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CAPSULE FOR SEBI GRADE A PHASE - 1

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INDIAN FINANCIAL SYSTEM

Definition:

A financial system (within the scope of finance) is a system that allows the **exchange of funds between** lenders, investors, and borrowers. Financial systems operate at national, global, and firm-specific levels. They consist of complex, closely related services, markets, and institutions intended **to provide an efficient and regular linkage between investors and depositors.**

The financial system of a country is an **important tool for economic development of the country**, as it helps in creation of wealth by linking savings with investments. It **facilitates** the flow of funds from the households (savers) to business firms (investors) to aid in wealth creation and development of both the parties.

The financial system of a country is concerned with:

- **Allocation** and Mobilization of savings
- **Provision** of funds
- **Facilitating** the Financial Transactions
- **Developing** financial markets
- **Provision** of legal financial framework
- **Provision** of financial and advisory services

Structure of Indian Financial System/Components of Indian Financial System:

Financial Institutions – Financial institutions are **intermediaries of financial markets** which facilitate financial transactions between individuals and financial customers. It simply refers to an organization (set-up for profit or not for profit) that collects money from individuals and invests that money in financial assets such as stocks, bonds, bank deposits, loans etc.

There can be **two types of financial institutions:**

- **Banking Institutions or Depository institutions** – These are banks and credit unions that collect money from the public in return for interest on money deposits and use that money to advance loans to financial customers.
- **Non- Banking Institutions or Non-Depository institutions** – These are brokerage firms, insurance and mutual funds companies that cannot collect money deposits but can sell financial products to financial customers.

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Other Important Categories in Financial Institutions:

- **Regulatory** – It includes institutions like SEBI, RBI, and IRDA etc. which regulate the financial markets and protect the interests of investors.
- **Intermediaries** – It includes commercial banks such as SBI, PNB etc. that provide short term loans and other financial services to individuals and corporate customers.
- **Non – Intermediaries** – It includes financial institutions like NABARD, IDBI etc. that provide long-term loans to corporate customers.

2) **Financial Markets** – It refers to any marketplace where buyers and sellers participate in **trading of assets such as shares, bonds, currencies and other financial instruments**. A financial market may be further **divided into capital market and money market**. While the capital market deals in long term securities having maturity period of more than one year, the money market deals with short-term debt instruments having maturity period of less than one year.

3) **Financial Assets/Instruments** – Financial assets **include cash deposits, cheques, loans, accounts receivable, letter of credit, bank notes and all other financial instruments** that provide a claim against a person/financial institution to pay either a specific amount on a certain future date or to pay the principal amount along with interest.

4) **Financial Services** – Financial Services are **concerned with the design and delivery of financial instruments and advisory services** to individuals and businesses within the area of banking and related institutions, personal financial planning, leasing, investment, assets, insurance etc.

FINANCE COMMISSION:

The First Finance Commission was established by the **President of India in November 22nd, 1951** under **Article 280** of the Indian Constitution. It was formed to define the financial relations between the central government of India and the individual state governments. The **Finance Commission (Miscellaneous Provisions) Act, 1951** additionally defines the terms of qualification, appointment and disqualification, the term, eligibility and powers of the Finance Commission. As per the Constitution, the Commission is appointed every five years and consists of a chairman and four other members.

There have been **fifteen commissions** to date. The most recent was constituted in 2017 and is chaired by **N. K.Singh**, a former member of the Planning Commission.

FINANCIAL ADMINISTRATION:

The financial management or administration of a state is the bigger edition of the financial management of a family or household. The term financial administration refers **to certain rules and methods relating**

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to revenue and expenditure. The **preparation of budget** is the first and most important aspect of financial administration. This is called "**Annual Financial Statement**".

REVENUE AND CAPITAL RECEIPTS OF GOVERNMENT RECEIPTS:

Government receipts are divided into **two groups**

- **Revenue Receipts**
- **Capital Receipts**

Revenue Receipts:

All Government receipts which **either create liability or reduce assets** are treated as capital receipts whereas receipts which neither create liability nor reduce assets of Government are called **revenue receipts**. Government revenue is the means for government expenditure. Revenue receipts are further classified Into **Tax Revenue and Non-tax Revenue** as explained in **Section 9.6**.

Capital Receipts:

Government receipts which **either create liabilities (e.g. borrowing) or reduce assets (e.g. disinvestment)** are called capital receipts. Thus when govt. raises funds either by incurring a liability or by disposing off its assets, it is called a **capital receipt**. In **post offices and banks** are treated capital receipts because they Increase liability of the government to repay these amounts to PPF (Public Provident Fund) holders and small savings depositors.

Difference between revenue and capital receipts:

Revenue Receipts	Capital Receipts
In case of revenue receipts, government is under no future obligation to return the amount, i.e., they are non-redeemable.	In case of capital receipts which are borrowings, government is under obligation to return the amount along with Interest.

GOVERNMENT EXPENDITURES:

Government expenditure refers to the **purchase of goods and services**, which include public consumption and public investment, and transfer payments consisting of income transfers (pensions, social benefits) and capital transfer. Government spending goes to the nation's **defense, infrastructure, health and welfare benefits**.

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CAPITAL MARKET

A capital market is a financial market **in which long-term debt (over a year) or equity-backed securities are bought and sold**. Capital markets channel the wealth of savers to those who can put it to long-term productive use, such as companies or governments making long-term investments.

Capital markets help channelize surplus funds from savers to institutions which then invest them into productive use. Generally, this market **trades mostly in long-term securities**.

Securities Market

A securities market is a market **where securities are traded** either on physical or electronic exchanges. Securities markets are generally divided between **stock markets and bond markets**. **A stock market** involves the trade of equity securities, which are ownership interests of a company commonly known as **shares**.

It is also classified into two interdependent segments, i.e.

They are

1. Primary Market

2. Secondary Market

BASIS FOR COMPARISON	PRIMARY MARKET	SECONDARY MARKET
Meaning	The market place for new shares is called primary market. or The securities are formerly issued in a market.	The place where formerly issued securities are traded is known as Secondary Market. or Issued securities is then listed on a recognised stock exchange for trading.
Another name	New Issue Market	(NIM) After Market
Type of Purchasing	Direct	Indirect
Financing	It supplies funds to budding enterprises and also to existing companies for expansion and diversification.	It does not provide funding to companies.
How many times a	Only once	Multiple times

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security can be sold?		
Buying and Selling between	Company and Investors	Investors
Who will gain the amount on the sale of shares?	Company	Investors
Intermediary	Underwriters	Brokers
Price	Fixed price	Fluctuates, depends on the demand and supply force
Organizational difference	Not rooted to any specific spot or geographical location.	It has physical existence.

The public issue is of two types, they are:

- **Initial Public Offer (IPO)** : Public issue made by an unlisted company for the very first time, which after making issue lists its shares on the securities exchange is known as the **Initial Public Offer**.
- **Further Public Offer (FPO)** : Public issue made by a listed company, for one more time is also known as a **Follow-On Offer**. An FPO is a stock issue of additional shares made by a company that is already publicly listed and has gone through the IPO process.

STOCK EXCHANGES

A **stock exchange**, securities exchange or bourse, is a facility where stock brokers and traders can **buy and sell securities**, such as shares of stock and bonds and other financial instruments. Stock exchanges may also **provide for facilities the issue and redemption** of such securities and instruments and capital events including the payment of income and dividends.

Two Important Stock Exchanges in India:

Bombay Stock Exchange (BSE) :

The Bombay Stock Exchange (BSE) is an Indian stock exchange established in **1875**, the BSE (formerly known as Bombay Stock Exchange Ltd.) . It is the **Asia's first stock exchange**. It claims to be the **world's fastest stock exchange**, with a median trade speed of 6 microseconds. The BSE is the world's 10th largest stock exchange with an overall market capitalization of **more than \$2.3 trillion** on as of **April 2018**.

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Over the past 141 years, BSE has facilitated the growth of the Indian corporate sector by **providing it an efficient capital-raising platform**. BSE's popular equity index - **the S&P BSE SENSEX** - is India's most widely tracked stock market benchmark index. It is traded internationally on the **EUREX** as well as leading exchanges of the BRICS nations (Brazil, Russia, China and South Africa) .

The BSE is also a **Partner Exchange** of the United Nations Sustainable Stock Exchange initiative, joining in September 2012. BSE established **India INX** on 30 December 2016. India INX is the **first international exchange of India**. Its headquarters is located in **Mumbai, Maharashtra**. Chairman of BSE - **S Ravi; Ashishkumar Chauhan** (MD & CEO) .

National Stock Exchange (NSE) :

The National Stock Exchange of India Limited (NSE) is the **leading stock exchange of India**. The NSE was established in **1992** as the **first demutualized electronic exchange** in the country.

NSE was the first exchange in the country to provide a modern, **fully automated screen-based electronic trading system** which offered easy trading facility to the investors spread across the length and breadth of the country. **Vikram Limaye** is Managing Director & Chief Executive Officer (MD & CEO) of NSE. **Ashok Chawla** is the chairman of NSE. Its headquarters is located in **Mumbai, Maharashtra**.

National Stock Exchange has a total market capitalization of more than US\$2.27 trillion, making it the **world's 11th-largest stock exchange** as of April 2018. NSE's flagship index, the **NIFTY 50**, the 50-stock index is used extensively by investors in India and around the world as a barometer of the Indian capital markets. Nifty 50 index **was launched in 1996** by the NSE.

TRADING SYSTEM IN STOCK EXCHANGES

Trading in a stock exchange takes place in two phases:-

In the first phase, the member **brokers execute their buy or sell orders** on behalf of their clients and in the second phase, **the securities and cash are exchanged**. For the exchange of securities and cash between traders, the service of two other agencies are required, namely clearing house (corporation) of the stock exchange and the depositories.

STOCK INDEX

A stock index or stock market index is a **measurement of a section of the stock market**. It is computed from the prices of selected stocks (typically a weighted average) . It is a tool used by investors and financial managers to describe the market, and to compare the return on specific investments.

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Two of the primary criteria of an index are that it is **investable and transparent**. The method of its construction should be clear. Many mutual funds and exchange-traded funds attempt to "track" an index (see index fund) with varying degrees of success. The difference between an index fund's performance and the index is called **tracking error**.

BOND MARKET

The bond market (also debt market or credit market) is a financial market where participants **can issue new debt, known as the primary market**, or buy and sell debt securities, known as the secondary market. This is usually in the form of bonds, but it may include notes, bills, and so on. Its primary goal is **to provide long-term funding for public and private expenditures**.

MONEY MARKET:

The Money market in India correlation for **short-term funds** with **maturity ranging from overnight to one year** in India including financial instruments that are deemed to be close substitutes of money.

The money market is where **financial instruments with high liquidity and very short maturities are traded**. It is used by participants as a means for borrowing and lending in the short term.

Money Market's Instruments are Call/Notice/Term money market, Repurchase Agreement (Repo & Reverse Repo) market, Treasury bill market, Commercial Bill market, Commercial paper market, Certificate of Deposit market, Cash Management Bill (CMB) .

CALL /NOTICE / TERM MONEY

The call/notice/term money market facilitates **lending and borrowing of funds between banks and entities** like Primary Dealers. An institution which has surplus funds may lend them on an **uncollateralized basis** to an institution which is short of funds. Money market transactions are categorized as follows:

- **Call Money** - Borrowing/Lending for 1 day
- **Notice Money** - Borrowing/Lending for 2-14 days
- **Term Money** - Borrowing/Lending for more than 14 days

The interest rates on such funds **depend on the surplus funds** available with lenders and the demand for the same which remains volatile. This market is governed by the **Reserve Bank of India** which issues guidelines for the various participants in the call/notice money market.

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Participants

Scheduled commercial banks (excluding RRBs) , co-operative banks (other than Land Development Banks) and Primary Dealers (PDs) , are permitted to participate in call/notice money market both as borrowers and lenders.

Prudential Limits

Prudential Limits for Transactions in Call/Notice Money Market

Sr. No.	Participant	Borrowing	Lending
1	Scheduled Commercial Banks	On a daily average basis in a reporting fortnight, borrowing outstanding should not exceed 100 per cent of capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125 per cent of their capital funds on any day, during a fortnight.	On a daily average basis in a reporting fortnight, lending outstanding should not exceed 25 per cent of their capital funds. However, banks are allowed to lend a maximum of 50 per cent of their capital funds on any day, during a fortnight.
2	Co-operative Banks	Outstanding borrowings of State Co-operative Banks/District Central Co-operative Banks/ Urban Co-operative Banks in call/notice money market, on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at end March of the previous financial year.	No limit.
3	PDs	PDs are allowed to borrow, on daily average basis in a reporting fortnight, up to 225 per cent of their net owned funds (NOF) as at end-March of the previous financial year.	PDs are allowed to lend in call/notice money market, on daily average basis in a reporting fortnight, up to 25 per cent of their NOF.

The prudential limits in respect of both outstanding borrowing and lending transactions in call/notice money market for scheduled commercial banks, co-operative banks and PDs are as follows: -

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- The limits so arrived at may be conveyed to the **Clearing Corporation of India Ltd. (CCIL)** for setting of limits in NDS-CALL System, under advice to Financial Markets Regulation Department (FMRD) , Reserve Bank of India.
- **Non-bank institutions** (other than PDs) are not permitted in the call/notice money market.
- Eligible participants **are free to decide on interest rates** in call/notice money market.
- With the implementation of the core banking solution, the **Negotiated Dealing System (NDS)** has been discontinued for reporting of OTC Call/Notice/Term Money transactions.

GOVERNMENT SECURITIES:

A Government Security (G-Sec) is a **tradeable instrument** issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Such securities are short term (usually called treasury bills, with original maturities of less than one year) or long term (usually called Government bonds or dated securities with original maturity of one year or more) .

In India, the **Central Government issues** both, treasury bills and bonds or dated securities while the **State Governments issue** only bonds or dated securities, which are called the State Development Loans (SDLs) . G-Secs carry practically no risk of default and, hence, are called risk-free gilt-edged instruments.

CORPORATE BOND MARKET:

A corporate bond is a bond **issued by a corporation** in order to raise financing for a variety of reasons such as to ongoing operations, M&A, or to expand business. The term is usually applied to longer-term debt instruments, with maturity of at least one year. Corporate debt instruments with maturity shorter than one year are referred to as commercial paper.

Corporate bonds trade in **decentralized, dealer-based, over-the-counter markets**. In over-the-counter trading dealers act as intermediaries between buyers and sellers. Corporate bonds are sometimes listed on exchanges (these are called "listed" bonds) and ECNs. However, vast majority of trading volume happens over-the-counter.

BOND VALUATION:

Bond valuation is a technique for **determining the theoretical fair value of a particular bond**. Bond valuation includes calculating the present value of the bond's future interest payments, also known as its cash flow, and the bond's value upon maturity, also known as its **face value or par value**. Because a bond's par value and interest payments are fixed, an investor uses bond valuation to determine what rate of return is required for a bond investment to be worthwhile.

BOND DURATION:

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Bond duration **measures how long it takes, in years, for an investor to be repaid the bond's price by the bond's total cash flows.** Not to be confused with maturity – which is how long a fixed-income investment lasts.

For each of the two basic types of bonds the duration is the following:

- **Zero-Coupon Bond** - Duration is equal to its time to maturity.
- **Plain Vanilla Bond** - Duration will always be less than its time to maturity.

If a bond has a duration of five years and interest rates increase 1%, the bond's price will drop by approximately 5% ($1\% \times 5$ years) . Likewise, if interest rates fall by 1%, the same bond's price will increase by about 5% ($1\% \times 5$ years) .

SENSITIVITY RISK

A sensitivity analysis determines **how different values of an independent variable affect a particular dependent variable under a given set of assumptions.** This technique is used within specific boundaries that depend on one or more input variables, such as the effect that changes in interest rates (independent variable) has on bond prices (dependent variable) .

FOREIGN EXCHANGE MARKET

The foreign exchange market (Forex, FX, or currency market) is a **global decentralized or Over-The-Counter (OTC) market for the trading of currencies.** This market determines the **foreign exchange rate.** It includes all aspects of buying, selling and exchanging currencies at current or determined prices. In terms of trading volume, it is by far the largest market in the world, followed by the Credit market. The main participants in this market are the **larger international banks.** Financial centers around the world function as anchors of trading between a wide range of multiple types of buyers and sellers around the clock, with the exception of weekends. Since currencies are always traded in pairs, the **foreign exchange market does not set a currency's absolute value but rather determines its relative value by setting the market price of one currency if paid for with another.** Ex: 1 USD is worth X CAD, or CHF, or JPY, etc.

FOREIGN EXCHANGE CONTROL

Foreign exchange controls are various forms of controls **imposed by a government on the purchase/sale of foreign currencies by residents or on the purchase/sale of local currency by nonresidents.**

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Common foreign exchange controls include:

- Banning the use of foreign currency within the country
- Banning locals from possessing foreign currency
- Restricting currency exchange to government-approved exchangers
- Fixed exchange rates
- Restrictions on the amount of currency that may be imported or exported

Countries with foreign exchange controls are also known as "**Article 14 countries**", after the provision in the **International Monetary Fund** agreement allowing exchange controls for transitional economies. Such controls used to be common in most countries, particularly poorer ones, until the 1990s when free trade and globalization started a trend towards economic liberalization. Today, countries that **still impose exchange controls are the exception rather than the rule.**

FIXED EXCHANGE-RATE SYSTEM

A fixed exchange rate, sometimes called a **pegged exchange rate**, is a type of exchange rate regime in which a currency's value is fixed **against either the value of another single currency to a basket of other currencies or to another measure of value, such as gold.**

A fixed exchange rate is typically used **to stabilize the value of a currency** by directly fixing its value in a predetermined ratio to a different, more stable, or more internationally prevalent currency (or currencies) to which the value is pegged.

EXCHANGE CONTROL IN INDIA

The **RBI** sets India's exchange-control policy and administers foreign exchange regulations in consultation with the GOI. India's foreign exchange control regime is governed by the **Foreign Exchange Management Act (FEMA)**, enacted with the **objective of facilitating external trade and payments**, promoting the orderly development and maintenance of the foreign exchange market in India and the liberalization of economic policies.

Foreign Exchange Management Act, 1999 (FEMA) :

The main objective of **Foreign Exchange Management Act, 1999 (FEMA)** is to consolidate and amend the law relating to foreign exchange with the **objective of facilitating external trade and payments** and for promoting the orderly development and maintenance of foreign exchange market in India.

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It was passed in the winter session of Parliament in 1999, replacing the **Foreign Exchange Regulation Act (FERA)** due to Foreign exchange reserves were low.

It also paved the way for the introduction of the **Prevention of Money Laundering Act, 2002**, which came into effect from 1 July 2005.

FEMA is **applicable to all parts of India**. The act is also applicable to all branches, offices and agencies outside India owned or controlled by a person who is a resident of India.

The FEMA head-office, also known as **Enforcement Directorate** is situated in **New Delhi** and is headed by a Director. The Directorate is further divided into 5 zonal offices in Delhi, Mumbai, Kolkata, Chennai and Jalandhar and each office is headed by a Deputy Director.

Remittance Facilities under FEMA:

Money Changing Activity:

- Authorised Money Changers (AMCs) are entities, authorised by the Reserve Bank under **Section 10 of the Foreign Exchange Management Act, 1999**. An AMC is a Full-Fledged Money Changer (FFMC) .
- FFMCs are authorised (a) **to purchase** foreign exchange from non-residents visiting India and residents; and (b) **to sell** foreign exchange for certain approved purposes.

MONEY TRANSFER SERVICE SCHEME(MTSS)

- Money Transfer Service Scheme (MTSS) is a quick and easy way of **transferring personal remittances from abroad to beneficiaries in India**.
- **Only inward personal remittances** into India such as remittances towards family maintenance and remittances favouring foreign tourists visiting India are permissible.
- **No outward remittance** from India is permissible under MTSS.
- The system envisages a tie-up between reputed money transfer companies abroad known as **Overseas Principals** and agents in India known as **Indian Agents** who would disburse funds to beneficiaries in India at ongoing exchange rates.
- The Indian Agent **is not allowed** to remit any amount to the Overseas Principal. Under MTSS the remitters and the beneficiaries are **individuals only**.
- A cap of **USD 2, 500** has been placed on individual remittances under the scheme. In addition, **thirty remittances** can be received by a single individual beneficiary under the scheme during a calendar year.
- Amounts up to **INR 50, 000/- may be paid in cash to a beneficiary in India**. These can also be loaded on to a pre-paid card issued by banks. **Any amount exceeding this limit** shall be paid by means

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of account payee cheque/ demand draft/ payment order, etc., or **credited directly to the beneficiary's bank account**. However, in exceptional circumstances, where the beneficiary is a foreign tourist, higher amounts may be disbursed in cash.

RUPEE DRAWING ARRANGEMENTS (RDA)

- Under the Rupee Drawing Arrangements (RDAs) , **cross-border inward remittances are received in India** through Exchange Houses situated in Gulf countries, Hong Kong, Singapore, Malaysia (for Malaysia only under Speed Remittance Procedure) and all other countries which are FATF compliant only under Speed Remittance Procedure.
- **No cash disbursement of remittances** is allowed under RDA. The remittances have to be credited to the bank account of the beneficiary.
- There **is no limit on the remittance amount** as well as on the number of remittances. However, there is an upper cap of **Rs.15.00 lakh** for trade related transactions.

About FATF:

The **Financial Action Task Force (FATF)** is an **intergovernmental organization** founded in 1989 on the initiative of the G7 **to develop policies to combat money laundering**. In 2001 its mandate expanded to include **terrorism financing**. Its headquarters is in **Paris, France**.

First issued in 1990, the FATF Recommendations were revised in 1996, 2001, and 2003 and most recently in **2012** to ensure that they remain up to date and relevant, and they are intended to be of universal application.

David Lewis joined the FATF as its Executive Secretary in November 2015.

LIBERALISED REMITTANCE SCHEME:

The Liberalized Remittance Scheme (LRS) is a facility provided by the RBI for all **resident individuals including minors to freely remit upto a certain amount in terms of US Dollar** for current and capital account purposes or a combination of both. Hence under the LRS, individuals are allowed to spend money in foreign countries for specific purposes like education, tourism, asset purchase etc.

The scheme was introduced on **February 4, 2004**, with a limit of USD 25, 000. But from April 2018, Resident individuals are permitted to make remittances up to **USD 250, 000 per financial year** for any permitted current or capital account transactions or a combination of both as per the regulations

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prescribed under the **Foreign Exchange Management (Current Account Transactions) Rules, 2000**, as amended from time to time, and the **Foreign Exchange Management Act, 1999** (FEMA) or the rules or regulations framed thereunder.

Conditions under LRS:

- Banks are required to furnish the information on remittances made under the **Liberalised Remittance Scheme** (LRS) on a monthly basis, on or before the fifth of the following month to which it relates through **Online Returns Filing System** (ORFS) for which purpose they have been given user ID and password by the Reserve Bank. Where there is no data to furnish, AD banks are advised to upload 'nil' figures in the ORFS system.
- Transactions relating to LRS are required to be reported in **Foreign Exchange Transactions Electronic Reporting System** (FETERS) to Department of Statistics and Information Management (DSIM) .
- It is **mandatory** for the resident individual to provide his/her Permanent Account Number (PAN) to make remittance under the Scheme.
- Individuals can avail of foreign exchange facility for the purposes within the limit of USD 2, 50, 000 only.

RUPEE DENOMINATED BOND:

A rupee denominated bond is a bond issued by an **Indian entity in foreign markets** and the interest payments and principal reimbursements are denominated (expressed) in rupees.

The term '**masala bond**' is also used to describe rupee denominated ever since the first issuer of rupee-denominated bonds used the name masala bonds in its first issue.

Issued By

- Any corporate (entity registered as a company under the Companies Act, 1956/ 2013) or body corporate (entity specially created out of a specific act of the Parliament) and Indian banks are eligible to issue Rupee denominated bonds overseas.
- The Rupee denominated bonds can only be issued in a country and can only be subscribed by a resident of a country: that is a member of Financial Action Task Force (FATF) or a member of a FATF-Style Regional body.

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Maturity:

- The minimum maturity period for Masala Bonds raised up to USD 50 million equivalent in INR per financial year should be 3 years and for bonds raised above USD 50 million equivalent in INR per financial year should be 5 years.
- In case the subscription to the bonds/ redemption of the bonds is in tranches, minimum average maturity period should be 3/5 years, as mentioned above.

COMMODITY MARKET

A commodity market is a market that **trades in primary economic sector rather than manufactured products**. **Soft commodities** are agricultural products such as wheat, coffee, cocoa, fruit and sugar. **Hard commodities** are mined, such as gold and oil. Investors access about 50 major commodity markets worldwide with purely financial transactions increasingly outnumbering physical trades in which goods are delivered. Futures contracts are the oldest way of investing in commodities. Futures are secured by physical assets.

Commodity markets can include **physical trading and derivatives trading** using spot prices, forwards, futures, and options on futures. Farmers have used a simple form of derivative trading in the commodity market for centuries for price risk management.

Commodity Trading & Exchanges in India:

Commodity Trading:

Commodity trading in India has a long history. In fact, commodity trading in India started much before it started in many other countries. However, **years of foreign rule, droughts and periods of scarcity and government policies** caused the commodity trading in India to diminish.

Commodity trading was restarted in India recently. Today, apart from numerous regional exchanges, India has six national commodity exchanges namely, **Multi Commodity Exchange (MCX)**, **National Commodity and Derivatives Exchange (NCDEX)**, **National Multi-Commodity Exchange (NMCE)** and **Indian Commodity Exchange (ICEX)**, the **ACE Derivatives exchange (ACE)** and the **Universal Commodity Exchange (UCX)**.

The regulatory body is **Forward Markets Commission (FMC)** which was set up in 1953. As of **September 2015** FMC was merged with the **Securities and Exchange Board of India, SEBI**.

Commodity Exchange:

A commodities exchange is an exchange **where various commodities and derivatives products are traded**. Most commodity markets across the world trade **in agricultural products and other raw**

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materials (like wheat, barley, sugar, maize, cotton, cocoa, coffee, milk products, pork bellies, oil, metals, etc.) and contracts based on them. These contracts can include spot prices, forwards, futures and options on futures. Other sophisticated products may include interest rates, environmental instruments, swaps, or ocean freight contracts. **Commodities exchanges usually trade futures contracts on commodities, such as trading contracts to receive something, say corn, in a certain month.**

INTERNATIONAL CAPITAL MARKETS

The **group of closed interconnected markets** in which residents of different countries trade assets such as currencies, stocks and bonds. Capital markets **promote economic efficiency** by channeling money from those who do not have an immediate productive use for it to those who do.

International Capital Market Association:

The International Capital Market Association or ICMA is a **self-regulatory organization and trade association for participants in the capital markets**. Despite the name suggesting a global outlook, it has a European focus. Its Headquarters is located in **Zurich, Switzerland**.

ICMA stated aims are **to promote high standards of market practice, appropriate regulation, trade support, education and communication**. It produces standard documentation for transactions such as equity and debt issuance and repos. ICMA market conventions and standards have been the pillars of the international debt market for almost 40 years, providing the self-regulatory framework of rules governing market practice which have facilitated the orderly functioning and impressive growth of the market.

FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investment (FDI) is an **investment made by a firm or individual** in one country **into business interests** located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets, including establishing ownership or controlling interest in a foreign company.

Foreign Direct Investments are distinguished from portfolio investments in which an investor merely **purchases equities of foreign-based companies**.

Indian company receive foreign investment

There are **two routes** under which foreign investment can be made is as under:

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➤ **Automatic Route:** Foreign Investment is allowed under the automatic route **without prior approval** of the Government or the Reserve Bank of India, in all activities/ sectors as specified in the **Regulation 16 of FEMA 20 (R)** .

➤ **Government Route:** Foreign investment in activities not covered under the automatic route **requires prior approval** of the Government.

Foreign Investment Promotion Board (FIPB) which was the responsible agency **to oversee this route** was abolished on May 24, 2017.

Foreign Investment:

- Foreign Investment means any **investment made by a person resident outside India** on a repatriable basis in capital instruments of an Indian company or to the capital of an LLP.

FOREIGN PORTFOLIO INVESTMENT (FPI)

In economics, Foreign Portfolio Investment is the entry of funds into a country **where foreigners deposit money in a country's bank** or make purchases in the country's stock and bond markets, sometimes for speculation.

Foreign portfolio investment shows up in a **country's capital account**. It is also part of the balance of payments which measures the amount of money flowing in and out of a country over a given time period.

QUALIFIED FOREIGN INVESTOR (QFI)

The **Qualified Foreign Investor (QFI)** is sub-category of Foreign Portfolio Investor and refers to any foreign individuals, groups or associations, or resident, however, restricted to those from a country that is a member of **Financial Action Task Force (FATF)** or a country that is a member of a group which is a member of FATF and a country that is a signatory to **International Organization of Securities Commission's (IOSCO)** Multilateral Memorandum of Understanding (MMOU) .

QFI scheme was introduced by **Government of India** in consultation with **RBI and SEBI** in the year 2011. The policy decision is **aimed to increase the depth** of the Indian Market and widen the range of investors. QFIs, have now been merged in to **Foreign Portfolio Investors (FPI)** , when the FPI regulations were introduced in 2014.

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The objective of enabling QFIs is **to deepen and infuse more foreign funds** in the Indian capital market and to reduce market volatility as individuals are considered to be long term investors, as compared to institutional investors.

If the QFI is an Institutional investor such as hedge funds, insurance companies, pension funds and mutual funds, **which are registered out of India** would be called **QFII (Qualified Foreign Institutional Investors)** .

DIFFERENCE BETWEEN FDI AND FPI

FDI (Foreign Direct Investment)	FPI (Foreign Portfolio Investment)
FDI is a long-term process wherein the investor reflects a long-lasting and controlling interest in the firm.	FPI is a short-term process
FDI is a direct investment in buildings, technologies, equipment and machinery belonging to the firm of a host country (foreign firm) .	FPI is an indirect investment in the foreign firm by simply buying the stocks of the company and not getting involved in any major activities of the firm.
It is difficult to sell off the shares in FDI	It is easy to sell off the shares in FPI
FPI investors are less vulnerable to liquidity.	FPI investors are more vulnerable to liquidity.
Investment is greater than 10%	Investment is less than 10%
Investment gives investors ownership right as well as management right	Investment gives investors only ownership right and not management right

FOREIGN INSTITUTIONAL INVESTORS (FIIS)

Foreign Institutional investors (FIIs) are entities established or incorporated outside India and **make proposals for investments in India**. These investment proposals by the FIIs are made on behalf of sub accounts, which may include foreign corporates, individuals, funds etc.

In order to act as a banker to the FIIs, the **RBI** has designated banks that are authorised to deal with them. The biggest source through which FIIs invest is the issuance of Participatory Notes (P-Notes) , which are also known as **Offshore Derivatives**.

FIIs can invest in the **stocks and debentures** of the Indian companies. In order to invest in the primary and secondary capital markets in India, they have to venture through the **Portfolio Investment Scheme (PIS)** . According to RBI regulations, the ceiling for overall investment for **FIIs is 24%** of the

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paid up capital of the Indian company. The limit is 20% of the paid up capital in the case of public sector banks.

Recently **SEBI** allowed FIIs to invest in unlisted exchanges as well, which means both **BSE and NSE** (the unlisted bourses) can now allot shares to FIIs also.

AMERICAN DEPOSITARY RECEIPT (ADR)

An **American Depositary Receipt** (ADR) is a **negotiable certificate** issued by a U.S. bank representing a specified number of shares (or one share) in a foreign stock traded on a U.S. exchange.

ADRs are denominated in **U.S. dollars**, with the underlying security held by a U.S. financial institution overseas, and holders of ADRs realize any dividends and capital gains in U.S. dollars, but dividend payments in euros are converted to U.S. dollars, net of conversion expenses and foreign taxes.

ADRs are listed on either the **NYSE, AMEX or NASDAQ** but they are also sold OTC. ADR holders **do not have to transact in foreign currencies** because ADRs trade in U.S. dollars and clear through U.S. settlement systems.

INDIAN DEPOSITARY RECEIPT (IDR)

Indian Depositary Receipt (IDR) is a financial instrument **denominated in Indian Rupees** in the form of a depository receipt. The IDR is a specific Indian version of the similar global depository receipts. IDR's are based on the original American Depositary Receipts that were first introduced in 1927 in the US.

It is created by a **Domestic Depository** (custodian of securities registered with the **Securities and Exchange Board of India**) against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian securities Markets.

The foreign company IDRs will deposit shares to an Indian depository. The depository **would issue receipts to investors** in India against these shares. The benefit of the underlying shares (like bonus, dividends etc.) would accrue to the depository receipt holders in India.

Operation instructions under the **Foreign Exchange Management Act** were issued by the Reserve Bank of India on July 22, 2009. **Standard Chartered PLC** became the first global company to file for an issue of Indian depository receipts in India in 2010.

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SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

The Securities and Exchange Board of India (SEBI) is the designated **regulatory body** for the finance and investment markets in India. The Securities and Exchange Board of India was established on April 12, 1992 in accordance with the provisions of the **Securities and Exchange Board of India Act, 1992**.

The board plays a vital role in **maintaining stable and efficient** financial and investment markets by creating and enforcing effective regulation in India's financial marketplace. India's SEBI is similar to the U.S. Securities and Exchange Commission (SEC) .

SEBI has its headquarters at **Mumbai, Maharashtra**. Chairman of SEBI – **Ajay Tyagi**.

Management

- SEBI is managed by its **chairman and 5 members** and has departments such as primary market Dept, Issue Management Dept, Secondary Market Dept, Institutional Investment Dept.
- It has **2 advisory committees**, one each for primary and secondary market to provide advisory guidance in framing policies and regulation.
- SEBI has to be responsive to the needs of three groups, which constitute the market: 1) the issuers of securities 2) the investors 3) the market intermediaries. Ultimately, the board has three powers: quasi-judicial, quasi-legislative and quasi-executive.

SECURITIES AND COMPANY LAW

Securities law:

Securities Laws (Amendment) Act, 2014 is a legislation in India which provided the securities market regulator **Securities and Exchange Board of India (SEBI)** with new powers **to effectively pursue fraudulent investment schemes, especially ponzi schemes**. The bill also provides guidelines for the formation of special fast trial courts.

Company Law:

Indian company law regulates the corporations formed **under the Section 2(20) Indian Companies Act 2013**. "Company means a company incorporated under this Act or under any previous Company Law". Corporate affairs in India are regulated through the Companies Act, 1956, Companies Act 2013 and related laws and regulations, which are administered by the **Ministry of Corporate Affairs (MCA)** .

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CORPORATIZATION & DEMUTUALIZATION OF STOCK EXCHANGES IN INDIA

Corporatization:

Corporatization of Stock Exchanges is the process of **converting the organizational structure of the stock exchange** from a non-corporate structure to a corporate structure. Traditionally, some of the stock exchanges in India were established as "Association of persons", like BSE, ASE and MPSE. Corporatization of these exchanges is the process of **converting them into incorporated Companies.**

Demutualization:

Demutualization refers to the **conversion of an existing non-profit organization into a profits-oriented company.** In other words, an association that is mutually owned by member's converts itself into an organization that is owned by shareholders. The company can take different shapes and forms, that is, it could be either a listed or unlisted company which may be closely held or publicly held. This process involves the **segregation of members' right into distinct segments**, viz. ownership rights and trading rights.

Listing Agreement:

Listing Agreement is the basic document which is **executed between companies and the Stock Exchange when companies are listed on the stock exchange.** The main purposes of the listing agreement are **to ensure that companies are following good corporate governance.** Listing Agreement is the basic document which is executed between companies and the Stock Exchange when companies are listed on the stock exchange.

The Listing Agreement comprises of **54 clauses stating corporate governance**, which listed companies have to follow, failing which companies have to face disciplinary actions, suspension, and delisting of securities. The companies also have to make certain disclosures and act by the clauses of the agreement.

Dematerialization:

Dematerialization is the process wherein share certificates or other securities **held in physical form are converted into electronic form** and credited to demat account of an investor opened with a depository participant. It introduced compulsory trading of shares in dematerialized form in specified scrips by institutional investors with effect from **January 15, 1998.**

Rematerialisation:

Rematerialisation is the process of conversion of **electronic holdings of securities into physical certificate form.** For rematerialisation of scrips, the investors have to fill up a **Remat Request Form (RRF)** and submit it to the depository participant.

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NATIONAL SECURITIES DEPOSITORY LIMITED (NSDL)

National Securities Depository Limited (NSDL) is an **Indian central securities depository** based in **Mumbai, Maharashtra**. It was established on 8 November 1996 as the **first electronic securities depository in India** with national coverage based on a suggestion by a national institution responsible for the economic development of India. MD & CEO of NSDL - **G.V. Nageswara Rao**.

Promoters / shareholders

NSDL is promoted by **Industrial Development Bank of India Limited** (IDBI) - the largest development bank of India, **Unit Trust of India** (now, Administrator of the Specified Undertaking of the Unit Trust of India) and **National Stock Exchange of India Limited** (NSE) - the largest stock exchange in India. Some of the prominent banks in the country have also taken a stake in NSDL. They are Axis Bank Limited, State Bank of India, Oriental Bank of Commerce, Citibank NA, Standard Chartered Bank, HDFC Bank Limited, The Hongkong and Shanghai Banking Corporation Limited, Deutsche Bank, Dena Bank, Canara Bank

CENTRAL DEPOSITORY SERVICES (INDIA) LTD (CDSL)

Central Depository Services (India) Ltd (CDSL) , is the **second Indian central securities depository** based in **Mumbai, Maharashtra**. Its main function is the holding securities either in certificated or uncertificated (dematerialized) form, to enable book entry transfer of securities. MD & CEO of CDSL - **P S Reddy**.

Promoters / shareholders:

- CDSL is promoted by **Bombay Stock Exchange Limited** (BSE) jointly with State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Axis Bank and Union Bank of India.

APPLICATIONS SUPPORTED BY BLOCKED AMOUNT (ASBA)

ASBA (Applications Supported by Blocked Amount) is a process developed by the India's Stock Market Regulator **Securities and Exchange Board of India (SEBI)** for applying to IPO. In ASBA, an IPO applicant's account doesn't get debited until shares are allotted to them.

ASBA can be used for **Initial and Follow-on Public Offers** (IPO & FPO) , Rights Issues, Debt Issues and Mutual Funds. Under ASBA, funds will continue **to earn interest** during the application processing period.

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Bank will mark a **lien on the deposit account** of the investor to the extent of the application money. Lien will be removed immediately after finalization of the basis of allotment. **If bid is successful**, the shares allotted will be transferred to the applicant's Demat account. An Investor can make 5 applications from a single deposit account.

Note: **Lien** is a right to keep possession of property belonging to another person until a debt owed by that person is discharged.

UNPUBLISHED PRICE-SENSITIVE INFORMATION AND DISCLOSURE REQUIREMENTS

Under **Regulation 3** of the **Insider Trading Regulations**, no insider should "communicate, provide, or allow access to any **unpublished price sensitive information, relating to a company or securities listed** or proposed to be listed, to any person including other insiders". However, it specifically excludes communications for legitimate purposes, the performance of duties, or the discharge of legal obligations.

Unpublished price sensitive information has been defined under **Regulation 2(n)** of the Insider Trading Regulations to include "any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the price of the securities.

MERGERS AND AMALGAMATION

Mergers:

When two or more existing companies merge and become one company it is called a merger. The companies which are being merged lose their respective identities and the existing shareholders receive shares of the new (merged) company in exchange for the shares held by them.

Amalgamation:

An amalgamation happens **when two different entities combine to form a completely new entity**. It is distinct from a merger as neither of the combining companies is left as a legal entity.

EXEMPTION BY SEBI:

Regulation 11(1) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (SAST Regulations) , gives power to the Board **to grant exemption from the obligation to make an open offer for acquiring shares**. Further, as per Regulation 11(3) of SAST Regulations, the acquirer shall file an application with the Board, supported by a duly sworn affidavit, giving details of the proposed acquisition and the grounds on which the exemption has been sought.

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SEBI TIGHTENED THE RULES FOR MERGERS AND AMALGAMATIONS BY INDIAN COMPANIES

The Securities and Exchange Board of India or SEBI, tightened the rules for mergers and amalgamations by Indian companies in an effort **to make listing process more transparent and give public shareholders** a bigger say in consolidations of companies.

- In case of merger of an unlisted company with a listed company, the unlisted company **will have to disclose all the material information** in the form of an abridged prospectus, similar to what companies file before launching initial public offering (IPO) .
- Additionally, the resultant public shareholding holding post such mergers or amalgamations between an unlisted entity and a listed entity **cannot be less than 25%**, which is similar to what all listed entities need to follow at present.
- Effective total of the public shareholding of the listed entity plus the **qualified institutional buyers** (QIBs) of the unlisted company has to be at least 25% after the two companies merge and the unlisted entity gets automatically listed.

UNFAIR TRADE PRACTICES IN THE SECURITIES MARKET

Unfair trade practice refers to the **use of various deceptive, fraudulent or unethical methods to obtain business**. Unfair trade practices include misrepresentation, false advertising or representation of a good or service, tied selling, false free prize or gift offers, deceptive pricing and non-compliance with manufacturing standards. Such acts are **considered unlawful by statute via Consumer Protection Law**, which opens up recourse for consumers by way of compensatory or punitive damages.

Securities fraud:

Securities fraud, also known as **stock fraud and investment fraud**, is a deceptive practice in the stock or commodities markets that induces investors to make purchase or sale decisions on the basis of false information, frequently resulting in losses, in violation of securities laws.

Securities fraud can also **include outright theft from investors** (embezzlement by stockbrokers) , stock manipulation, misstatements on a public company's financial reports, and lying to corporate auditors. The term encompasses a wide range of other actions, **including insider trading**, front running and other illegal acts on the trading floor of a stock or commodity exchange.

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Insider Trading:

There are two types of "insider trading". The first is the **trading of a corporation's stock** or other security by **corporate insiders** such as officers, key employees, directors, or holders of more than ten percent of the firm's shares. This is generally legal, but there are certain reporting requirements.

The other type of insider trading is the purchase or sale of a security based on **material non-public information**. This type of trading is illegal in most instances. In illegal insider trading, an insider or a related party trades based on material non-public information obtained during the performance of the insider's duties at the corporation, or otherwise misappropriated.

Prohibition of Insider Trading by SEBI:

In exercise of the powers conferred by **section 30 read with clause (g)** of sub-section (2) of section 11 and clause (d) and clause (e) of section 12A of the Securities and Exchange Board of India Act, 1992 (15 of 1992) , the Board hereby makes the following regulations, **to put in place a framework for prohibition of insider trading in securities and to strengthen the legal framework thereof.**

PENALTIES FOR COMMITTING INSIDER TRADING

The penalties and punishments for committing insider trading have been defined under Chapter IV-A of the SEBI Act. The penalties have been discussed below according to the SEBI (Amendment) Act, 2002.

- **Section 15(G) (i)** – if an insider either on its own or on behalf of any person has dealt on behalf of his company any unpublished information then he may be fined with Rs. 25 crores or 3 times the profit made, whichever is higher.
- **Section 15G(ii)** – if an insider has given any price sensitive information then he may be fined up to Rs. 25 crores or 3 times the profit made.
- **Section 15G(iii)** – if an insider has procured any other person to deal in securities of anybody corporate on basis of published information then he may be fined up to Rs. 25 crores or 3 times the profit made which is higher.

SEBI ICDR REGULATIONS

These regulations may be called the **Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018**. The ICDR Regulations provide detailed provisions relating to public issue such as conditions relating to an **IPO and Further Public Offer (FPO)** , conditions relating to pricing in public offerings, conditions governing promoter's contribution, restriction on

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transferability of promoter's contribution, minimum offer to public, reservations, manner of disclosures in offer documents, etc.

Entities not eligible to make an initial public offer

5. (1) An issuer shall not be eligible to make an initial public offer-

(a) if the issuer, any of its promoters, promoter group or directors or selling shareholders are debarred from accessing the capital market by the Board.

(b) if any of the promoters or directors of the issuer is a promoter or director of any other company which is debarred from accessing the capital market by the Board.

(c) if the issuer or any of its promoters or directors is a wilful defaulter.

(d) if any of its promoters or directors is a fugitive economic offender.

SECURITIES APPELLATE TRIBUNAL

SEBI has been invested with **three necessary functions** rolled-in to enable it to carry out its mandate:

Quasi-legislative function means drafts regulation; **Quasi-judicial function** means passes rulings and judgments; prosecute and judge directly certain violations; **Quasi-executive function** means investigation and enforcement actions.

For the quasi-judicial functions, there is a **Securities Appellate Tribunal**, which is a three-member tribunal. A second appeal lies directly to the Supreme Court. It was created by **SEBI**.

Securities Appellate Tribunal is a **statutory body established under the provisions of Section 15K of the Securities and Exchange Board of India Act, 1992** to hear and dispose of appeals against orders passed by the Securities and Exchange Board of India or by an adjudicating officer under the Act; and **to exercise jurisdiction, powers and authority conferred on the Tribunal by or under this Act or any other law for the time being in force.**

SAT hears and disposes of appeals against orders passed by the Pension Fund Regulatory and Development Authority (PFRDA) under the **PFRDA Act, 2013**. 23rd March, 2015, SAT hears and disposes of appeals against orders passed by the **Insurance Regulatory Development Authority of India (IRDAI)** under the Insurance Act, 1938, the General Insurance Business (Nationalization) Act, 1972 and the Insurance Regulatory and Development Authority Act, 1999 and the Rules and Regulations framed thereunder.

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ROLE OF COURTS IN ENFORCING SECURITIES REGULATIONS

Under the **SEBI Act, 1992**, Securities Contracts (Regulation) Act, 1956 (SCRA) and the Depositories Act, 1996, SEBI pursues **two streams of enforcement actions** i.e. **Administrative/Civil or Criminal**. Administrative/civil actions include issuing directions such as remedial orders, cease and desist orders, suspension or cancellation of certificate of registration and imposition of monetary penalty under the respective statutes and action pursued or defended in a court of law/tribunal. Criminal action involves initiating prosecution proceedings against violators by filing complaint before a criminal court.

Procedure for consent orders where Adjudication Proceedings are pending:

- a. If the party against whom an adjudication proceeding is pending proposes passing of a consent order, the proposal may be referred to a high powered Committee consisting of a retired judge of a High Court and two other external experts.
- b. The Committee will consider the proposal of consent, requisite waivers by the party, the facts and circumstances of the case, material available on records and take into account the factors. Where the Committee finds the terms for passing a consent order inadequate, it may ask the party to revise the consent terms.
- c. The consent terms finalized by the Committee and agreed to by the party shall be forwarded to the Adjudication Officer for passing a suitable order in line with the consent terms.

Settlement before Securities Appellate Tribunal (SAT) / Courts:

Where a matter is pending before SAT/Court, the same consent process will be undertaken and the draft consent terms recommended **by the Committee and approved by the panel of two Whole Time Members will be filed before the SAT/ Court**. The SAT/Court may if found fit, pass an order in terms of the consent terms and subject to such further terms as the SAT/ Court may find appropriate in the facts and circumstances of the case.