnership deed.

Association of Persons
These are associations set up by individuals to undertake a set of activities as defined by the terms of their charter.

Societies and Trusts
These are organisations that pool individual contributions and manage them according to set objectives. Trusts and societies can be set up for social, religious, and educational purposes.

Banks and Financial Institutions (FIs)
Banks are set up under the Banking Regulation Act. Financial institutions are either set up by an Act or as corporations.

Foreign Institutional Investors (FIIs)
FIIs are foreign institutions that are permitted to invest in the Indian securities markets after having obtained registration as FII from SEBI.

Overseas Corporate Bodies (OCBs)
OCBs are organisations founded by NRIs, or entities in which majority stake is held by NRIs. OCBs are currently prohibited from investing in Indian mutual funds.

Individual investors invest in their own capacity. Institutional investors have to follow a process before they can invest in mutual funds. Institutions usually authorise specific individuals to execute the investment decision on their behalf. The process for institutional investors investing in mutual funds involves the following three components:

- Authorisation for the organisation to undertake investment activity has to be in its charter.
- Managers need approvals before investing the funds of the institution in mutual funds.
- Authorised signatories should be designated to execute the decision on behalf of the organisation.
Key Points

1. Individual investors and Institutional investors are the two broad categories of mutual fund investors.

2. Individual investors can either be resident or Non resident investors (NRI). NRIs may be Indian citizens or PIO.

3. The ‘karta’ undertakes transactions on behalf of a Hindu Undivided Family.

4. Individual investors have to provide information such as name, address, bank account details, and information about joint holders.

5. Investors need to have a PAN to be able to invest in mutual funds and comply with the ‘Know Your Customer’ (KYC) norms.

6. A minor can invest in a mutual fund through a guardian. The guardian has to provide all information as if they were applying for themselves.

7. NRI investors invest in mutual funds using their NRO or NRE account. If the original investment was made from the NRE account, the funds are repatriable on redemption. Investments made from the NRO account cannot be repatriated.

8. Individual investors can empower another person to act on their behalf by executing a Power of Attorney (PoA).

9. Institutional investors are allowed to invest in mutual funds. At the time of making the investment they need to provide authorization for the investment, approval for the same and a list of signatories who can act on their behalf.
Quick Recap

Fill in the Blanks

1. The two types of investors in mutual funds are ____ and ______ investors.
2. Individual investors above the age of 18 are classified as ______ investors.
3. An NRI may be a/an ______ or ______.
4. ______ and ______ are not allowed to invest in mutual funds in India.
5. ______ conducts the transactions on behalf of the HUF.
6. A mutual fund can have up to ______ joint holders.
7. The single identification number for all financial transactions is the ______
8. KYC norms is applicable for mutual fund transactions ______
9. In a mutual fund transaction by a minor the PAN details of the ______ has to be given
10. NRI investments made by a foreign currency demand draft out should be accompanied by _____ for funds to be repatriable.
11. ______ cannot be a nominee of a mutual fund investor.
12. The authorization for an institutional investor to undertake an investment is found in ______
State true or False

1. Investors are categorized as individual or institutional investors because the documentation required for both are different.
2. All Indians who have stayed outside the country for any length of time are classified as NRIs.
3. The address of any of the joint holders can be specified as the address for correspondence.
4. Only investors investing more than Rs 50,000 need to provide PAN details.
5. KYC application form can be submitted for verification to the mutual fund distributor.
6. Minors execute a PoA in favour of their guardian.
7. All investments made out of NRE accounts are repatriable.
8. An investor can directly operate their account even after granting a PoA.
9. If the institutional investor is allowed to invest as per its charter then no further approvals are required.
Answers:

Fill in the Blanks:

1-Individual, Institutional,
2- Resident,
3-Indian citizen or PIO,
4-Foreign nationals and Overseas Corporate Bodies,
5- Karta,
6- Three,
7-PAN,
8- Above Rs 50,000,
9- Guardian,
10-FIRC,
11- PoA,
12-Its charter.

State True or False

1-True  2-False  3-False  
4-False  5- False  6-False  
7-True  8- True  9- False  
10-False  11- False  12-False
12.1 Bank Accounts

A mutual fund scheme has several bank accounts through which it receives and pays out money for various purposes. The types of accounts maintained are as under:

- Collection Accounts are maintained to receive investments into schemes from investors.
- Investment Accounts are maintained by the custodian bank, to settle securities transactions.
- Redemption Accounts are specifically funded to payout investors.
- Expense Accounts are used to meet regular fund running expenses.

A mutual fund does not keep money in the bank accounts idle. Idle funds do not earn any return. At the same time, it is also important to make all payments that become due, on time. Mutual funds therefore need to manage their cash balances efficiently. Banks enable mutual funds to efficiently use their cash balances by providing a facility called Cash Management Service (CMS).

A mutual fund scheme may appoint one or more collecting bankers. The names of such banks and their branches are listed in the NFO application form. Since the NFO price applies uniformly to all purchases during the NFO period, there is no time stamping requirement. Therefore the branches of the collecting bank are also available for collecting NFO applications and payment instruments.
Investors use various payment options — cheques, demand draft (DDs), auto-debits and the like for buying mutual fund units. These payment instruments collected at ISCs and AMC offices are also deposited into the collecting bank. Deposit into the collecting bank account is done by using manual pay-in slips or pay-in slips generated from the system using scheme CMS codes.

The collecting banks provide a CMS code for each scheme. Its bank branches upload the soft copy of the pay-in details into its CMS. The collecting banker notifies the AMC and the R&T agent about the status of the deposited instrument.

The functions of collecting bankers are as follows:

- They collect payment instruments through the clearing process to realise the funds paid by the investors.
- They provide reverse feeds showing the cleared or bounded status of the instruments.
- The NFO collecting bankers accept NFO applications. After the NFO, they provide a ‘collections confirmation certificate’. The bank’s collection figures are reconciled with the R&T agent’s records before allotting units to investors.

12.2 Payment Instruments
Mutual funds do not accept or disburse cash. Payment instruments like cheques and demand drafts are used in transactions with investors.
Payment instruments differ in terms of how the funds are collected from the payer's account into the beneficiary's account. This transfer usually involves more than one bank, or more than one branch of the same bank, and sometimes a centralized clearing agency.

The clearing process determines the time it takes for the funds to move out of the payer’s account into the account of the beneficiary. Mutual funds do not accept cash, money orders or out-station cheques.

Consider the table alongside. The scheme’s collection account is with HDFC Bank.

Investors make payments from their bank accounts. Depending on the bank and branch, the cheques will go through different clearing processes.

<table>
<thead>
<tr>
<th>Cheque</th>
<th>Clearing Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>HDFC Bank, Dadar Branch</td>
<td>Transfer of funds from one branch to another</td>
</tr>
<tr>
<td>ICICI Bank, Powai Branch</td>
<td>Local clearing ICICI Bank to HDFC Bank within Mumbai clearing circle</td>
</tr>
<tr>
<td>Canara Bank, Baroda</td>
<td>Local clearing if cheque is handed over at Baroda. Outstation clearing if handed at any other location.</td>
</tr>
</tbody>
</table>

**Transfer Cheque**

If the investor holds accounts in the same bank, then the cheque only involves a transfer of funds within the same bank. (Row 1 of the table).
Local Cheque
If the investor’s account is with another bank but in the same city, the collecting bank will have to go through the local clearing house, to get the cheque collected. (Row 2 of the table).

Outstation Cheque
If the paying bank account is located in another city, the cheque will have to go through two clearing houses at two different locations. (Row 3 of the table).

In a select number of cities, where the volume of transactions is very high, there is a segregation of cheques whose value is higher than a given amount, say Rs 1 lakh. These cheques, called High Value (HV) cheques, are put through a preferential process and cleared on the same day.

HV cheques must be MICR enabled (Magnetic Ink Character Recognition (MICR) is an electronic coding at the bottom of the cheque that enables overnight clearing).

Banks offer multi-city cheques or at par cheques facility to their preferred or current account customers. At par implies that the instrument is as good as drawn on any other branch of the same bank. An at-par cheque is a local cheque when presented at any of the bank’s branches and goes into local clearing.
12.3 **Electronic Payment Instruments and DDs**

Electronic payment instruments are modern facilities, where the clearing process need not be initiated by the mutual fund. The investor completes the transfer of funds, and provides the proof of such transfer to the mutual fund. In order to complete the electronic transfer of funds, investors must know the scheme’s account details. AMCs provide this information to investors.

Electronic Fund Transfer (ETF) is a facility to move funds from one account to another at specific times of the day. Transfer happens thrice a day at 12 noon, 2 pm and 4 pm.

Real Time Gross Settlement (RTGS) is a facility to move funds electronically on an instant basis. Funds are immediately transferred from one bank to another.

Electronic Clearing System (ECS) is a batch process, where funds are moved from or to several accounts, simultaneously, on given dates. Electronic instruments are mostly used by large institutional investors. Retail investors use ECS for their systematic investment plans.

In cases where mutual funds are unable to reach investors in certain locations and provide for a branch or ISC, they accept DDs and also bear the charges. Demand drafts have to be payable on any bank in the nearest ISC or mutual fund branch’s clearing area. It will be sent by the collection bank for local clearing.
Demand draft charges are usually not reimbursed by the mutual fund. The mutual fund instead bears the charges incurred to buy the DD, subject to limits, and treats the gross amount as the amount invested.

For example, assume the investor likes to invest Rs.10,000. If the fund agrees to bear the DD charges of Rs.200, the value of the DD attached to the application would be Rs 9,800. The DD would be drawn on a bank branch local to the ISC/mutual fund location. The amount invested would be Rs 10,000, which is the DD value plus the DD charges the AMC has agreed to bear.

Electronic payment modes are used for making liquid scheme purchases for historic NAV. These instruments should be stamped with a confirmation by the paying banker that funds are available for bring into effect the said transfer.

If a purchase is accompanied by an internet/wire transfer, since no banking is involved, the application form/transaction request and transfer instruction acknowledged by the bank may be faxed to the AMC or ISC and will be accepted.
Key Points

1. Mutual funds use separate designated accounts for collection, investment, expenses and redemption.
2. Collecting banks give the AMC and R&T agent feedback on the status of the deposited instruments.
3. During an NFO, the banks also collect NFO applications along with the payment instruments and provide reports on the collection to the R&T agent.
4. Investors use various payment instruments to buy mutual fund products.
5. Transfer cheques are used to transfer funds between two accounts of the same bank.
6. Local cheques are used for transfer of funds between accounts held in the same city but in different banks.
7. Out-station cheques are used when the accounts are held in different banks in different cities.
8. Investors also use At-Par cheques that work like local cheques and go into local clearing.
9. High value cheques are cheques for more than a specified amount and are cleared the same day.
10. Electronic fund transfers such as RTGS, EFT and ECS are initiated by the investor who provides proof of the transfer along with the application form.
11. Demand Drafts (DD) are accepted as payment instruments where a location is not serviced by an ISC or branch.
Quick Recap

Fill in the Blanks

1. Funds received from investors are paid into the __________.
2. ________ account is used meeting the expenses of running the fund.
3. CMS code is provided for each ________.
4. Investors cannot use ______ and ______ for investing in mutual funds.
5. A transfer cheque is used if the investor and the mutual fund have the bank account in ________.
6. An At-Par cheque is equivalent to a ______ cheque.
7. To complete an electronic fund transfer, the investor must have information about ________.
8. ________ is an electronic fund transfer method that moves funds instantaneously.
9. ECS is used by retail investors for ________.
10. Electronic payment modes are usually used for buying units of ________ schemes.
State True or False

1. The investment made by investors is held in the investment account.

2. The cash management service provided by banks help funds use cash efficiently.

3. The collection bank is responsible for the funds received in the on-going purchase of units only.

4. If both the investor and the mutual fund have the bank accounts in the same city local cheques are used for fund transfer.

5. To qualify for high value clearing, it is sufficient if the cheques are for at least a minimum specified amount.

6. Demand draft is an accepted mode of payment for all investors in mutual funds.

7. If payment for an investment of Rs 10,000 is received by DD and a DD charge of Rs 200 is deducted from it, the mutual fund will make the investment for Rs 10,000.
Answers:

Fill in the Blanks:

1-Collection account
2-Expense account
3- Scheme of a Mutual fund
4-Cash, Out-station cheques
5-The same bank
6- Local
7-Scheme's bank account
8- RTGS
9-SIP
10- Liquid

State True or False:

1-False
2- True
3- False
4- True
5- False
6- False
7- True
13.1 Application Form

The application form is the first point of contact between an investor and a mutual fund. The information captured in the application form is entered in the R&T records. The investor is then assigned a folio number. A folio is a like a bank account, created for a fund house and its investor. Investors can hold units under multiple schemes of a fund house, in a folio. Folios have a number assigned to them by the R&T agents.

An investor fills out the details in the application form and signs it. In order to verify subsequent transactions from the investor, the investor's signature is scanned and maintained in the R&T system with the investor records. For subsequent purchase transactions, if the folio number is quoted, several fields in an application form need not be filled up again.

The fields in the application form are largely standardized across mutual funds, because of the mandatory information required. There are however, minor differences in the presentation, detail and font sizes. Some of the fields in the application form are mandatory, for the application to be correct and complete. The application form should then be checked and validated for these fields before accepting it.

The following are mandatory fields:

- Investor status in terms of resident/non-resident
- Details of bank account
- Complete address of first holder
- Date of birth and guardian details for minors
- PAN details
- Signature of applicants.

13.2 Transaction Slip
The application form is designed to capture all investor information for the first time. Investors can use a transaction slip for most subsequent transactions. A transaction slip has the folio number to identify the investor in the system.

The transaction slip is designed to capture multiple transaction type requests. Investors use it for carrying out redemptions, additional purchases, switches and even non-financial transactions such as change of address or change of bank details. It has to be signed according to the mode of holding of the folio, to be valid.

Most AMCs provide transaction slip as a counterfoil to the account statement sent to the investor. The transaction slip has the folio number and account number of the investor, pre-printed. An investor can either use a pre-printed transaction slip form or he can use a blank transaction slip, which is available with AMC branches, distributors and ISCs.

13.3 Payment Instruments
Payment instruments have to be accepted from investors only if they are valid. When a payment instrument is received it has to be ensured that:
- Scheme name is mentioned on the instrument, and is same as on the application form.
- Short name or abbreviation used for scheme name is one of valid alternatives as per offer document/AMC instructions.
- The cheque date is current or valid (not stale or more than 6 months old).
- The cheque is not post-dated.
- Amount in words and figures matches with the investment amount.
- Cheque is signed.
- Cheque is not mutilated.
- Cheque is drawn on a local bank branch or is at-par.
- DD is accepted only if investor is from a city not serviced by an ISC.
- In case of NRI applications with cheque, cheque is drawn on NRE or NRO or FCNR account.
- In case of NRI applications with DD, banker’s FIRC (Foreign Inward Remittance Certificate) is enclosed.

13.4 Purchase Transactions
Mutual fund units can be purchased during NFO or after the scheme opens for on-going offer (if open-ended) after allotment of NFO units. When a new investor applies for units either during NFO or during continuous offer, it is called fresh purchase. Fresh purchases are made by investors by submitting an application form complete in all respects.
After the fresh purchase, every subsequent purchase by the unit holder is called additional purchase. Additional units can be purchased by using a transaction slip. An existing investor may decide to make additional purchases under a new folio. This will be considered as fresh purchase.

Mutual funds incur expenses such as advertisement costs, commission to distributors, and printing costs towards selling and marketing a scheme. To meet these expenses, funds charge entry load or sales load.

The investor pays entry load as a one-time charge at the time of purchasing units. SEBI has prescribed the upper limit for the entry load. In case of open ended funds, the load cannot be over 7%; in case of closed end funds load cannot be over 5%

Entry load is a percentage of the NAV of the unit. In an NFO, load is charged as percentage of the face value. Entry load increases the price at which an investor buys units. Hence, for the same amount invested, units allotted to investors paying a load are lesser, as compared to units allotted without load. It may be noted that SEBI has abolished entry load vide its circular SEBI/IMD/CIR No. 4/168230/09 applicable from August 1, 2009. However the candidate should be familiar with the concept.

Investors can also buy without an entry load. The application has to be marked direct, and submitted by the investor at the ISC or mutual fund office, without going through the distributor.
13.5 Statement of Account (SoA)
Statement of account is proof of investment for the investor. R&T agents, on behalf of mutual funds, despatch SoAs to investors, whenever there is a transaction on a folio. As per SEBI regulations, the dispatch date should not be later than 10 business days from the date of the transaction.

Even if there is no transaction on a folio, investors are entitled to get their updated SoA, once a year, for all folios they hold with a mutual fund. An SoA is sent when an investor makes a fresh purchase transaction. The amount, price, and units are shown. For subsequent transactions, apart from these details, the balance units in the folio and their current market value are also shown.

Unit holders receive account statement by ordinary post or courier. If an investor chooses to receive the account statement by e-mail, the R&T sends a soft copy through secured e-mail.

AMCs specify in the scheme offer document, the number of days within which they would dispatch account statement to unit holders, say, three business days (from date of acceptance of valid transaction slip or application form to date of despatch).

13.6 Systematic Investment Plan (SIP)
Most mutual funds offer the investors Systematic Investment Plan (SIP), a facility to make periodic or recurring purchases in mutual fund schemes. An SIP is like a recurring deposit with a mutual fund. An SIP can be viewed as a series of purchase transactions. The
difference between an SIP and a regular purchase transaction are as follows:

<table>
<thead>
<tr>
<th>Feature</th>
<th>Regular Investment</th>
<th>SIP Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Investment</td>
<td>Usually Rs 5000</td>
<td>Usually Rs 1000. Lower in case of ELSS schemes. Few funds offer SIPs with instalment of Rs 100 or Rs 50 as well.</td>
</tr>
<tr>
<td>Entry</td>
<td>Applicable</td>
<td>Applicable in most cases. Some mutual funds may not charge entry load for SIPs.</td>
</tr>
<tr>
<td>Payment Mode</td>
<td>Valid cheque on investment date</td>
<td>Post-dated cheques or electronic transfer options on a set of future dates.</td>
</tr>
<tr>
<td>Account Statement</td>
<td>Within 10 working days of investment</td>
<td>Every quarter. Mutual funds may choose to send the statement after every instalment.</td>
</tr>
</tbody>
</table>

1 It may be noted that SEBI has abolished entry load vide its circular SEBI/IMD/CIR No. 4/ 168230/09 applicable from August 1, 2009. However the candidate should be familiar with the concept.

Investors commit a periodic investment over a chosen length of time. AMCs offer specific intervals in which SIP investment can be made.
These can be monthly, quarterly, half yearly or annual. SIPs are to be made on specific dates, for example - 5th, 15th or 25th of a month. SIPs can be committed for six months, one year, or even more.

An investor can invest over a year by selecting a date, for example 15th of the month, and invest Rs. 1000 each, on the 15th of every month for the entire year. SIPs can be made along with an NFO. The first instalment is at the NFO purchase price and is allotted like an NFO. The second instalment begins after the scheme reopens for continuous purchase transactions.

**Payment Instruments for SIPs**

Post dated cheques (PDCs): Investor issues cheques for each SIP instalment, which have to be deposited in the bank on that date.

ECS Mandate: ECS is available in select locations as given by the AMC. Investors fill up the ECS mandate form and submit it with their application.

Standing Instruction (SI): If the investor holds an account in the same bank as the scheme, he can give a standing instruction to his bank to transfer the money on the SIP date.

Mandates for direct debit of bank accounts require signatures of holders of the bank account, according to the mode of operation of the account (joint or either or survivor).
The applicable NAV for an SIP is the NAV on the instalment date or if that day is a holiday, then the NAV of the next business day.

13.7 Redemption

After the NFO, when a scheme re-opens, the continuous offer is for both purchase and redemption of units. Redemption refers to investors' request to return their investments in a fund.

In case of open-ended funds, on redemption the units are extinguished or cancelled and are not re-issued. Redemption alters the unit capital of an open ended scheme. Therefore outstanding unit capital is communicated by the R&T agents, after processing all purchase and redemption transactions for every business day.

In case of closed end funds, redemption of units happens only on the maturity date of the scheme. Redemption may be allowed during specified periods before maturity date or at a cost as specified in the offer document.

Investors can specify the redemption of units held in a folio either in terms of number of units or as amount in rupees. Where redemption is specified in amount, the investor must ensure that the value of their holding is sufficient to meet the amount.

Investors can redeem all or part of the units in a folio; or they can redeem all or part of the amount in the folio. The redemption request has to be equal to or more than the minimum amount or units
specified in the offer document. Mutual funds may specify the minimum balance to be maintained in a folio after redemption.

**Exit Load**

Exit load has the effect of reducing the redemption price for the investor. If the investor has specified the redemption in unit terms, the redemption value comes down because of the load.

For example, at an NAV of Rs 20 per unit, redeeming 1000 units will get the investor Rs 20,000. However, if the exit load is 1%, the redemption price is 20 - 0.20 = Rs 19.80. Therefore the redemption proceeds are Rs 19,800 for 1000 units.

If the amount to be redeemed is specified, the number of units that has to be redeemed goes up after applying the exit load. In the above example, the investor has to redeem 1010.10 units to get a redemption amount of Rs 20,000. Loads are charged to investors at the discretion of the AMC and are mentioned in the offer document. They are subject to an overall limit imposed by SEBI.

Mutual fund investors are required to indicate in the application form, their preference for receiving redemption proceeds. The proceeds can be paid by cheque or through direct credit as indicated. As per SEBI mandate, the account holder’s bank account and bank details have to be printed on the redemption cheques, to prevent fraudulent encashment.

Redemption cheques are drawn payable to the first holder in a folio. Mutual funds cannot issue third party payments. If the AMC’s paying bank is not present in the location where the investor is, redemption
proceeds are paid by demand draft. If the investor redeems units purchased on multiple dates, redemption will be made on a first-in-first-out basis.

Redemption proceeds have to be paid within 10 working days of receiving the request. Delays attract a 15% penal interest to be paid by the AMC.

Redemption proceeds have to be paid to NRI investors as per the RBI Regulations in force. The general rule to remember is that redemption payments have to be paid according to the source of funds of the purchase transaction.

Those investments that have been made from NRE or FCNR accounts or by remittance of foreign exchange from abroad can be paid on a repatriation basis. If the investor mandates, such payment can be made into a non-repatriable account. If the investment has been made from a rupee account, or an NRO account, redemption cannot be paid into a repatriable account. Capital gains arising on redemption have to be deducted at source for NRI investors.

13.8 Switches

A switch is a redemption and purchase transaction rolled into one. A redeeming scheme is called source scheme from which money is switched out. The purchasing scheme is called target scheme, into which the money is switched in. Switch can also be done from one option to another. An investor who has chosen a growth option can switch to a dividend option, for example.
The following are steps an investor would have to normally take to move from one scheme to the other:

- Fill a redemption request and submit it (Day T)
- Receive redemption cheque and deposit it in bank (Day T+3/T+4)
- Receive cleared funds in bank account (Day T+5)
- Fill a purchase request for the desired scheme and submit with a cheque (Day T+5)

The above steps spread across five days can be crunched into a single transaction in switch request. There is no need for funds to move out and in through a bank. The transaction will be put through by the R&T in the books.

AMCs may or may not charge loads to switch transactions. Generally, no entry or exit load is charged for switching within options of the same scheme. For inter-scheme switching, the AMC may specify an independent load structure, which may differ based on the nature of the source scheme and the target scheme, whether it is liquid, equity, or debt fund.

Switch transactions always have two legs – the switch-out leg and the switch-in leg. Switch-out leg is treated as redemption and switch-in leg is treated as purchase. Both options are processed at the respective Applicable NAV of the scheme/plan/option.

The procedure to determine the applicable NAV for switch transactions is similar to the process for individual purchase and redemption transactions.
13.9 **Systematic Withdrawal and Transfer**

Mutual funds also offer investors systematic transfer plans and systematic withdrawal plans.

Systematic Transfer Plan (STP) is a periodic redemption from one scheme and investment into another scheme of the same fund. STP allows unit holders to transfer fixed sums from an existing scheme to another scheme of the same mutual fund. Click here to read why investors opt for STP.

Systematic Withdrawal Plan (SWP) is a facility for periodic or recurring redemptions. This facility allows unit holders to withdraw sums from an existing scheme at periodic intervals. Unit holders can redeem or purchase units at the Applicable NAV on the respective SWP/STP dates. However, if any of the dates on which the redemption/transfer is sought is a non-business day, the units are redeemed at the Applicable NAV of the next business day.

An account statement is sent to a unit holder within 10 working days from the date of the transaction. The first account statement confirms the first systematic transaction. The account statement confirming subsequent systematic transactions is sent on a quarterly basis.

Some funds give investors the choice of withdrawing or transferring a fixed sum over a defined period. This is known as the fixed option. Under this option, a unit holder withdraws or switches a fixed amount of not less than the minimum from his unit account.

Investors can also opt for withdrawing or transferring only the appreciation on the investment. This is known as the appreciation
option. Under this option, a unit holder withdraws or switches an amount equal to the periodic appreciation on the original investment.

A unit holder can redeem or switch only proportionate number of units, which when multiplied by the applicable NAV equals the appreciation in the investment over the last period.
Key Points

1. The R&T agent captures the information about an investor under a folio created for the investor.
2. Subsequent transactions of the investor can be conducted using the transaction slip.
3. The payment instrument attached to the application must be checked for validity.
4. Mutual funds charge an entry load when investments are made through a distributor.
5. The statement of Account (SoA) sent by the R&T agent is the proof of investment in the mutual fund for the investor.
6. Systematic investment plan (SIP) allows investor to invest a fixed sum of money periodically in a mutual fund scheme.
7. An investor can use post-dated cheques, ECS or standing instruction as the payment mode for a SIP.
8. Investors can choose to withdraw their investment by redeeming the units held in a mutual fund. Redemption can be specified either in amount or units.
9. A switch transaction combines redemption from one scheme and purchase of another of the same fund house into one.
10. A systematic transfer plan allows periodic transfers from one scheme to another.
11. A systematic withdrawal plan allows periodic redemptions.
Quick Recap

Fill in the Blanks

1. Details of guardian have to be mandatorily provided for investment made by_______.

2. The transaction slip has the ______ mentioned on it to identify the investor in the system.

3. Fresh purchase transaction has to be done by the investor using ________.

4. The maximum entry load that an investor can impose on a purchase transaction in an open-ended scheme is ______.

5. The face value of a unit is Rs 10 and the NAV is Rs 24. The scheme has an entry load of 2%. The purchase price for the investor is _______.

6. ______ investors do not pay an entry load

7. SoA has to be dispatched within _____ days of transaction.

8. The minimum amount to be invested through an SIP is usually _____ than that for regular investment.

9. The redeemed units from an open-ended fund are ________.

10. Exit load has the effect of ______ the redemption amount for the investor.

11. Capital gains on redemptions made by NRIs are __________.

12. The switch –out leg of a switch implies ________
State True or False

1. A mutual fund investor can have many folios in a fund.
2. A transaction slip is used to make a fresh purchase.
3. An investor can use only the pre-printed transaction slip that accompanies the account statement for valid transactions.
4. A post-dated cheque is not a valid payment instrument.
5. The R&T agent creates a folio using the information in the transaction slip.
6. The current value of the units is shown in the SoA.
7. The SoA has to be sent to the investor immediately after each instalment of SIP is invested.
8. SIPs can be made along with an NFO.
9. Investors cannot redeem all the units held in a folio.
10. Units bought earlier are redeemed first.
11. Redemption proceeds may be paid to a third party on receiving instructions from the investor.
Answers:

Fill in the Blanks:

1- Minor
2- Folio Number
3- Application form
4- 7%
5- Rs24.48
6- Direct
7- Ten
8- Lower
9- Extinguished
10- Reducing
11- Deducted at source
12- Redemption

State True or False:

1- True 2- False 3- False
4- True 5- False 6- True
7- False 8- True 9- False
10- True 11- False

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Investors may need to update or change the personal information given to the mutual fund. Address for communication, bank details, and change in status among others, may require change from time to time. These transactions are non-financial transactions. They do not have a financial or NAV implication.

An investor becomes a unit holder of a mutual fund after buying units of the fund. Investors provide general information about themselves in the application form at the time of purchase. The registrar and transfer agent captures the contact address, bank account, status, plan or option chosen and all other relevant information. The R&T links the information given in the application to the folio allotted to the investor. In other words, folio number is a unique identification number that helps R&T recognise an investor.

14.1 Change of Address (CoA)

Investors provide their address and contact details in the application form during the first purchase. R&T agent captures this information and maintains it. The statement of account (SoA) and other statutory communication goes to the address for communication mentioned by the investor.

Investors may request a change of address or contact details only by applying to CVL, by using a KYC update form, where they will provide their new address. They should mention their PAN details and the new address. They also have to submit documentary proof for the change of address.
After updating the new address in the records, CVL communicated the change in address to the R&T agents, who will update all the folios of the investor, across mutual funds, using the PAN as the identification for the investor. Change of address requests are no longer accepted at AMC offices or the investor service centres of R&T agents.

14.2 Change of Bank Details (CoB)

It is mandatory to provide details of investor’s bank account at the time of investing in a mutual fund. As per SEBI regulations, dividend and redemptions are payable only to the investor’s bank accounts registered with R&T. Investors may register multiple bank accounts and indicate the default account into which the redemption proceeds should be paid. They can add and delete form the list of registered bank accounts. Investors may request a change in the bank details either at the time of a redemption or otherwise through the prescribed format for change in bank details.

Investors should provide the complete details of the bank account for the CoB request to be valid. This includes bank name, branch name, MICR (where applicable), IFSC code (where applicable) account number and type of account. The investor should also submit a cancelled blank cheque to enable verification of the bank details.

14.3 Change in Option

Investors choose a dividend option or growth option when they apply for a scheme. Investors who have chosen the dividend option in a mutual fund investment select between dividend payout option -
where the dividends are paid out to the investor by cheque re-
investment option - where additional units equivalent to the dividend 
amount is issued to the investor.

Investors may want to change from growth payout to reinvestment 
option. To request this change, investors can use the either the 
transaction slip (switch option provided in the slip) or write a letter to 
the mutual fund. Investors have to provide the folio details.

If the investor decides to change the dividend option, there is no 
financial implication. This is because the NAV for dividend payout 
and dividend reinvestment is the same. Therefore, change of 
dividend payout option is a non-financial transaction and not a 
financial transaction.

14.4 Change in Name (Individual Investors)

Investors may request a change of name under which they have 
invested in a mutual fund scheme. Common cases for change of 
name are women who like to change their maiden name to married 
name. In such cases, investors must submit a letter requesting the 
change.

Documents that should accompany the request letter are:

- Name change certificate by a regulatory authority
- Official Gazette copy
- Copy of Marriage Certificate
- Details of the Folio
- Signature of the account holder (the unit holder whose name is being changed must sign with the old signature and the new signature)
- Bank account details with the new name incorporated.

14.5 Change in Corporate Name or Status

Change in corporate status refers to the change from a private limited company to a public limited company or from a partnership firm into a private limited company. Change in the name of a company can happen when there is a merger or acquisition, or the board decides to change the name. The investments in the old name will have to now be held in the new name, for valid transactions to happen.

The following documents should accompany the change of status request:
- The name change certificate from the Registrar of Companies.
- An authorisation to invest, approval from the board, and list of authorised signatories.

Change in Authorised Signatories

Institutional investors authorise officials to sign on their behalf. Companies change or replace authorised signatories from time to time. Officials holding senior positions in institutions change. Companies recruit new officials when old ones leave or get transferred. As a result, authorised signatories change.
R&T is given this information so that the necessary validation of the investment transaction happens with the updated authorised signatories list.

The corporate or institution should submit the following documents to register a change in authorized signatories:

- Certified true copy of the Board of Directors resolution authorising the change
- Instruction letter from the corporate or institution signed by the existing authorised signatory with names and specimen signatures of the new signatories.
Key Points

1. The personal information given by the investor in the application may be required to be changed. The address, bank details and option chosen are the common changes that are made.

2. These changes do not have a financial implication. The changes are made in the records of the R&T agent.

3. A request for a change of address may be done using the transaction slip. The R&T agent updates the records and sends confirmation to the old and new addresses.

4. An investor may request a change of bank details for a particular transaction or for all transactions in a folio.

5. Investors may request a change of name in which the units are held.

6. An institutional investor such as a company may request a change in the name.
Quick Recap

Fill in the Blanks

1. Changes in the personal information of the investor are made by the _______

2. Change in option from growth to dividend will ______ the number of units held by the investor.

3. A change in option from dividend re-investment to dividend will ______ the number of units held by the investor.

4. The request for a change in name of the holder is made through _______.

State True or False

1. A change in the personal information implies creating a new folio.

2. Change in information can be made only through the pre-printed transaction slip.

3. Change in bank details can be requested at the time of redemption or otherwise.

4. Change in the name of the individual holder is not allowed.

5. A change in the authorized signatories of an institutional investor has to be accompanied by a copy of the board resolution for the same.
Answers:

Fill in the Blanks:

1- R&T agent
2- Increase
3- Not Change
4- A letter

State True or False:

1- False
2- False
3- True
4- False
5- True
# List of Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ADR</td>
<td>American Depository Receipt</td>
</tr>
<tr>
<td>AMC</td>
<td>Asset Management Company</td>
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<tr>
<td>AUM</td>
<td>Assets Under Management</td>
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<tr>
<td>CBLO</td>
<td>Collateralized Borrowing Lending Obligation</td>
</tr>
<tr>
<td>CD</td>
<td>Certificate of Deposit</td>
</tr>
<tr>
<td>CMS</td>
<td>Cash Management Service</td>
</tr>
<tr>
<td>CoA</td>
<td>Change of Address</td>
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<tr>
<td>CoB</td>
<td>Change of Bank</td>
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<td>CP</td>
<td>Commercial Paper</td>
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<tr>
<td>CSDL</td>
<td>Central Securities Depository Limited</td>
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<tr>
<td>DD</td>
<td>Demand Draft</td>
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<tr>
<td>DDT</td>
<td>Dividend Distribution Tax</td>
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<tr>
<td>DR</td>
<td>Depository Receipt</td>
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<tr>
<td>ECS</td>
<td>Electronic Clearing System</td>
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<td>EFT</td>
<td>Electronic Fund Transfer</td>
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<td>ELSS</td>
<td>Equity Linked Saving Scheme</td>
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<td>ETF</td>
<td>Exchange Traded Fund</td>
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<td>FCCB</td>
<td>Foreign Currency Convertible Bond</td>
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<td>FCD</td>
<td>Fully Convertible Debenture</td>
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<td>FCNR</td>
<td>Foreign Currency Non Resident</td>
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<td>FEMA</td>
<td>Foreign Exchange Management Act</td>
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<td>FI</td>
<td>Financial Institution</td>
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<td>FII</td>
<td>Foreign Institutional Investor</td>
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<td>FIRC</td>
<td>Foreign Inward Remittance Certificate</td>
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<td>FMP</td>
<td>Fixed Maturity Plan</td>
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<tr>
<td>FoF</td>
<td>Fund of Funds</td>
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<td>FRE</td>
<td>Fund Recurring Expense</td>
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<td>GDR</td>
<td>Global Depository Receipt</td>
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<table>
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<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>HNI</td>
<td>High Net worth Individual</td>
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<tr>
<td>HUF</td>
<td>Hindu Undivided Family</td>
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<tr>
<td>HV</td>
<td>High Value</td>
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<tr>
<td>IDR</td>
<td>Indian Depository Receipt</td>
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<tr>
<td>IEPF</td>
<td>Investor Education and Protection Fund</td>
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<td>IPO</td>
<td>Initial Public Offer</td>
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<tr>
<td>IRDA</td>
<td>Insurance Regulatory Development Authority</td>
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<tr>
<td>ISC</td>
<td>Investor Service Centre</td>
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<tr>
<td>KIM</td>
<td>Key Information Memorandum</td>
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<tr>
<td>KYC</td>
<td>Know Your Customer</td>
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<tr>
<td>LTCG</td>
<td>Long term Capital Gain</td>
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<td>MICR</td>
<td>Magnetic Ink Character Recognition</td>
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<td>MIP</td>
<td>Monthly Income Plan</td>
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<td>MoA</td>
<td>Memorandum of Association</td>
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<tr>
<td>NAV</td>
<td>Net Asset Value</td>
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<tr>
<td>NBFC</td>
<td>Non Banking Finance Company</td>
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<td>NFO</td>
<td>New Fund Offer</td>
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<td>NRE</td>
<td>Non Resident External</td>
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<td>NRI</td>
<td>Non Resident Indian</td>
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<td>NRO</td>
<td>Non Resident Ordinary</td>
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<td>NSDL</td>
<td>National Securities Depository Limited</td>
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<td>NSE</td>
<td>National Stock Exchange</td>
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<td>OCB</td>
<td>Overseas Corporate Bodies</td>
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<td>OD</td>
<td>Offer Document</td>
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<td>PCD</td>
<td>Partially Convertible Debenture</td>
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<tr>
<td>PDC</td>
<td>Post- dated Cheque</td>
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<td>PIO</td>
<td>Persons of Indian Origin</td>
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<td>PMLA</td>
<td>Prevention of Money Laundering Act</td>
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<td>PoA</td>
<td>Power of Attorney</td>
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<tr>
<td>R&amp;T</td>
<td>Registrar and Transfer</td>
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<tr>
<td>RBI</td>
<td>Reserve Bank of India</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>RTGS</td>
<td>Real Time Gross Settlement</td>
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<tr>
<td>SAI</td>
<td>Statement of Additional Information</td>
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<td>SCRA</td>
<td>Securities Contract Regulation Act</td>
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<td>SEBI</td>
<td>Securities and Exchange Board of India</td>
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<td>SI</td>
<td>Standing Instruction</td>
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<td>SID</td>
<td>Scheme Information Document</td>
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<td>SIP</td>
<td>Systematic Investment Plan</td>
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<tr>
<td>SO</td>
<td>Structured Obligation</td>
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<td>SoA</td>
<td>Statement of Account</td>
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<td>STCG</td>
<td>Short Term Capital Gain</td>
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<td>Systematic Transfer Plan</td>
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<td>Securities Transaction Tax</td>
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<td>SWP</td>
<td>Systematic Withdrawal Plan</td>
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<td>YTM</td>
<td>Yield to Maturity</td>
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