

GUIDELINE ANSWERS

PROFESSIONAL PROGRAMME (NEW SYLLABUS)

DECEMBER 2014

**MODULE III
Elective Paper(s)**



**THE INSTITUTE OF
Company Secretaries of India**

IN PURSUIT OF PROFESSIONAL EXCELLENCE

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The Guideline Answers contain information based on the Laws/Rules relevant for the Session. Students are expected to be well versed with the amendments in the Laws/Rules made upto **six** months prior to the date of examination.

The Guideline answers to December 2014 session examination are based on Companies Act, 1956. Students may please note that June 2015 examinations will carry questions from those sections of the Companies Act, 2013 and the rules made there under which have been notified by the Government of India upto December, 2014). In respect of sections of The Companies Act, 2013 which have not been notified, applicable sections of Companies Act, 1956 shall apply.

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BANKING LAW AND PRACTICE

(Elective Paper 9.1)

Time allowed : 3 hours

Maximum marks : 100

NOTE: Answer **ALL** Questions.

Question 1

The details of financial state and activity of XYZ Ltd. for the period from 01.01.2012 to 31.12.2014 are given below :

Structure of the Assets and Liabilities

Indicator	Value						Change for the period analysed	
	₹(in thousand)			% of the balance total		₹(thousand) (col.5-col.2)	±% (col.5-col.2) : col.2	
	31.12.2011	31.12.2012	31.12.2013	31.12.2014	at the beginning of the period analysed (31.12.2011)			
1	2	3	4	5	6	7	8	9
Assets								
1. Non-current assets	187,625,543	322,273,637	416,299,008	503,097,289	52	76.4	+315,471,746	+168.1
2. Current assets, total	173,184,851	191,660,913	207,513,814	155,460,157	48	23.6	-17,724,694	-10.2
Inventories	4,770,370	4,985,680	76,222	55,162	1.3	<0.1	-4,715,208	-98.8
Trade and other current receivables	128,380,239	147,904,069	175,094,863	89,543,524	35.6	13.6	-38,836,715	-30.3
Cash and cash equivalents	7,132,445	2,811,891	3,354,882	17,435,540	2	2.6	+10,303,095	+144.5
Other current assets	32,901,797	35,959,273	28,987,847	48,425,931	9.12	7.35	+15,524,134	+47.18
Equity and Liabilities								
1. Equity	236,892,662	263,953,835	296,713,355	328,181,421	65.7	49.8	+91,288,759	+38.5
2. Non-current liabilities	24,814,976	82,295,647	85,046,637	26,441,244	69	4	+1,626,268	+6.6
3. Current liabilities	99,102,756	167,685,068	242,052,830	303,934,781	27.5	46.2	+204,832,025	+2.07 times
Total Assets/Equity and Liabilities	360,810,394	513,934,550	623,812,822	658,557,446	100	100	+297,747,052	+82.5

Keeping the above details in view, answer the following questions :

(a) Prepare a comprehensive analysis of the balance sheet of XYZ Ltd. (10 marks)

(b) Give a detailed financial sustainability analysis with the help of key financial ratios and comment on the same. (10 marks)

(c) Prepare a detailed working capital analysis and comment on the same. (5 marks)

(d) Provide a liquidity analysis and comment on the same. (10 marks)

(e) Analyse the overall financial results and give a brief conclusion on the financial condition of the company. (15 marks)

Answer 1(a)

The balance sheet is an important consideration for analysing the financial position of a company because it is a reflection of what the company owns and owes. The strength of a company's balance sheet can be evaluated by analyzing working capital, adequacy, asset performance and capitalization structure. Generally, ratios are used to analyse the financial position, these ratios makes the interpretation easy. The objective is to see a company's position in terms of cash, assets, debt, equity etc. to analyse whether the company could continue operations without running into financial trouble.

Some of the ratios calculated for XYZ Ltd. are given below:

Ratios	Significance	31.12.11	31.12.12	31.12.13	31.12.14	Interpretation
Quick /Acid Test Ratio (current assets- inventories)/ current liabilities	Measures ability to meet short-term obligations with most liquid assets. The higher the quick ratio, the better the position of the company.	1.70	1.11	0.86	0.51	The quick ratio is decreasing signifying company's inability to repay its short term debt
Current Ratio (Current Assets / Current liabilities)	Determines the company's ability to pay back its short term liabilities. Acceptable current ratios generally lie between 1.5 and 3 for healthy businesses.	1.75	1.14	0.86	0.51	Since, the ratio is below 1, it raises a warning as to whether the company is able to pay its short term obligations when due.
Debt Equity Ratio (Total Liabilities/ Equity)	If the ratio is increasing, the company is being financed by creditors rather than from its own financial sources. Acceptable debt-to-equity ratio is 1.5 and less.	1.52	0.95	1.1	1.01	Ratio lies between acceptable levels however this need to be further analysed by calculating long term and short term debt to equity ratio
Long Term Debt Equity Ratio (Long	This ratio is used to calculate company's financial leverage.	0.10	0.31	0.29	0.08	The long term debt is below acceptable

Ratios	Significance	31.12.11	31.12.12	31.12.13	31.12.14	Interpretation
Term Liabilities/ Equity)	Acceptable debt-to-equity ratio is between 1-2.					limits indicating that the company may not be taking advantage of the increased profits that financial leverage may bring.
Debt Ratio/ Total Liabilities to Total Assets (Total Liabilities/ Total Assets)	Shows the proportion of a company's assets which are financed through debt. The higher the ratio, the higher the degree of leverage, and consequently, financial risk.	0.34	0.14	0.087	0.50	A lower liability dimension reflecting low financial risk
Working Capital (Current Asset - Current Liabilities) (in thousands Rs.)	Key indicator of company's solvency. Must be positive.	74,082,095	+23,975,845	-34,539,016	-148,474,624	Working capital has become negative, showing that company may have difficulty in meeting its credit obligations.

Some of the other Key findings of the Analysis are:

1. The share of XYZ's current assets equaled about a quarter (23.6%) on the last day of the period analysed (31.12.2014), while non-current assets equaled three quarters of all the assets.
2. An increase in the assets to Rs. 658,557,446 thousand (Rs. +297,747,052 thousand) was seen during the reviewed period (31st December, 2011 to 31st December, 2014).
3. The total growth of XYZ's assets value is primarily connected with the value growth of the item "other non-current financial assets" by Rs. 331,695,629 thousand.
4. The most significant growth is in current liabilities which grew by 207% over the period of 4 years. While value of current assets fell down by around 10%
5. The inventories equaled Rs. 55,162 thousand on the last day of the period analysed (31.12.2014). An alteration in the inventories made Rs. -4,715,208 thousand for the entire period analysed. The current receivables reduced by Rs. 38,836,715 thousand for the last 3 years.

6. The company's asset structure as on 31.12.2014 is as under:

S. No.	Particulars	% of Total assets (2011)	% of Total assets (2014)
1	Non Current Assets	52.00	76.39
2	Current Assets	48.00	23.61
3	Inventories	1.32	0.01
4	Trade And Other Receivables	35.58	13.60
5	Cash And Cash Equivalents	1.98	2.65
6	Other Current Assets	9.12	7.35

7. The table below shows the structure of company's capital:

S. No.	Particulars	% of Total Liabilities as on 31.12.2011	% of Total Liabilities as on 31.12.2014
1	Equity	65.66	49.83
2	Non Current Liabilities	6.88	4.02
3	Current Liabilities	27.47	46.15

8. XYZ Ltd. has continuously increasing cash and cash equivalents (+144.4%) while decreasing total current assets (-10.2%) from 2011 to 2014, indicating that idle cash could be there.

9. Having too much debt relative to cash flows required to pay for interest and debt repayments is one way a company can go bankrupt. Here, XYZ Ltd. is having a significantly higher level of short term debt which offers a quick check for red flags.

10. Corporate intellectual property (items such as patents, trademarks, copyrights and business methodologies), goodwill and brand recognition are all common assets in today's marketplace. But they are not listed on company's balance sheet.

Answer 1(b)

A sustainable business requires effective financial and planning management. Ratio analysis is useful management tool that improves understanding of financial results and trends over time, and provide key indicators of organizational performance. Some of the key financial sustainability ratios for XYZ Ltd are given below:

Key indicators of the company's Financial Sustainability

Indicator	Value			Change (column 5 - Column 2)		The indicator description and its recommended value	Company's Position
	2011	2012	2013	2014	6		
1	2	3	4	5	7	8	
Debt to equity ratio	0.52	0.95	1.1	1.01	+0.49	It is the key financial ratio used as a standard for judging a company's financial standing. Acceptable value: no more than 1.5 (optimum 0.43-1)	The company's debt is increasing. It has increased beyond optimum level. However, it may still be acceptable.
Debt to asset ratio	0.34	0.49	0.52	0.5	+0.16	It shows how much the company relies on debt to finance assets (similar to debt to equity ratio) acceptable value: 0.6 or less (optimum 0.3-0.5)	The ratio is at optimum level showing the company does not rely too much on debt for purchasing its assets.
Long term debt equity ratio	0.1	0.31	0.29	0.08	-0.02	It shows the leverage and the share of borrowed capital to the owners' capital. Acceptable debt-to-equity ratio is between 1-2.	The long term debt is below acceptable limits.
Fixed Asset/ non-current assets to net worth	0.79	1.22	1.4	1.53	+0.74	It measures the extent of a company's capital is blocked in fixed assets. Normal value: no more than 0.75	The ratio has increased beyond acceptable levels showing that too much of the capital is tied up in the fixed assets.

Some other sustainability ratios are capitalization ratio (Calculated by dividing non-current assets by the sum of equity and non-current liabilities- Acceptable ratio less than 0.75), current liability ratios (Current liability ratio is calculated by dividing current liabilities by total i.e. current and non-current liabilities.) etc.

Some of the key findings regarding sustainability of XYZ Ltd:

1. Firstly attention should be drawn to the debt to equity ratio and debt ratio as the indicators describing the capital structure. On the last day of the period analysed,

the debt-to-equity was equal to 1.01. During the period analysed, there is a notable increase in debt ratio (+0.16)

2. The debt ratio describes XYZ's financial condition as a good one on 31.12.2014
3. The percentage of liabilities makes 50.2%, while a maximum acceptable percentage is deemed to be 60%. The values of the debt ratio corresponded to acceptable ones during the whole period.
4. The non-current assets to Net worth ratio equaled 1.53 on 31.12.2014. During the last 3 years, the ratio was found to spike rapidly by 0.74, additionally, the value of the ratio is not a satisfactory one.
5. The current liability ratio as on 31.12.2014 is 0.92 which shows that the amount of long-term debts of XYZ is significantly lower than the amount of short term debts on 31.12.2014, (8% and 92% respectively of the total liabilities). Liabilities with short maturity are less preferred than long term liabilities from positions of financial stability. In relation to this, the company should be more careful when borrowing short term capital.

Answer 1(c)

The working capital analysis helps in measuring a company's ability to pay off its current liabilities with current assets. It is an important analysis for the creditors because it shows the liquidity of the company. The working capital is calculated by deducting current liabilities from the current assets. A positive working capital is where current assets exceed current liabilities, it shows whether the company has enough capital to run its day-to-day operations. The table below shows the working capital analysis for XYZ Ltd.:

Working Capital Analysis

Indicator	Value				Change during the period (col.5- col.2)
	31.12.2011	31.12.2012	31.12.2013	31.12.2014	
1	2	3	4	5	6
1. Working capital (net working capital), thousand Rs.	+74,082,095	+23,975,845	-34,539,016	-148,474,624	-222,556,719
2. Inventories, thousand Rs.	+4,770,370	+4,985,680	+76,222	+55,162	-4,715,208
3. Working capital sufficiency (1-2), thousand Rs.	+69,311,725	+18,990,165	-34,615,238	-148,529,786	-217,841,511
4. Inventory to working capital ratio (2:1) Normal value: 1 or less.	0.06	0.21	-<0.01	-<0.01	-0.06

Some of the Key findings of the working capital analysis are:

1. XYZ's working capital has a negative value (Rs. -148,474,624 thousand) on the last day of the period analysed (31.12.2014). This means that current liabilities exceed current assets.
2. Working capital sufficiency means the working capital calculated excluding the value of inventories, the idea behind is to get true picture of the situation. Here since working capital itself is negative, the working capital sufficiency is bound to be negative.
3. The company's inventories have reduced significantly, under normal conditions, the inventory to working capital ratio should not be less than 1, however in the given case the ratio has consistently been less than 1.
4. The company is not having enough of current assets to meet its current obligations. However it do have non-current assets but the same could not liquidated easily, thus the negative working capital of XYZ signals an alarming liquidity position of the company.
5. XYZ's Working Capital Ratio (current assets/ current liabilities) is less than 1 because of its increasing debt and decreasing current assets. This makes the business of XYZ Ltd. more risky to new potential credits. Further, if XYZ Ltd wants to apply for loan, it should pay off some of the liabilities to improve its working capital ratio.

Answer 1(d)

Liquidity analysis assists in determining a company's ability to meet its short-term debt obligations. Banks often take a close look at liquidity ratios when performing fundamental analysis on a company. Since a company that is consistently having trouble meeting its short-term debt is at a higher risk of bankruptcy, liquidity ratios are a good measure of whether a company will be able to comfortably continue as a going concern. There are three important liquidity ratios these are current ratios, quick ratios and cash ratios. Current ratio is one of the most widespread and shows to what degree the current assets of the company are meeting the current liabilities. The solvency of the company in the near future is described with the quick ratio which reflects if there are enough fund's for normal execution of current transactions with creditors. All three ratios for XYZ are calculated in the following table.

Liquidity Analysis of XYZ Ltd.

Liquidity indicator	Value				Change (col.5-col.2)	The indicator description and its recommended value
	2011	2012	2013	2014		
1	2	3	4	5	6	7
1. Current Ratio (working Capital ratio)	1.75	1.14	0.86	0.51	-1.24	It indicates a company's ability to meet short - term debt obligations. Acceptable value: 2 or more.
2. Quick ratio (acid-test ratio)	1.7	1.11	0.86	0.51	-1.19	It is a measure of a company's ability to meet

its short-term obligations using its most liquid assets (near cash or quick assets). Normal value: no less than 1.

3. Cash ratio	0.07	0.02	0.01	0.06	-0.01	Cash ratio is calculated by dividing absolute liquid assets (cash and cash equivalents) by current liabilities. Normal value: no less than 0.2.
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Some of the key findings from the above analysis are:

1. The current ratio equalled 0.51 at the end of the period analysed. For the 3 years, the current ratio significantly dropped (-1.24). The value of the ratio can be described as obviously critical on 31.12.2014.
2. The quick ratio was equal to 0.51 on 31.12.2014. For the reviewed period (31.12.11-31.12.14), the quick ratio was found to undergo a significant decrease of 1.19, moreover, tendency of the quick ratio to fall is also proven with an average (linear) trend. On the last day of the period analysed, the value of the quick ratio can be deemed as an unsatisfactory one.
3. The value of the third rate, the cash ratio, like of the two previous rates, does not lie in the acceptable range on 31.12.2014. XYZ is observed to have a deficit of cash and cash equivalents to meet current liabilities.
4. All three liquidity related ratios negatively describe the structure of the Statement of financial position of XYZ from the point of view of solvency.

Answer 1(e)

Overview of the Financial Results

The given financial data indicates the following positive points:

1. The net worth (net assets) of the company is much higher (by 15,433.7 times) than the share capital on 31.12.2014.
2. The debt ratio describes XYZ's financial condition as a good one on 31.12.2014.
3. The percentage of liabilities in the total capital structure of XYZ makes 50.2% which is normal for stable activity.

The following values indicate the negative points:

1. The value of the non-current assets to net worth ratio equal to 1.53 is not a normal one.
2. The increase in equity for the 3 years was lower than the growth rates of total assets.
3. Quick ratio is 0.51 (while the acceptable value makes 1).
4. The cash ratio is equal to 0.06 on the last day of the period analysed (31.12.2014) (a low cash in hand level required for current payments).

5. Working capital of the company is negative showing critical liquidity position of the company.
6. The current ratio (0.51) is significantly lower than the standard value of 2.
7. Not enough long-term resources of financing company activity.

Conclusion

The company is not having a proper debt and capital structure, as the current assets should be backed by current liabilities and long term assets be backed by long term liabilities however, in the case of XYZ Ltd. the reverse could be seen.

Also, the increase in current liabilities by 207% followed by decrease in current asset by 10.2% is not a good sign as it plays a significant role in decreasing the working capital of the company.

Non-current assets are defined as anything not classified as a current asset. This includes items that are fixed assets, such as property, plant and equipment (PP&E). Unless the company is in financial distress and is liquidating assets, investors generally do not pay too much attention to fixed assets. Since companies are often unable to sell their fixed assets within any reasonable amount of time they are carried on the balance sheet at cost regardless of their actual value. As a result, it's possible for companies to grossly inflate this number, leaving investors with questionable and hard-to-compare asset figures. However, these assets could be used as collateral security for taking loan from the bank.

The look at the quick ratio shows that the company does not have enough cash and liquid assets to cover its short-term debt obligations.

Most of the information about debt can be found on the balance sheet - but some assets and debt obligations are not disclosed there. Companies often possess hard-to-measure intangible assets.

There is also off-balance sheet debt to be aware of. This is form of financing in which large capital expenditures are kept off of a company's balance sheet through various classification methods. Companies will often use off-balance-sheet financing to keep the debt levels low.

Question 2

- (a) *Explain the circumstances under which a banker is permitted to close an account without instructions from the customers.* (10 marks)
- (b) *Discuss the precautions which a banker should take while granting advances with special reference to the various types of securities that a banker takes to secure the advance.* (10 marks)
- (c) *A cheque is an instrument used for almost all banking transactions. Explain the different type of cheques along with their legal implications. Also explain the legal provisions which allow the cheque to be transferred.* (10 marks)

Answer 2(a)

Under Banker Customer relationship, the Banker is required to follow the instructions given by the customer pertaining to the account including instructions to close the account. However the banker is permitted to close the account without the instructions from the client. The Banker would close the account as per requirement of law which permits or directs that the Banker-Customer relationship be terminated. The banker can close the account under certain circumstances. The circumstances under which the Banker would take such an extreme step of closing the account would be when:

- (a) Bank finds the customer undesirable i.e. the customer conducts the account in an unsatisfactory manner such as issuance of cheques without maintaining sufficient balance, or has forged cheques, bills or other instruments in his dealings with the bank.
- (b) Account has not been operated for a very long period and the Banker feels that he no longer needs the account.
- (c) The customer is a defaulter on some advances granted by the bank and the banker has exercised his right of Lien and set-off under which the balance in the account has become nil.
- (d) One of the holders in the account is declared as incompetent to contract. Since the account was opened by more than one holder under their signatures, the instructions to operate the account would also have been given with their joint consent. Thus in case of lunacy or insolvency of one of the joint holders the operations in the account will be stopped.
- (e) The account holder becomes a Lunatic or a person of unsound mind, he is not permitted to enter into contract u/s 11 of the Indian Contract Act.
- (f) An individual is declared insolvent/ bankrupt or a company is wound up under provision of law.
- (g) It has received Garnishee order from the Income Tax authorities.
- (h) In case of death of a bank account holder.

However, in case the banker decides to close the account he will have to follow certain rules and will have the following obligation:

- (a) In most cases in order to minimize frauds in inoperative accounts the Banker would first mark the account as dormant and various stringent rules with senior person authentication and customer's personal identification are followed
- (b) Give sufficient notice in writing to the customer. In case the customer does not respond, another reminder should be sent.
- (c) The customer should be given an opportunity to represent his case on why the account should not be closed.
- (d) After giving sufficient notice if the customer does not respond or the customer is not traceable, the banker would transfer the balance to "Unclaimed Deposit Account".
- (e) Bank can refuse to accept credits in the account or issue a new cheque book.

(f) However Bank would be under an obligation to honor all cheques issued by the customer. In case the banker dishonors any cheque he would be liable for damages under section 31 of the Negotiable Instruments Act.

Answer 2(b)

The banker has to secure the advance with adequate mix of marketable and liquid securities to secure the advance and safeguard it from the unforeseen circumstances. For this the banker is required to take certain precautions while granting loan against different types of securities:

1. *Land and Real estate* : Bankers were some years ago adverse to accept land as security. Finance granted for building would have to include land as securities as the two cannot be separated at the time of sale. Further bankers normally insist on mortgage of land and building as collateral securities for various obvious reasons such as:

- (i) Value always increases and thus the advance is sufficiently secured at all times
- (ii) The same cannot be shifted or misappropriated. With the setup Mortgage Repository provided by SARFAESI Act, the risk of the assets being fraudulently mortgaged to multiple lenders is also eliminated.

However, the banker is required to take precaution with reference to Valuation of property, realize the securities, ascertainment of the title of the security, encumbrances on the property resulting out of occupation by third parties and various other acts such as rent control act, land ceiling act, etc.

2. *Stocks, shares and debentures* : These can be listed or unlisted. Bankers normally grant loans or overdrafts against listed securities while they accept unlisted securities as additional collateral. The bankers should consider following while accepting stocks, shares and debentures as security:

- (i) Ascertain the value and monitor the same to calculate mark to market margin.
- (ii) Credit periodic returns such as dividends and maturity value to the loan account.
- (iii) Whether they are traded regularly or not.
- (iv) Whether all the shares are fully paid up or not.
- (v) Whether the company whose shares etc. are given as security is having sound performance or not.

3. *Goods as security* : Almost all working capital advances are secured by hypothecation of pledge of goods. The goods could comprise of Raw materials or work in progress or finished goods. The Bank should take precautions regarding following aspects:

- (i) Risk of deterioration and resulting reduction in value.
- (ii) Risk of frauds as bulk quantities stored cannot be verified

- (iii) Price fluctuations as a result of changes in consumer preferences new advance products introduced in the market or changes in fashions etc.
- (iv) Storage of goods on appropriation and the rent to be paid thereof for such storage.
- (v) Problems and cost associated with transportation at the time of appropriation as well as the time of sale.
- (vi) Banker is required to ensure that the borrower has paid the warehouse rent to safeguard himself from warehouse keepers lien.

4. *Book Debts* : Normally Bankers grant cash credit limits against book debts. This is done because in many cases the buyers of the goods sold would not be able to accept bills and thus this is the only way the banker can finance the borrower for the credit sales. The banker must ensure that the book debts are not time barred. Usually the banker permits finance against book debts up to 6 months only. However, when the book debts financed become more than 6 months old the drawing limit for the book debts is reduced. If the borrower is unable to pay for the same the account remains overdrawn. These debts due to various reasons or dispute may remain unpaid for more than 3 years. The banker should in such cases ensure that the borrower files suit against the debtors before they become time barred.

5. *Insurance Policies* : Insurance policies are rarely taken as principal security but are taken as co-lateral security. In advances like housing loans and personal loans where the credit rating of the borrower and his income and the ability to pay the installments are the main consideration for granting the advance, the bankers normally insist on a life insurance policy on the life of the borrower be taken and assigned to the bank. This ensures the payment of the loan on the death of the borrower. The main points that a banker has to consider are:

- (i) The assignment of the policy to be recorded with the insurance co and on the policy.
- (ii) The policy to be kept in the possession of the bank.
- (iii) The bank would take an undertaking from the borrower that the premiums should be paid by the bank by debiting his account.
- (iv) The Policy could be reducing sum policy where the sum assured and premium reduces as the loan is repaid.

6. *Fixed Deposits as security* : In order to make fixed deposits liquid the banks usually grant loans against the fixed deposits. Further the banks may ask the borrower to pledge his deposits with the bank as co-lateral security. While taking FDs as security the banker should :

1. Mark his lien on the deposits.
2. The deposits should be in the name of the borrower and in case they are in the name of a third party the deposit holder should be made a guarantor.
3. In case of deposits in joint names the holders should be joint borrowers.

4. If the FD is in the name of a minor a declaration should be taken from the guardian that the loan would be used for the benefit of the minor.
7. *Supply bills as security* : Supply bills which are accepted by the purchaser are taken as security for working capital finance. Here the banker depends on purchaser to make payment and the debt would devolve on the borrower only if the purchaser defaults. Sometimes the supplier requires that the bills are co-accepted by the purchaser's banker. In such cases the banker accepting the bills acts as a guarantee and the bill discounting bank is assured of payment. This type of finance is common when Letter of credit is issued by a bank to the supplier.

Thus, in all cases the banker is required to consider the aspects related to marketability of securities, adequate margins, realization of the advance and proper documentation. Although securities play an important role in securing an advance and help in protecting the deposits of customers, the Banker and his ability to assess the customer and the loan requirement goes a long way in securing an advance and preventing the same from becoming Non Performing Asset.

Answer 2(c)

A cheque gets its legal status under the Negotiable Instruments Act (NIA). Section 6 of the Act defines a cheque as:

1. A bill of exchange;
2. Drawn on a specified banker; and
3. Payable on demand.

Under the Information Technology Act a truncated cheque (i.e the scanned image of the cheque) is recognized by law. Further an electronic instruction which is digitally signed or electronic transfer instructions which replace a cheque are also considered as valid.

The parties to the cheque are:

1. *Drawer* : A customer who draws the cheque or writes/signs the cheque.
2. *The Drawee* : Since the cheque is an order on the banker where the customer holds an account, the Banker on whom the cheque is drawn is the Drawee.
3. *Payee* : He is the beneficiary of the cheque and the person to whom the drawer intends to make payment.
4. *Endorser* : A person who has a right to the cheque and transfers this right to another person. He can be the drawer or any person (endorsee) to whom the cheque is transferred.

Cheques are classified into different categories based on the intent of the drawer. They are:

1. *Open Cheque* : It is a cheque which can be encashed over the counter. Usually such cheques are drawn on "self", further the word "bearer" printed on the cheque has not been cancelled.

2. *Bearer cheques* : An open cheque or a cheque that is payable across the counter but has the name of the person to whom the drawer intends to make payment is a Bearer cheque.
3. *Order Cheque* : It is a cheque on which the word "Bearer" has been cancelled. The effect of such cancellation is that the cheque cannot be paid across the counter and has to be credited to a bank account. The payee whose name is written on the cheque can transfer the same as was payable to him or to any person to whom he has "ordered" the payment to be made.
4. *Crossed cheque* : A crossed cheque is an order cheque which has further restrictions attached to it. This is done by putting 2 lines across the cheque (called crossing) or by writing certain words on the cheque. The restriction mentioned above will depend on the type of crossing. Under simple crossing, 2 lines are drawn across the cheque and cheque is similar to an order cheque while under General Crossing, cheque has words like "and Company" or any such variations or words such as "not negotiable" and cheque can only be credited to the account of the payee or the endorsee of a valid endorsement.
5. *Account Payee cheques* : This type of crossing is in practice in India only. Since the NIA was framed from the English law on the subject, the Indian NIA has no reference to this type of crossing. Thus, in order to standardize the practices adopted by the banks RBI has come out with directives on the subject.

The NIA defines the rules for endorsement of all negotiable instruments. Thus, they become applicable to cheques also. Section 15 defines an endorsement as "when the maker or holder of a negotiable instrument signs the same, other than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto or signs for the same purpose a stamp paper intended to be completed as a negotiable instrument, he is said to have endorsed the same and is called endorser." From the above it can be seen that a valid endorsement must:

1. Can be made by the maker (drawer) or the holder;
2. The maker or the holder must sign thereon;
3. The intent of the maker or holder must be to negotiate the cheque;
4. The signature or the written can be done on the face of the cheque or on the reverse or on a separate sheet of paper attached to the cheque (known as allonge) or on a stamp paper mentioning the negotiation;
5. The person who signs the endorsement is called the endorser & the person in whose favor the cheque is transferred is called the endorsee.

The important provisions of the NIA pertaining to endorsements are:

1. *Effects of endorsements* : Under Section 50 an endorsement of a cheque of a delivery transfers the ownership as well as the right to negotiate. Thus, the endorsee acquires the ownership & right of the cheque of the holder and can negotiate further if such a right is not restricted.
2. *Endorser* : An endorser can be the sole maker, drawer, payee or endorsee or all or some of them jointly. However this is subject to the restriction on the right to

negotiate specified by the drawer or subsequent endorsees. (Section 51) The restriction should be specific and mentioned on the cheque and cannot be implied.

3. *Time* : section 60 of the NIA specifies that a negotiation can be done until payment has been made by the banker, drawer or acceptor at or after maturity but not thereafter. Since the possession of the cheque is essential for valid endorsement this rule which is applicable to other negotiable instruments, would not be applicable to cheques.
4. *Endorsement of part amount* : Section 56 provides that a endorsement made for part of the amount due is not a valid endorsement. However a bill of exchange or a promissory note or any other instrument is paid in part, the unpaid portion of the instrument can be negotiated further. However this would not be applicable to a cheque as it cannot be paid in part.
5. *Joint endorsement* : An endorsement to two or more parties jointly is valid. However an endorsement intending to transfer the instrument separately is not valid.
6. If the endorsee is deceased all further negotiation are stopped as the heirs of a deceased person cannot endorse the same. (section 57). Similarly if the endorser dies after making the endorsement but before delivering the instrument to the endorsee, the legal representatives are barred from completion of the negotiation.
7. *Order of endorsement* : section 118 provides that it is presumed that the endorsements appearing on the instruments are made in the order they appear on the instruments. For this purpose the date mentioned on the endorsements would be considered. In case the date is not mentioned, the order in which they appear on the instrument would be considered.
8. *Signature of the Endorser* : An endorsement must be signed by the person making the endorsement or a person duly authorized to endorse on his behalf. If the cheque is payable to two persons both must sign the endorsement. Endorsees shall spell his name as it appears on the endorsement.

Question 3

A bank maintains the following accounts :

- (i) *Individual account of Anil with a balance of ₹10,000.*
- (ii) *A joint account of Anil and Bimal with a balance of ₹20,000.*
- (iii) *An individual account of Chandan with a balance of ₹1,25,000.*
- (iv) *An account of a partnership firm where Anil, Bimal and Chandan are partners with a balance of ₹50,000.*
- (v) *A loan account of Anil with a debit balance of ₹45,000. The bank has recalled the same as a result of non-payment of interest and installments.*

The bank has received the following orders :

- *A Court order is received to attach the property of Anil for ₹1.50 lakh.*

— *An order from income-tax department to attach the assets of the partnership firm for ₹1,70,000.*

Explain how the bank will appropriate the amounts in the various accounts.
(5 marks)

Answer 3

1. *To fulfill the Court's order to attach the property of Anil for Rs. 1,50,000*

The Bank may use its right of lien and setoff to appropriate the Loan amount up to the available balance in account held individually by Mr. Anil's i.e. Rs 10,000. Further, the remaining debit balance in loan account of Mr. Anil i.e. Rs 35,000 shall be recovered in other ways as the joint account or Partnership accounts cannot be attached for the dues of Mr. Anil.

2. *To fulfill the order from Income Tax Department to attach the asset of Partnership firm for Rs. 1,70,000:*

The bank may :

- (a) Utilize the balance in the account of the partnership firm i.e. Rs 50,000
- (b) Utilize the balance in the joint accounts of Anil and Bimal i.e. Rs. 20,000
- (c) Utilize the balance in the Chandan's account for the remaining amount i.e. Rs. 1,00,000

This is because the partners are jointly and severally liable. Here the question of which of the accounts mentioned i.e. account jointly held by Anil and Bimal or individually held by Chandan above would have priority, the bank is at liberty to use its discretion as the partners are jointly liable and any arrangement or adjustments in the amount appropriated by the bank can be done between the partners privately.

Question 4

The summary of per unit cost of production of a product of A & Co. is as under :

- (i) *Raw material cost ₹25*
- (ii) *Labour and other manufacturing cost ₹35*
- (iii) *Factory expenses ₹10*
- (iv) *Office expenses ₹20*
- (v) *Depreciation on machinery is ₹5 for a production capacity of 25,000 units per month.*
- (vi) *The optimum batch quantity is 5,000 units with a work cycle of 1 week.*
- (vii) *The credit available for raw materials is 2 weeks.*

(viii) Sales are 20% in cash and the remaining on credit with an average period of 30 days' credit.

(ix) Holding period of stock of finished goods is 15 days.

(x) The article is sold for ₹105 and average sales for the next year is estimated at 17,000 units per month.

The proprietor wants to avail of working capital limits from the bank. Guide him as to what limits he should apply ? (5 marks)

Answer 4

For a production of 17,000 units per month following data base will emerge:

Particulars	Amount	For 1 month	Working Capital assessment
Raw materials per month (25x17,000)	Rs 1,75,000	Half month credit requirement	Rs. 87,500
1. Cost of production per month per unit 35+ 10+20+ (12,500/17,000=.74)*	Rs. 65.74	Production cycle of 1 week for 5000 units	Rs. 3,28,700
Sales per month = Rs.105x 17,000	Rs. 17,85,000	Receivables against debtors will be 80% of sales	Rs. 14,28,000
Total Requirement			Rs. 18,44,200

The requirements in banking terminology should have following break up:

(i) Stock Cash credit (For raw material+ stock in process)** Rs 4,16,200

(ii) Cash credit bills (For debtors) Rs 14,28,000

Notes:

- *(total depreciation= 2,500xRs 5 (per unit not mentioned in the question) = Rs. 12,500 and is constant for any level of working)
- In case the raw material inventory has been considered for credit purchases period only, since the inventory norm is not mentioned in the question the requirement against raw material will be nil and the total requirement will come down by Rs 87,500.
- **Stock Cash credit will be Rs 3,28,000 if the holding period for raw material is not considered

Alternative Answer 4**Calculation of Working Capital**

<i>Particulars</i>	<i>Amount in Rs.</i>		
(a) Work in Progress			
Raw Material $(17000 \times 12 \times 25) / 52$	98,077		
Labour $(17000 \times 12 \times 35) 50\% / 52$	68,654		
Factory Expenses $(17000 \times 12 \times 10) \times 50\% / 52$	19,615	1,86346	
(b) Finished Goods $(17000 \times 12 \times 70) \times 15 / 365$	5,86,849	5,86,849	
(c) Debtors $(17000 \times 12 \times 105) \times 80\% \times 30 / 365$	14,08,438	14,08,438	
(d) Total current assets (a + b + c)		21,81,633	
(e) Current liabilities $(17000 \times 12 \times 25) \times 2 / 52$	1,96,154	(1,96,154)	
Working capital (d - e)		19,85,479	

As per Tondon Committee limits would be either of the following :

1. 75% of Working Capital = Rs. 14,89,109
2. 75% of Current Assets less 100% of current liabilities = Rs. 14,40,071

Notes:

- It has been assumed that depreciation is not considered in factory expenses and so it has been ignored as it is not a part of working capital.
- For raw material 1 week holding is considered as production cycle is of 1 week
- For labour and factory expenses 50% are considered as part of WIP

Alternative Answer 4

<i>S.No.</i>	<i>Particulars</i>	<i>per unit</i>	<i>For 5,000 units</i>	<i>For 17,000 units</i>	<i>For 20,000 units</i>	<i>Amount in Rs.</i>
1.	Raw materials	25	1,25,000	4,25,000	5,00,000	
2.	Labour and other cost	35	1,75,000	5,95,000	7,00,000	
3.	Factory expenses	10	50,000	1,70,000	2,00,000	
4.	Office expenses	20	1,00,000	3,40,000	4,00,000	
5.	Total cost	90	4,50,000	15,30,000	18,00,000	
6.	Sale price	105	5,25,000	17,85,000	21,00,000	
	Less Total cost	90	4,50,000	15,30,000	18,00,000	
7.	Profit	15	75,000	2,55,000	3,00,000	

The working capital requirement would have to be calculated for 20,000 units as the min batch size is 5000 units. The working capital requirements will be as under:

S. No.	Particulars	Cost per Month in Rs.	Basis	Working capital	Deductions weeks	Deductions in Rs	Total working	Remarks capital
1.	Raw materials	5,00,000	actual	5,00,000	2	1,66,666	3,33,334	
2.	Labour and other cost	7,00,000	6 weeks	8,40,000	0		8,40,000	
3.	Factory expenses	2,00,000	6 weeks	2,40,000	0		2,40,000	
4.	Office expenses	4,00,000	6 weeks	4,80,000	0		4,80,000	
5.	Total cost	18,00,000		20,60,000		18,93,334		
6.	Sale price	21,00,000	6 week	25,20,000	504000 +1680000	21,84,000	3,36,000	20%+ 5 weeks on 80%
7.	Total Working capital					22,29,334		
8.	Rounded up					22,30,000		

While calculating the working capital the cost for 6 weeks is considered and the credit period for purchase of raw materials is reduced. Since the total cost of manufacture is considered the working capital requirement for credit sale of only 1 week is considered to avoid duplication.

The limits to be applied for would be as under:

Cash credit against stock Rs 19.00 Lakhs

Cash credit against Book debts Rs 3.26 Lakhs

Bills discount Rs 3.36 Lakhs

Maximum Rs 22.30 Lakhs

Note for Students

Since, no particular method is mentioned in the question, it could be solved using different methods and/or taking different assumptions so the difference in answers is likely.

Question 5

Ajay has availed of 3 loans from his bank amounting to ₹ 2 lakh, ₹ 3 lakh and ₹ 5 lakh carrying interest of 12%, 13% and 15% respectively. Further, the loan of ₹ 2 lakh has become time barred. Ajay pays ₹ 5 lakh without indicating the loan for which he has made payment. The bank appropriates the amount towards the first two loans. Ajay disputes this and explains that the amount was meant to pay-off the third loan where interest rate was highest. Explain the position of the banker. (5 marks)

Answer 5

When an individual or entity is a debtor as well as a creditor, the entity has a right to set off monies receivable against monies payable. Section 59 and 61 of the Indian Contract Act, 1872 contains provisions for appropriation. Under section 59, the right of appropriation, rests with the debtor who has to make payment to his creditor to whom he owes debts. He may appropriate the payment by intimation or implying that the payment is to be applied towards settling a particular debt.

However, if the Debtor does not intimate the creditor that for which debt the payment is being made, the right of appropriation rests with the creditor. And creditor may apply the monies received at his discretion to any lawful debt payable by the debtor. Further where interest is also overdue the banker has a right to appropriate the deposits against interest unless there is an agreement to the contrary.

Thus, in this example there are 2 points to be considered. These are:

1. Whether the bank can appropriate the debt which is time barred and
2. Whether it was right in appropriating the payment towards the loans with lower interest.

A debt which is time barred is neither extinguished nor can it be recovered. However, under the Limitation Act, the lender loses his right to recover the debt through court or legal process. In the given case as the customer did not mention the details that for which debt is he paying the bank, the right to decide that against which of the loans the amount is to be appropriated lies with the bank.

Thus, the Bank has acted within its right by appropriating the amount to the first 2 loans.

Question 6

A banker has different relationship in various capacities with customers. Explain these relationships in brief.
(5 marks)

Answer 6

A banker has different relationship in various capacities with customers, some of these are explained below:

1. *Relationship as Debtor and Creditor:* On the opening of an account the banker assumes the position of debtor. He is not depository or trustee of the customer's money because the money over to the banker becomes a debt due from him to the customer. Banker's relationship with the customer is reversed as soon as the customer's account is overdrawn. Banker becomes creditor of the customer who has taken a loan from the banker and continues in that capacity till the loan is repaid.
2. *Banker as Trustee:* Ordinarily, a banker is a debtor of his customer in respect of the deposits made by the latter, but in certain circumstances he acts as a trustee also. A trustee holds money or assets and performs certain functions for the benefit of some other person called the beneficiary.

3. *Banker as a Bailor/ Bailee*

Section 148 of Indian Contract Act, 1872, defines bailment, bailor, and bailee. A bailment is the delivery of goods by one person to another for some purpose upon a contract. As per the contract, the goods should when the purpose is accomplished, be returned or disposed off as per the directions of the person delivering the goods. The person delivering the goods is called the bailer and the person to whom the goods are delivered is called the bailee. Banks secure their loans and advances by obtaining tangible securities. In certain cases banks hold the physical possession of secured goods (pledge)- cash credit against inventories; valuables-gold jewels (gold loans); bonds and shares (loans against shares and financial instruments). In such loans and advances, the collateral securities are held by banks and the relationship between banks and customers are that of bailee (bank) and bailer, (borrowing customer).

4. *Banker as a Lessor /Lessee*

Section 105 of 'Transfer & Property Act' deals with lease, lessor, lessee. In case of safe deposit locker accounts, the banker and customer relationship of lessor/ lessee is applicable. Banks lease the safe deposit lockers (bank's immovable property) to the clients on hire basis. Banks allow their locker account holders the right to enjoy (make use of) the property for a specific period against payment of rent.

5. *Banker as Agent*

A banker acts as an agent of his customer and performs a number of agency functions for the convenience of his customers. For example, he buys or sells securities on behalf of his customer, collects cheques on his behalf and makes payment of various dues of his customers, e.g. insurance premium, etc. The range of such agency functions has become much wider and the banks are now rendering large number of agency services of diverse nature. For example, some banks have established Tax Services Departments to take up the tax problems of their customers.

CAPITAL, COMMODITY AND MONEY MARKET **(Elective Paper 9.2)**

Time allowed : 3 hours

Maximum marks : 100

NOTE: Answer **ALL** Questions.

Question 1

The Amazing Co. Ltd. (ACL) is a listed company on BSE and NSE for over 15 years. The financial performance of the company is rated to be good while the stock performance is lacklustre. The liquidity in the stock is random and often neglected. Poor liquidity is often attributed to poor holding of stock in the hands of retail investors. The shareholding pattern of the company as filed with the stock exchange is as under:

S. No.	Category of shareholder	No. of Shareholders	No. of shares (₹ 10 each)
1.	<i>Promoter & Promoter Group and Person acting in concert</i>	15	29,56,500
2.	<i>Public financial institution</i>	4	1,50,000
3.	<i>Foreign institutional investor</i>	2	50,000
4.	<i>Bodies corporate</i>	15	27,340
5.	<i>Resident individuals</i>	102	34,450
6.	<i>Others</i>	6	3,400
		144	32,21,690
7.	<i>GDR</i>	74	1,24,400
		218	33,46,090

The company has also allotted 1,67,304 convertible debentures of ₹100 each to promoters, which are due for conversion in the next six months. Each debenture will be converted into one equity share of ₹10 each at a premium of ₹90 each.

In light of the above, answer the following :

- (a) *What is the percentage of public holding required to be maintained in ACL under Rule 19A of Securities, Central's (Regulations) Rules, 1957 ? How much of the promoter holding is required to be diluted to comply with the continuous listing requirements ? Mention the percentage of holding by each category. (8 marks)*
- (b) *Justify whether the underlying shares issued against GDR constitute public holding. (8 marks)*

(c) *What are the options available to promoters for increasing public holding and the pros and cons of each process ?* (12 marks)

(d) *Whether acquisition by way of convertible debentures trigger the provisions of takeover code. Analyse with relevant provisions.* (8 marks)

(e) *Briefly describe the process of offer for sale (OFS) for dilution of promoter holding.* (14 marks)

Answer 1(a)

The percentage of holding is as under:

Sl. No.	Category of Shareholder	No. of Share Holders	No. of Shares (₹10 Each)	Percentage of Holding	No of Shares Including Convertible Debentures (Conversion Due in Next Six Months)	Percentage of Holdings Including Convertible Debentures (Conversion Due in Next Six Months)	Public Holding/ Promoter Holding
1	Promoter and Promoter Group and PAC	15	29,56,500	88.36%	3123804	88.91%	Promoter
2	Public Financial Institution	4	1,50,000	4.48%	1,50,000	4.27%	Public
3	Foreign Institutional Investor	2	50,000	1.49%	50,000	1.42%	Public
4	Bodies Corporate	15	27,340	0.82%	27,340	0.78%	Public
5	Resident Individuals	102	34,450	1.03%	34,450	0.98%	Public
6	Others	6	3,400	0.10%	3,400	0.096%	Public
		144	32,21,690				
7	GDR	74	1,24,400	3.72%		3.54%	Not to be considered public holding till it's conversion. (Refer Rule 2(e) of Securities Contracts Regulation Rules, 1957)
		218	33,46,090		3513394		

From the above table:

- (i) Total promoter holding before including the convertible debentures which is due for conversion within six months = 88.36%
- (ii) Total promoter holding after including the convertible debentures which is due for conversion within six months = 88.91%
- (iii) Percentage of GDR to be excluded from public holding (before inclusion of convertible debentures which is due for conversion within six months) = 3.72%
- (iv) Percentage of GDR to be excluded from public holding (after inclusion of convertible debentures which is due for conversion within six months) = 3.54%

Accordingly the calculation of public holding:

- (a) *Before inclusion of convertible debentures which is due for conversion within six months*

100- (Total promoter holding before including the convertible debentures which is due for conversion within six months+ Percentage of GDR to be excluded from public holding(before inclusion of convertible debentures which is due for conversion within six months)=100-88.36-3.72=7.92%

- (b) *After inclusion of convertible debentures which is due for conversion within six months*

100- (Total promoter holding after including the convertible debentures which is due for conversion within six months+ Percentage of GDR to be excluded from public holding(after inclusion of convertible debentures which is due for conversion within six months)=100-88.91-3.54=7.55%

Under Rule 19(2) and Rule 19(A) of the securities contracts (Regulations) Rules, 1957, the minimum public holding in ACL should be at 25% of the issued capital. The public holding in ACL is 7.92% (before including convertible debentures) and 7.55% (after including convertible debentures).

Accordingly the promoters are to dilute 17.08% (before including convertible debentures) and 17.45% (after including convertible debentures)

Answer 1(b)

As defined in Rule 2(e) of Securities Contracts Regulation Rules 1957, public shareholdings means equity shares of the company held by public and shall exclude shares which are held by custodian against depository receipts issued overseas. Accordingly underlying shares issued against Global Depository Receipts will not constitute public shareholding, till conversion of GDRs into equity shares.

Answer 1(c)

As per Clause 40A (ii) of equity listing agreement, where the issuer company is required to achieve the minimum level of public shareholding specified in Rule 19(2)(b) and/or Rule 19A of the Securities Contracts (Regulation) Rules, 1957, it shall adopt any of the following methods to raise the public shareholding to the required level:-

- (a) *Issuance of shares to public through prospectus*

The Promoters may dilute their shareholding in the Company in percentage

terms by issuing additional shares to public through prospectus. This will increase the share capital of the Company and thus bring down the shareholding of the promoters. However, this process is time consuming and takes six months to one year. Moreover, the company may not require the funds and servicing capital may put additional burden on the company. However, the chance of success of increasing public holding will be high as substantial marketing is done by lead managers.

(b) *Offer for sale of shares held by promoters to public through prospectus*

This option available to the promoters is to dispose of their shareholding in the Company through offer for sale of shares to public through prospectus. It is much the same way as (a) above except that the proceeds accrue to promoters (seller) and the cost of public issue is also borne by the promoter (seller).

(c) *Sale of shares held by promoters through the secondary market in terms of SEBI circular CIR/MRD/DP/05/2012 dated February 1, 2012*

This is also called Offer for sale by promoters through stock exchanges. This method offers flexibility, savings in cost and time and tax advantages over the alternative, which is follow-on public offering.

(d) *Institutional Placement Programme (IPP) in terms of Chapter VIIIA of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, as amended*

While this process of IPP is also economical, it restricts offer only to institutions, which may not show interest in the stock, being a mid-sized company. Therefore, the purpose may not be served.

(e) *Rights Issues to public shareholders, with promoter/promoter group shareholders forgoing their entitlement to equity shares, whether present or future, that may arise from such issue*

The promoters may also dilute their shareholding through issue of additional shares to the existing shareholders, other than promoters, on rights basis. However, this is again a time consuming process and may not get desired success unless the issue price is kept much lower than the market price of the shares. Further, this may bring down the market capitalization of the stock. Therefore, this option is not advisable.

(f) *Bonus Issues to public shareholders, with promoter/promoter group shareholders forgoing their entitlement to equity shares, whether present or future, that may arise from such issue*

Under this process the promoters are to forego their entitlement of bonus shares which is a loss for them.

(g) any other method as may be approved by SEBI, on a case to case basis.

Answer 1(d)

As reported, the company has allotted 1,67,304 lakh fully convertible debentures of ₹100 each to promoters which results into 1,67,304 additional shares upon conversion leading to increase in promoter holding beyond 75%. It will trigger takeover code under which the promoters have to offer to acquire the balance public holding and delist the company from the stock exchanges.

Alternatively, the promoters may plan the dilution of promoter holding to the necessary level to bring the minimum public shareholding as prescribed. However, disclosure has to be made to stock exchange and SEBI.

Answer 1(e)

OFS i.e. Offer for sale facilitates promoters of a listed company to dilute their existing shareholding through an exchange based bidding platform. The process is transparent, secure and convenient. Except promoters and persons acting in concert who are offering the securities, all class of investors can participate in buying the shares through OFS route. The following are the steps involved in OFS process:

- The promoter shall appoint a broker for OFS and declare the intention to sell shares at least one clear trading (on T-2 day, T being the day of OFS issue) day before trading starts. The announcements for OFS shall contain following details:
 - (i) Name of the Seller(s) i.e. Promoters/Promoter group entities/ Non-Promoter shareholder and the name of the company whose shares are proposed to be sold.
 - (ii) Name of the Exchange(s) where the orders shall be placed. In case orders are to be placed on both BSE and NSE, one of them shall be declared as the Designated Stock Exchange ("DSE").
 - (iii) Date and time of the opening and closing of the offer.
 - (iv) Allocation methodology i.e. either on a price priority (multiple clearing prices) basis or on a proportionate basis at a single clearing price.
 - (v) Number of shares being offered for sale.
 - (vi) The maximum number of shares that the seller may choose to sell over and above the offer made at point (v) above.
 - (vii) The name of the broker(s) on behalf of the seller(s).
 - (viii) The date and time of the declaration of floor price, if the seller(s) chooses to announce it to the market. Alternatively, a declaration to the effect that the floor price will be submitted to the DSE in a sealed envelope that shall be disclosed post closure of the offer.
 - (ix) Conditions, if any, for withdrawal or cancellation of the offer.
- The bids are accepted only for one day during trading hours.
- All orders must be backed by a margin as may be stipulated by an exchange from time to time.
- Orders will be allowed to be cancelled / modified only if they are supported by 100% upfront margin.
- If the seller chooses to declare floor price, it shall be declared after the close of trading hours. If the floor price is not to be declared, it shall be given in a sealed envelope before the opening of the offer which shall be disclosed at the end of the trading.
- 25% of the offer shall be reserved for mutual funds and insurance companies. Minimum 10% of the offer size must be reserved for the retail investors.

- No single bidder other than mutual funds and insurance companies shall be allotted more than 25% of the size of the OFS.
- Settlement takes place on T+1 basis.
- If the offer price is lower than the floor price, allotments take place on T+1 day and investors are credited with the share and promoters are given funds.
- Funds of the unsuccessful bidders will be returned by the exchange to the investors concerned.
- Brokers would issue contract notes to all successful bidders.

Question 2

(a) *XYZ Ltd. is considering merger with ABC Ltd. The shares of XYZ Ltd. are currently traded @ ₹25. It has 2,00,000 shares outstanding and its earnings after taxes (EAT) amount to ₹4,00,000.*

ABC Ltd. has 1,00,000 shares outstanding, its current market price is ₹12.50 and its EAT are ₹1,00,000. The merger will be effected by means of stock swaps (exchange). ABC Ltd. has agreed to a plan under which XYZ Ltd. will offer the current market value of the shares of ABC Ltd. :

- (i) *What are the pre-merger earnings per share (EPS) and P/E ratio of both the Companies ?*
- (ii) *If P/E ratio of ABC Ltd. is 8, what is the current market price of the share of the company ? What is the exchange ratio ? What will be the post-merger EPS of XYZ Ltd. ?*
- (iii) *What must the exchange ratio be for XYZ Ltd. so that pre and post-merger ratio be the same ?*

(10 marks)

(b) *Poor 'due diligence' erodes the confidence of public investing in capital markets. Justify and elaborate as to what constitutes due diligence.* (10 marks)

(c) *What are the norms for framing a corporate disclosure policy ?* (10 marks)

Answer 2(a)(i)

Pre-merger EPS and P/E Ratio of XYZ Ltd. and ABC Ltd.

Particulars	XYZ Ltd.	ABC Ltd.
Earning after taxes	4,00,000	1,00,000
No. Of shares outstanding	2,00,000	1,00,000
EPS (Earning after tax/No. of shares)	2	1
Market share per share (Rs.)	25.00	12.50
Price Earning (P/E) Ratio (Market Price / EPS)	12.50	12.50

Answer 2(a)(ii)

If the P/E Ratio of ABC Ltd. is 8, the Current Market price of ABC Ltd. shall be = ₹8
i.e. EPS * P/E (Rs. 1 x 8)

Exchange Ratio = ₹25/8 = 3.125 i.e. One share of XYZ Ltd. for every 3.125 Equity Share of ABC Ltd.

Post Merger EPS of XYZ Ltd.

$$\begin{aligned}
 &= \frac{[(\text{Rs. 4,00,000} + \text{Rs. 1,00,000})]}{[2,00,000 + (1,00,000/3.125)]} \\
 &= 5,00,000/2,32,000 \\
 &= ₹2.16
 \end{aligned}$$

Answer 2(a)(ii)**Desired Exchange Ratio**

Total No. Of shares in post-merged company = (Post-merger earnings)/ Pre-merger EPS of XYZ Ltd.

$$= 5,00,000/2 = 2,50,000$$

$$\begin{aligned}
 \text{Number of shares required to be issued} &= 2,50,000 - 2,00,000 \\
 &= 50,000
 \end{aligned}$$

$$\begin{aligned}
 \text{Therefore, the exchange ratio} &= 5,00,000/1,00,000 \\
 &= 0.50
 \end{aligned}$$

i.e. one share of XYZ Ltd. for every two Equity Shares of ABC Ltd.

Answer 2(b)

Due Diligence is nothing but an independent and a professional verification of material information required to be furnished in the prospectus for making informed investment decisions. Due diligence is with respect to financials (past, present, future), business opportunities, strengths and weaknesses of the business in which the company is operating, the litigation that the companies are drawn into including but not limited to the tax liabilities, the risk management systems in the company, internal controls, key managerial personnel, etc.

Areas for Due Diligence

Some of the areas under which documents are to be looked at in the due diligence process is as under:

Legal status of the company : A merchant banker has to review the Memorandum and Articles of Association of the company, its certificate of incorporation, commencement of business of the company, change of name certificate, history / businesses of the company, any special rights available to any shareholder through a special agreement, restriction on transfer of securities, etc.

Promoters/Key Managerial Personnel: The background / track record of the promoters, their experience, their credit worthiness, the organogram of the company, the emoluments of the promoters and the KMPs and the terms of contract of the KMPs, constitution of various Board Committees and their composition.

Financials : The major sources of revenue including the products and services and their contribution has to be identified. If any product is predominantly contributing for the revenue of the company, the stability of such revenue streams are to be examined. If the sales of the company are also predominantly to a small group of customers, the dependency of the same has to be highlighted as a major risk factor. Merchant bankers are also required to look at the internal control systems. The tax compliance status of the company and the disputes, if any, are required to be brought out. If there are many related party transactions which are contractual in nature, the contract terms have to be examined to ensure the pricing and other terms and conditions of the contract are fair and equitable. The age wise analyses of the debtors are also looked at. Also, any of the directors and relatives are forming part of such debtors has to be highlighted.

The due diligence should also focus on the likely scenario that the company may face if the projection given in the project feasibility report does not materialize. Some companies did raise huge sums of money in the past for general corporate purposes without fully explaining as to what constitutes such general corporate purpose requirements. The merchant bankers, as a part of due diligence, must examine the requirements of the company and the ability of the company to deploy the resources to earn competitive returns. The credit rating of the company and its directors and promoters is also required to be verified from independent sources. The merchant banker will be able to gather quality information about the company and its promoters only through interaction with its stakeholders such as creditors, suppliers, customers, employees, bankers, attorneys, etc. It will also involve substantial time and efforts. If these areas of due diligence are ignored to save cost and time, the quality will deteriorate which leads to erosion of investor confidence in the capital markets.

General Information : The Merchant Bankers shall also check details on litigations, disputes, overdue, statutory dues, other material development and tax disputes of the company and its promoters. Copy of documents for collaborations / marketing tie ups / other tie ups, if any, shall also be checked. Incentives, if any, such as subsidy, sales tax loans / exemptions / concessions / power subsidy etc. shall also be checked. Copies of the documents filed with the office of Registrar of Companies and the reasons for delays in filing of such documents should also be verified by the Merchant Banker. Details of patents, trademarks, copyrights, licenses etc. shall also be reviewed.

Answer 2(c)

Schedule II of SEBI (Prohibition of Insider Trading) Regulations, 1992 prescribes about the code of corporate disclosure practices for prevention of insider trading. To ensure proper and timely disclosure of price sensitive information, the following disclosure norms shall be followed by listed companies as prescribed under SEBI (Prohibition of Insider Trading) Regulations, 1992:

Prompt disclosure of price sensitive information: The Company shall promptly notify the price sensitive information to the stock exchanges and disseminate on continuous and immediate basis before the same are made public. Companies may also consider

ways and means of improving investor access to their public announcements through flashing the same on their own websites.

Overseeing and coordinating disclosures : A senior official of the company such as compliance officer shall oversee timely dissemination of price sensitive information to stock exchanges, analysts, shareholders and media. The senior official shall also educate other staff members who are handling price sensitive information about the disclosure policy and procedures. If there is an inadvertent error committed by any member of the staff in accidentally disclosing the information without the prior approval of the senior official, the same should be brought to the notice of the designated officer immediately.

Responding to market rumours : When exchanges seek information from companies based on market rumours, newspaper reports, etc., a designated official shall decide whether a public announcement is necessary for confirming or denying rumours and to make submission accordingly to the stock exchange.

Timely reporting of shareholders/changes in ownership : Whenever material changes in shareholding pattern takes place it shall be reported to the exchange promptly.

Briefing analysts/institutional investors : As a listed company, only publically available information is to be shared with analysts and institutional investors. Alternatively, the information given to the analysts should be simultaneously made public through exchanges and the websites. The discussions with analysts, brokers must be recorded to avoid misquoting and misinterpretations. During the meeting with analysts if any unanticipated questions are responded which is not in the public domain, the same shall be intimated to the exchanges. Ideally, live webcasting of analysts meet will take care of unintended lapses.

Medium of disclosure/dissemination : Dissemination of information by the company may be done through various media to ensure maximum reach with the least time taken. The company may also post it on its website, which not only provides various announcements made by the company to investors but also the analyst briefing material, the background information and question and answers.

Question 3

Explain briefly about money market mutual funds (MMMFs).

(5 marks)

Answer 3

One of the recent developments in money market is the establishment of Money Market Mutual Funds, the guidelines of which have been prescribed by the Reserve Bank of India. These can be set up by the Banks and Financial Institutions. There can also be Money Market Deposit Accounts (MMDAs). The main features are given below:

- (a) *Limit* : The resources raised under Money Market Mutual Funds should not exceed 2% of the sponsoring bank's fortnightly average aggregate deposits. If the limit is less than 50 crores for any bank, it may join with some other bank for the purpose. In case of Financial Institution, the limit should not exceed 2% of the long term domestic borrowings as per latest audited balance sheet.
- (b) *Eligibility* : MMMFs are primarily intended for individual investors including NRIs who may invest on a non-repatriable basis and would be free to determine the minimum size of the investment by a single investor.

- (c) *Minimum Rate of Return* : There is no guaranteed minimum rate of return.
- (d) *Lock-in Period* : The minimum lock-in period is 46 days.
- (e) *Deployment of Capital* : The resourced mobilized by MMMFs should be invested exclusively in various Money Market Instruments.
- (f) *Money Market Mutual Funds Investment Limits* :
 - (i) Treasury Bills and dated government securities having unexpired maturity up to one year- Minimum 25%
 - (ii) Call/Notice Money- Minimum 30%
 - (iii) Commercial Paper – maximum 15%. The exposure to CP issued by an individual company should not be more than 3%
 - (iv) Commercial Bills accepted/co-opted by Banks- Maximum 20%
 - (v) Certificate of Deposits- No limits.

Question 4

What do you understand by exchange traded funds (ETFs) ? Briefly discuss the various types of ETFs traded on stock exchanges. (5 marks)

Answer 4

Exchange Traded Funds (ETF) are essentially index funds that are listed and traded on exchanges like other stocks. ETFs are ideal for investors who are satisfied with a return approximately equal to that of an index. ETFs enable investors to gain broad exposure to entire stock markets as well as specific sectors with relative ease, on a real time basis and at a lower cost than many other forms of investing. An ETF is a basket of stocks that reflects the composition of an index, like S&P CNX Nifty, BSE Sensex, CNX Bank Index, CNX PSU Bank Index etc. The ETFs trading value is based on the net asset value of the underlying stocks that it represents. It is a security that tracks an index, a commodity or a sector like an index fund or a sectoral fund and trades like a stock on an Exchange. It is similar to a close-ended mutual fund listed in Stock Exchanges. ETFs experience price changes throughout the day as they are brought out and sold.

Different types of ETFs

- (a) *Equity ETFs* : It is a basket of stocks that reflects the composition of an index,
- (b) *Gold ETFs* : These are units representing physical gold which may be in paper or dematerialized form. These units are traded on Exchanges like a single stock of any company.
- (c) *Liquid ETFs* : These are funds whose unit price is derived from money market securities comprising of government bonds, treasury bonds, call money market, etc.

Question 5

What do you understand by investible weighted factors (IWFs) ? Explain with the help of an example. (5 marks)

Answer 5**Investible Weight Factors (IWF)**

This is a unit of floating stock expressed in terms of a number available for trading and which is not held by entities having strategic interest in a company. Higher IWF suggest greater number of shares held by the investors as reported under public category within a shareholding pattern reported by each company.

The IWF for each company in the index are determined based on the public shareholding of the companies as disclosed in the shareholding pattern submitted to the stock exchanges on quarterly basis.

Example : For XYZ Ltd.

	Shares	%
Total Shares	1,00,00,000	100
	Shares	%
Shareholding of Promoters and Promoter Group	19,75,000	19.75
Govt. holding in the capacity of strategic investor	50,000	.50
Shares held by Promoters through ADR/GDR	2,50,000	2.50
Equity held by Associate/Group Companies (Cross-holdings)	12,575	0.13
Employee Welfare Trusts	1,45,987	1.46
Shares under Lock-in Category	14,78,500	14.79

IWF=

Question 6

What do you understand by a designated depository participant (DDP) ? Describe the eligibility criteria required to be fulfilled to become a DDP. (5 marks)

Answer 6

Designated Depository Participant means a person who has been approved by SEBI under chapter III of SEBI (Foreign Portfolio Investors) Regulation, 2014. A person shall not act as Designated Depository Participant unless it has obtained the approval of SEBI.

Eligibility Criteria for DDP

SEBI shall grant to a person to act as DDP subject to satisfaction, inter alia, the following conditions:

- (a) The applicant is a participant and custodian registered with the SEBI,
- (b) The applicant is an Authorised Dealer Category-1, bank authorized by the Reserve Bank of India.
- (c) The applicant has multinational presence either through its branches or through agency relationships with intermediaries regulated in their respective home jurisdictions.
- (d) The applicant has systems and procedures to comply with the requirements of FATF Standard Prevention of Money Laundering Act, 2002 and the Rules and Circulars prescribed there under.
- (e) A certificate of registration granted to a DDP shall be permanent unless suspended or cancelled by SEBI or surrendered by the DDP.

INSURANCE LAW AND PRACTICE

(Elective Paper 9.3)

Time allowed : 3 hours

Maximum marks : 100

NOTE : Answer **ALL** Questions.

Question 1

R Ltd. is a public limited company and is engaged in procurement of rice and its exports. In the course of its business, it has utilised godown facilities offered by the port authorities for storing rice bags awaiting shipment. Right from the commencement of its business, it has covered the risks under a fire insurance policy taken from a very reputed public sector general insurance company. The insurer has been servicing the account through one of its development officers. The policy period normally runs between the first of July of one year and the end of June of the subsequent year.

There were cyclonic storms and heavy rains on 22nd and 23rd July, 2010 resulting in severe flooding of the godowns of the port trust where R Ltd. had stored rice bags awaiting shipment. On ceasing of the rains on 25th July, 2010, R Ltd. found that most of the rice bags stored in the port godowns had either been damaged or washed away. The doors of the godowns had been lifted and carried away by the rainwater and except for some clusters of rice grains found on the floors of the godown here and there, the entire stock of rice had been washed away. The insured immediately lodged a claim with the insurer asking for a compensation in terms of the fire policy.

On examination of the case, the insurance company noticed the following :

The policy was due for renewal on 1st July, 2010. A notice for the payment of the premium had been issued to the insured and served on it. The insured had drawn a cheque on 28th June, 2010 on its bankers for the insurance premium due on the basis of the premium notice and had handed over the cheque to the development officer servicing the amount, on the evening of 30th June, 2010. This was duly acknowledged by the development officer, who also issued a cover-note for the oncoming period. The cheque was deposited by the development officer with the insurer's branch to which he was attached on 17th July, 2010 when he returned to the headquarters from his officials tour. The branch officials deposited the cheque into the insurance company's bank account on 18th July, 2010 and the bank credited the account with the premium on 25th July, 2010 because of the intervening public and bank holidays. The regular policy for the year 2010-11 was not issued by the insurance company till the event of loss. The insured had enjoyed the cover with the same insurance company from the year 2003-04 and no major loss claim had been made by R Ltd. so far on the insurance company.

On receipt of the claim paper from R Ltd., the insurance company's claims department made an analysis of the same and sent a reply to R Ltd. rejecting the claim for the following reasons :

- (i) *The insurance company was not on cover at the time of the loss since no premium had been paid by R Ltd.*

- (ii) *The premium was received on 25th July, 2010 after the loss had occurred and hence no insurance policy can be granted.*
- (iii) *Loss due to floods is not covered under a fire policy.*
- (iv) *The cover note issued by the development officer did not bind the insurance company.*

On receipt of this reply, R Ltd. has approached you for advice on the resolution of the dispute. One of the methods suggested by R Ltd. was to proceed against the insurer before the insurance Ombudsman. R Ltd. also felt that the IRDA could be approached directly for the resolution of the dispute.

Additional facts that may assist in the formation of your views are as follows :

- (a) *Goods stored in the godowns were 20,000 tonnes of rice whose cost of acquisition was ₹200 crore. The quantum of storage was supported by independent stock registers maintained by the port authorities.*
- (b) *The district collector of the area, who was appointed by the State Government as the Relief Commissioner, certified that all the goods in the godowns were lost in the floods and there existed no salvage.*
- (c) *The stocks in the godowns carried an insurance cover for ₹250 crores.*
- (d) *A public sector bank had advanced ₹80 crore against the stock in the godowns and on the date of flood loss, the outstanding loan amount was ₹75 crore. The bank has lodged independently a claim with the insurance company asking the insurer to pay the claim directly to it against the loan outstanding.*

In the backdrop of the above information, make an assessment of the situation and form your opinion on the following issues :

- (i) *Whether a cover for insurance existed on the day of the accident ? (10 marks)*
- (ii) *Whether the claim was covered in terms of a fire policy. Also indicate what type of losses are not covered under a fire policy ? (10 marks)*
- (iii) *Whether the IRDA can intervene in the matter, on behalf of the insured/Bank for settlement ? (10 marks)*
- (iv) *Whether the insured is entitled to any claim under the policy from the insurer ? (5 marks)*
- (v) *If the claim has arisen, the amount of the same ? (5 marks)*
- (vi) *Whether the insured company can approach the insurance Ombudsman for the settlement of the claim ? (5 marks)*
- (vii) *Whether the lender bank has an insurable interest in the property and hence be a party to the claim settlement ? (5 marks)*

Answer 1

This question brings into focus all the aspects of insurance claims management and requires a sound knowledge of principles and practice of insurance. Considering the various facts of the case, the answers to the various questions raised are as under:

(i) Whether a policy existed on the date of occurrence of fire:

It is clear that on the facts of the case, there existed a fire cover. It is to be borne

in mind that the company has been taking the Policy with this Insurance Company for over 20 years and had a fire cover without break for this particular risk. The company obviously was a reputed exporter and has extensively used the port facility for storage and dispatch etc. These facilities are run by independent statutory bodies and thus be trusted with the facts. The period for cover was to start on 1st July. A premium notice based on the existing policy coverage, terms & conditions was issued by the insurance company before the expiry of the existing policy and the client R has issued the renewal premium cheque for the same and handed the same to the development officer- an employee of the insurer and noting at its records. Development Officer is the employee of the Insurance company and hence an authorised representative. He had received the cheque on 30th June- before the expiry of the current policy and also had acknowledged it by issue of a cover note pending issue of the policy document. The development officer is an authorised official to issue cover note and in fact it is part of his assigned duties to issue one, it is in clear position in law that a cover note is a valid document that brings into existence the relationship of insurer and insured between the parties and has a validity for 60 days by when the normal formalities of issue of a policy could be completed.

The second feature is that the cover is not a new one but is only a renewal of the existing policy on the same terms as agreed to between the parties earlier. Thus it is clear that there exists a contract between the Parties, a valid Insurance Contract between the two parties on the subject matter of cover.

The third feature to be noticed is the provision of section 64VB of the Insurance Act which clearly stipulates the payment of premium in advance before commencement of the of the cover. Facts indicate that the amount of premium was collected by the Development Officer of the Insurance company on 30th June, 2010- a day prior to the commencement of the next year of risk cover. The insurer lodged the cheque for collection on the same day but the banker credited the insured account only on 24th July due to intervening government and bank holidays. However, it shall be noted here that once the premium is received by the Insurance Company, the Risk is deemed to have been commenced and it is immaterial when they deposited the Premium cheque in their accounts. Another point to be noticed is that the cheque was honoured on presentation and that there was no indication that the customer had no balance in his account, the cheque was liable to be dishonoured on presentation etc. Issue of a cheque and its collection were a part of normal commercial activities. Thus it has to be concluded that the payment of the premium has been made by R in the normal course and section 64VB's requirement has been complied with in all aspects. Thus all the pre-requisite for the coming into existence of a fire policy has been satisfied and as on the date of the accident, a valid insurance cover existed in favour of R.

(ii) Whether claim was covered in terms of policy:

The cover that existed was a fire policy- *prima facia* a standard one. This policy generally covers losses arising out of fire and special allied perils such as storms, floods, typhoon, earthquake, inundation, lightening, strikes, and landslides. In the case of Standard Fire Policy with Special Perils covered, the risks of Storm,

Cyclone, Flood, Inundation and Earthquake risks are covered on payment of applicable additional premium. In the present case, the cause for loss is damage due to storms flooding and consequent inundation, it is noticed that such a risk is covered under the standard fire policy, subject to other conditions being satisfied, the insurer is liable for the losses.

A standard fire policy usually does not cover losses on account of damages caused by war and warlike operations, nuclear perils, pollution or contamination, electrical or mechanical breakdowns, burglary and housebreaking.

(iii) Whether R can approach IRDA for settling the issue

IRDA is the Regulatory Authority or insurance business in India. The Act that established it has defined its powers under section 14 and apart from other duties outlined in the section, the following is clearly indicated "to protect the interest of the policy holder with regard to settlement of claims and other terms and conditions".

This specific object of the IRDA has to be invoked by R to support his claims for IRDA's intervention in regard to this matter if the insurer does not act fairly and reasonably in the matter. The fact outlined in the question clearly established on liability of insurance company towards R- claims whether there existed a policy. Whether fire perils covered flood losses etc.- and it will, therefore, be very appropriate if R approached IRDA seeking its intervention. Whilst IRDA may intervene in this case and issue a direction to a public sector company, consider different on the part of R and the public sector bank which has lent money to R may result in IRDA deciding to intervene.

Past records establish the fact in an identical case, where a client has approached IRDA for its intervention when its long period of negotiation with a public sector insurance company did not result in any solution. After examining all the factors IRDA decided to intervene and passed an order directing the insurer to pay the claim. The insurer not satisfied with the IRDA's direction, took the matter in appeal to the court which clearly indicated that IRDA did have the powers and infact an obligation to intervene on behalf of the insured. That step will not only be necessary to protect the interest of a policy holder but represented wholly and truly authority, obligation to control, nurture and develop the insurance industry.

Following this example, therefore it will be easy to state that IRDA has the powers of intervention under section 14 of the IRDA Act and such a move may not only be a necessity but decisive.

(iv) Whether any liability accrued on the part of the insurer

Yes, Insurers are liable for the loss as per the terms and conditions of the Policy because two important conditions have been fulfilled/ / Firstly there exists the policy coverage. Secondly the policy is valid as on the date of loss. Thirdly, the loss occurred due to a peril covered under the policy issued. With the client / policy holder complying with all the required formalities, the insurer is liable for the loss.. The client has also informed the insurer of the accident immediately after it knew of its occurrence. Therefore it has to be concluded that there existed a policy on the date of the event in terms of which a claim has to be settled.

(v) If the claim has arisen, the amount of the claim

We have already noticed that under a valid policy in existence, a claim has arisen. It has to be assessed and the amount of compensation has to be determined. To assess the damage, the insurer has to appoint a surveyor who has to finalise his assessment to the insurer based on the documents submitted and facts of the case and this assessment will form the basis for settlement. In the present case, the loss has been established independently in that stocks those were in the garden. 20,000 tonnes of rice had been verified by the stock record maintained by the Port Trust which is an independent statutory authority. Its certificate can be accepted *prima facia*. In addition, physical examination of the Godown established the fact that the entire stock at Godown had been either damaged or washed away due to the force of the storm coupled with heavy rain and there was no salvage at the godown. The district collector who also was the Relief commissioner had confirmed about the total loss of the stock. It is thus crystal clear that the entire stock had been lost. Hence this is a claim for total loss and accordingly the total cost of the stock is payable.

(vi) Approach to Insurance Ombudsman

The establishment of Ombudsman at different parts of the country is a facility to enable insured to get an opportunity to settle outstanding issues at no cost. An insured can approach an Ombudsman with his case for settlement when the insurance company refuses to accept the claim or settle it at lower value than expected by the insured. The only drawback to this facility is that commercial claims of more than ₹20 lakh cannot be referred to Ombudsman. In this case R cannot go to the Ombudsman to settle the claim since loss amount is above the limit. Alternative available is to move the Consumer Courts where no such limit of loss is fixed.

(vii) The interest of the lender bank

The bank had advanced money to R on the stock held in Port godowns to the extent of ₹80.00 Crores and as on the date of loss had an outstanding of ₹75 crore due to it. This makes the bank as a Party with an insurable interest which will permit it to raise with the insured the question of the settlement of the claims. It will be within the rights of the bank to have the claim amount, to the extent of amount of the loan outstanding, to be released to it.

Question 2

- (a) *Indicate the pre-conditions that must exist for an effective supervision to enforce the core insurance principles of the International Association of Insurance Supervisors (IAIS).* (10 marks)
- (b) *It is generally believed that an insurance contract wholly and fully handles and eliminates all risks. Do you agree with the statement ? Discuss.* (10 marks)
- (c) *Distinguish between 'insurance contracts' and 'wagering agreements'.* (10 marks)

Answer 2(a)

An effective system of insurance supervision needs a number of external elements,

or preconditions, on which to rely as they can have a direct impact on supervision in practice. The preconditions include:

- *Sound and sustainable macroeconomic and financial sector policies* : Sound macroeconomic policies must be the foundation of a stable financial system. This is not within the mandate of supervisors, although they will need to react if they perceive that existing policies are undermining the safety and soundness of the financial system. In addition, financial sector supervision needs to be undertaken within a transparent government policy framework aimed at ensuring financial stability, including effective supervision of the insurance and other financial sectors
- *A well developed public infrastructure* : A well developed public infrastructure needs to comprise the following elements, which if not adequately provided, can contribute to the weakening of financial systems and markets or frustrate their improvement:
 - a system of business laws, including corporate, insolvency, contract, consumer protection and private property laws, which is consistently enforced and provides a mechanism for the fair resolution of disputes;
 - an efficient and independent judiciary;
 - comprehensive and well defined accounting principles and rules that command wide international acceptance;
 - a system of independent audits for companies, to ensure that users of financial statements, including insurers, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;
 - the availability of skilled, competent, independent and experienced actuaries, accountants and auditors, whose work complies with transparent technical and ethical standards set and enforced by official or professional bodies in line with international standards and is subject to appropriate oversight;
 - well defined rules governing, and adequate supervision of, other financial sectors and, where appropriate, their participants;
 - a secure payment and clearing system for the settlement of financial transactions where counterparty risks are controlled; and
 - the availability (to the supervisor, financial services and public) of basic economic, financial and social statistics.
- *Effective market discipline in financial markets* : Effective market discipline depends, in part, on adequate flows of information to market participants, appropriate financial incentives to reward well managed institutions, and arrangements that ensure that investors are not insulated from the consequences of their decisions. Among the issues to be addressed are the existence of appropriate corporate governance frameworks and ensuring that accurate, meaningful, transparent and timely information is provided by borrowers to investors and creditors.

- *Mechanisms for providing an appropriate level of protection (or public safety net):* In general, deciding on the appropriate level of policyholder protection is a policy question to be addressed by the relevant authorities, particularly if it may result in a commitment of public funds. Supervisors will normally have a role to play because of their in-depth knowledge of the entities involved. They should be prepared, as far as possible, and equipped to manage crises involving insurers. Such mechanisms of protection could include a system of policyholder compensation in the event of insolvency of an insurer. Provided such a system is carefully designed to limit moral hazard, it can contribute to public confidence in the system.
- *Efficient financial markets :* Efficient financial markets are important to provide for both long-term and short-term investment opportunities for insurers. They facilitate the assessment of the financial and risk position of insurers and execution of their investment and risk management strategies. When the financial market loses its efficiency, assessment of financial and risk positions can be more challenging for both insurers and supervisors. Therefore, supervisors will need to give due consideration to the impact of financial market efficiency on the effectiveness of their supervisory measures.

As these preconditions are normally outside the control or influence of the supervisor, the supervisor should not be assessed against these preconditions. However, the preconditions can have a direct impact on the effectiveness of supervision in practice. Therefore, where shortcomings exist, the supervisor should make the government aware of these and their actual or potential negative repercussions for the supervisory objectives and should seek to mitigate the effects of such shortcomings on the effectiveness of supervision. The supervisor should have the necessary powers to make rules and establish procedures to address shortcomings. Where the preconditions for effective insurance supervision are not yet met, the supervisor should have additional powers or adopt other measures to address the weaknesses.

Answer 2(b)

One of the essential components of management is planning and control and once a risk is identified and analysed, it is important to plan and adopt a suitable strategy for effective controlling. Risk planning and controlling is the stage that comes after the risk analysis process is over. There are five methods of handling and controlling risk and these are –

- (a) Risk avoidance
- (b) Risk retention
- (c) Risk transfer
- (d) Loss control and
- (e) Insurance

Of all the methods stated above, Insurance is a method of risk financing or loss financing, which is used to guard against the risk of losses. Losses are guarded against by transferring the risk to another party through the payment of an insurance premium, as an incentive for bearing the risk. Insurance is a more commonly known concept that

describes the act of guarding against risk. An insured is the party who seeks to obtain an insurance policy while the insurer is the party that shares the risk for a paid price called an insurance premium. However, it is to be noted that an insurance cover does not wholly or fully handles or eliminates all risks. Insurance does not eliminate risk. It only compensates or indemnifies for the losses as per the policy conditions and provisions. Therefore, an Insurance policy pays compensation only if a loss has occurred due to insured perils or insured risks and for insured properties.

Purchasing insurance, however, is not risk management. A thorough and thoughtful risk management plan is the commitment to prevent harm. Risk management also addresses many risks that are not insurable, including brand integrity, potential loss of tax exempt status for volunteer groups, public goodwill and continuing donor support.

Further Insurance is primarily concerned with risks that have a financially measurable outcome. But not all risks are capable of measurement in financial terms. One example of a risk that is difficult to measure financially is the effect of bad publicity on a company-consequently this risk is very difficult to insure. However, this is a good point to stress how innovative some insurers are in that they are always looking for ways to provide new covers, which the customers want. The difficult part is to be innovative and still make a profit.

It is thus that the concept of insurance is only one of the methods of risk management and is practised in useful situations. It must be noted here that the Insurance contract covers only all pure risks and not speculative risks. Further, all risks Insurance policy covers all the risk, it is a myth. The fact is all policies are subject to certain exclusions.

Answer 2(c)

The following are the points of distinction between Wagering Agreement and Insurance Contracts:-

- (a) The parties have no Insurable Interest in Wagering Agreement. An Insurance Policy on the other hand must have an Insurable Interest.
- (b) In Wagering Agreement, neither party has any interest in the happening or non-happening of an event. In Insurance Contract however, both parties are interested in the subject matter.
- (c) Contract of Insurance generally is contracts of Indemnity except Life Insurance which is a benefit policy. Wagering Agreement however, is a conditional Contract.
- (d) Insurance Contracts are based on Scientific and Actuarial evaluation of Risk. Wagering Agreement is a gamble without any scientific evaluation of risk.
- (e) Insurance Contracts are beneficial to the public and hence encouraged by the state. Wagering agreement serve no useful purpose.
- (f) A Contract of Insurance is a valid contract enforceable in a Court of Law. On the other hand, a Wagering Agreement is void and illegal.

Question 3

Write a note on 'warranties in marine insurance'.

(5 marks)

Answer 3

A warranty means a condition or a stipulation or term, in a Policy the breach of which entitles the Insurer to make the insurance policy altogether invalid and void and any loss may not be paid under the Policy and this is so even though the breach arises through circumstances beyond the control of the warrantor. The following warranties are generally recognised under the Marine Insurance Act:

- (a) warranty of neutrality
- (b) warranty of good safety
- (c) warranty of sea worthiness of the ship/vessel
- (d) where the policy relates to a voyage performed in different stages, during which the ship require different kinds of or further preparation or equipments for the purpose of that stage
- (e) in a time policy there is no implied warranty that the ship shall be sea worthy at any stage of the adventure but where, with the privity of the assured, the ship is sent to sea in a unseen worthy condition, the insurer is not liable for loss attributable to unseen worthiness
- (g) in a voyage policy on goods or other movables, there is an implied warranty that at the commencement of the voyage the ship is not only sea worthy as a ship but also that it is reasonably fit to carry the goods or other movables to the destination by the party
- (h) warranty of legality
- (i) warranted that goods are packed in suitable condition to withstand the normal transit damages.

Question 4

Explain the concept of 'trust in life policy'.

(5 marks)

Answer 4

The concept of trust in life policy is necessitated by the applicability of estate or death duty on transfer/of benefits under a life policy including annuities. Since estate duty has been established in India, the concept of trust may no longer be relevant.

Section 6 of the Married Women's Property Act, 1874 provides for a security of benefits under a life insurance policy to the wife and children.

A trust under a life insurance policy is created by the policy holder on his own life and where the survival benefits incur to the policy holder. The trust set up is under an irrevocable, non- amendable, trust deed and can cover one or more life policies. It is important to appoint a trustee for administration of the trust property, being the benefits under the life policy. By creating a trust for the policies, the policy holder gives up his rights under the policy (ies) and upon the death of the assured, the trustee invests the insurance proceeds and administrates the trust for one or more beneficiaries. While it is a practise to create the trust for the benefit of one's spouse and children, the beneficiaries can be any other legal person. Creation of a trust ensures that the proceeds of the policy are invested wisely during the minority of the beneficiaries and also secure the amount against creditors.

Under the Married Women's Property Act, 1874 a trust gets created when a policy of insurance is effected by a married man on his own life but expressed on the face of it to be for the benefit of his wife or of his wife and children or any one of them, so long as any object of the trust remains, no part of the estate shall be subject to the control of the husband or his creditors and the amount held by the trust shall not form part of the husband's estate.

Creation of a trust does not generally impose the right of any creditor to be paid out of the proceeds of any policy of insurance which may have been effected with an intent to defraud the creditors.

Question 5

How does 'insurance' differ from 'hedging'? (5 marks)

Answer 5

Though both Insurance and Hedging techniques are similar in that risk is transferred by a contract and no new risk is created, there are major differences between them which are as under:-

- (i) Insurance transactions involve transfer of Insurable risk which can generally be met. Hedging on the other hand is a technique of handling risks that are typically uninsurable, for example protection against decline in the price of agriculture products and raw materials. Which are speculative risks and not pure and insurable risks
- (ii) Insurance can reduce the risk of an insured by the law of large numbers. In contrast, Hedging risk typically involves only risk transfer, not risk reduction
- (iii) In an insurance contract, both the parties win if the loss does not occur, while in an hedging contract, the risk of adverse price fluctuation is transferred to speculators who believe that they can make a profit because of superior knowledge of market conditions. Thus mere transfer of risk takes place, but no reduction.

Question 6

Describe the rules of interpretation of a policy. (5 marks)

Answer 6

Like any other contract, disputes do arise in Insurance contracts, regarding liability, quantum, extent and duration of cover, especially in cases where the insurer may have earlier repudiated the claim. It follows therefore, that interpretation of the policy document, is of paramount importance even at the time of inception and during the currency of the policy and not only in a court of law. In case of any difficulty in understanding the language or rules of the contract, the policy document being a standard document, drafted by the insurer, the benefit of doubt is always in favour of the insured, as a principle of natural justice. This is as per the *doctrine of contra preferentum* rule which states that where the contractual language is capable of alternative interpretations, it will be construed or translated in favour of the insured, who accepts the standard contract. Therefore, the following rules for interpretation of the policy are applied:

1. Printed and written portion of the policy is to be construed together as far as possible.

2. In case of contradiction, the written portion over-rides the printed portion.
3. The policy is to be interpreted as a whole.
4. The words in the policy are to be given their plain, ordinary and popular meaning.
5. Technical words are to be given their strict technical meaning.
6. The ordinary rules of grammar shall apply.

INTELLECTUAL PROPERTY RIGHTS – LAW AND PRACTICE

(Elective Paper 9.4)

Time allowed : 3 hours

Maximum marks : 100

NOTE: Answer **ALL** Questions.

Question 1

Sorafenib Tosylate is a compound patented by Bayer Corporation (Bayer), a renowned USA based developer and manufacturer of innovative drugs. It is marketed as NEXAVAR (the Drug) and is used in the treatment of advanced stages of kidney cancer and liver cancer. The drug is life-extending drug and not a life-saving drug. It can increase the life of a kidney cancer patient by 4-5 years and that of a liver cancer patient by 6-8 months.

Bayer was granted a patent as well as regulatory approval for importing and marketing the Drug in India in the year 2008. Bayer does not hold a manufacturing approval in India, but has only a marketing and import license.

Natco Pharma (Natco) filed an application in July, 2011 under section 84(1) of the Patents Act, 1970 for grant of Compulsory Licence (CL) in respect of Sorafenib Tosylate covered under Bayer's patent. In its application, Natco proposed to sell the drug at a price of INR 8,800 (about USD 175) for one month therapy as against Bayer's INR 2,80,428 (about USD 5,600) for one month therapy.

*The Controller of Patents (Controller), upon noting that 3 years had elapsed since the grant of patent and being satisfied that a *prima facie* case existed, issued an order for publishing the CL application in the official journal. Upon this, Bayer filed its opposition to the CL application. Each party filed its respective evidence. The parties were given a hearing by the Controller.*

Natco urged that as per GLOBOCAN 2008, there were 20,000 patients of liver cancer and 8,900 cases of kidney cancer in India. Assuming 80% of patients needed the Drug treatment, approximately 23,000 patients required the Drug. According to the Form 27 (statement of working of Patents) filed by Bayer, they imported no units in 2008 and approximately 200 bottles in 2009 and no further units in 2010. Hence, the reasonable demand or requirement of the public was not being met. Natco argued that Bayer did not manufacture the Drug in India but imported it and that it was exorbitantly priced and usually out of stock and available only in pharmacies attached to a few hospitals in metro cities. Bayer launched the product worldwide in 2006 and made thumping sales to the tune of USD 2,454 million dollars. Thus, the insignificant number of bottles imported in India showed Bayer's neglectful conduct.

Bayer responded by demonstrating that the actual number of patients of kidney and liver cancer requiring treatment was 8,842 and not 23,000. The Drug was being made available by Bayer to all cancer treatment centres in India.

This objection was dismissed by the Controller on the basis that as per Form 27 filed by Bayer at the Patent Office, Bayer had imported grossly inadequate quantities

of *NEXAVAR* in the previous 3 years – which was ample material that a *prima facie* case had been made out. Furthermore, the Controller observed that the number of patients needing the Drug would be much higher than 8,842 and that as per Bayer's own numbers they had been able to supply the Drug to not more than 200 patients which is a mere 2% of the 8,842 patients who, according to Bayer's own estimate needed the Drug. He ruled that Bayer's conduct was not justifiable as it was already marketing the drug worldwide since 2006.

The next argument advanced by Natco was that the price of the patented product was too high and therefore the patented invention was not available to the public at reasonably affordable prices. The exorbitant pricing was an abuse of its monopolistic rights and amounted to unfair and anti-competitive practice. Bayer countered this by contending that innovative drugs cost significantly more than generics since the innovator's costs included R&D expenses which generics did not incur as they merely copied the drugs. The higher price included the costs of failed projects also which accounted for nearly 75% of total R&D cost. According to Bayer, it took an investment of more than €2 billion to bring a new medical entity (NME) to the market. Also, the price being charged by Bayer was comparable to other oncology drugs of innovation-based companies. Replacing innovative drugs with generics would in the long-run damage patients as originators also provided for the education of doctors and pharmacovigilance which generics did not. Only the patentee, being the innovator and having invested in the R&D would be able to determine what would constitute a 'reasonably affordable price' for the Drug. The term reasonable should be construed as to mean reasonable for both the patients and the patentee and a 'reasonable' price is needed to factor in R&D costs and reasonable commercial gain.

Bayer argued that 'public' denoted different sections of public – rich class, middle class and poor class. A blanket CL which gave the patented product at the same price to all sections of the public was not reasonable, amounted to treating 'unequal as equal' and was discriminatory. A CL would lower the price of a patented product even for people who could pay – which could not be the intention of the Legislature. One of the ways by which people afford medical treatment is medical insurance. 'Affordability' should be determined by asking whether the patient could afford insurance cover or not.

The Controller in his decision agreed with Bayer that public included different sections of the public, but also observed, that Bayer was free to have offered differential pricing to different classes, but chose not to. The Controller partially disagreed with Bayer that in determining reasonableness, both the Patentee and the public needed to be factored in, but observed that "reasonably affordable price has to be construed predominantly with reference to public." The Controller added that the sales by Bayer during previous 4 years constituted only a fraction of the requirement of the public and came to the conclusion that lower sales had been due to high price of the patented product. Therefore, the Controller held that the Drug was not available to the public at a 'reasonably affordable price'.

Natco advanced another argument that patented invention was not worked by Bayer in the territory of India. Natco pointed out to the Controller that since the Drug was being imported, it was not being commercially worked in India. Bayer responded by contending that the 'working' requirement of section 84(1)(c) of the Patents Act,

1970 did not mean that the patented product had to be locally manufactured. According to Bayer 'working' of a patent would mean that there should be a supply of the patented product in the territory of India. Bayer also argued that it had centralised its manufacturing in Germany for reasons of economies of scale and for maintaining high quality.

The Controller relied on Paris Convention, TRIPS Agreement, the unamended Patents Act of 1970 and in particular sections 84(7), 83(b) and 90(2) thereof to come to the conclusion that importation would not amount to working of a patented product. He observed that the term 'work the invention' did not include imports as a CL holder had to necessarily work the patent by manufacturing the patented invention in India.

The Controller granted a non-exclusive and non-assignable CL to Natco, solely for the purpose of making, using, offering to sell and selling the Drug for the purpose of treating kidney and liver cancer patients within the territory of India, adding that the Drug would have to be manufactured by Natco in its own manufacturing facility only and not outsourced.

Thereafter, Bayer filed an appeal challenging the order of the Controller before the Intellectual Property Appellate Board (IPAB). The IPAB, in March 2013, dismissed the appeal and upheld the decision of the Controller. However, in the order IPAB raised the rate of royalty to be paid by Natco to Bayer from 6% to 7%.

Bayer challenged IPAB's order before the High Court of Bombay by way of a writ petition. The HC examined the relevant provisions of the Act and upheld IPAB's Order and ruled that in respect of medicine the adequate extent for meeting the demand of the drug should be 100%. It further held that dual pricing could be applied to meet the requirement of the public and not for making available the drug under reasonably affordable price.

In the light of the aforesaid case and the relevant provisions of the Indian Patent Act (as amended), answer the following :

- (i) Under what circumstances can CL be granted ? (5 marks)
- (ii) In considering the application for CL, what factors are required to be taken into account by the Controller ? (10 marks)
- (iii) While settling the terms and conditions of a CL, what factors does the controller secure ? (15 marks)
- (iv) Is manufacture in India the sole method of working a patent in the territory of India? Do you agree with the Controller's decision on this question ? (10 marks)
- (v) Under what exceptional circumstances can CL be granted for export of patented pharmaceutical products ? (10 marks)

Answer 1(i)

The provisions for compulsory licenses are made to prevent the abuse of patent as a monopoly and to make the way for commercial exploitation of the invention by an interested person. According to section 84 of the Patents Act, 1970, any person interested can

make an application for grant of compulsory license for a patent after three years from the date of grant of that patent on any of the following grounds —

- (a) that the reasonable requirements of the public with respect to the patented invention have not been satisfied, or
- (b) that the patented invention is not available to the public at a reasonably affordable price, or
- (c) that the patented invention is not worked in the territory of India.

An application for compulsory licence may be made by any person notwithstanding that he is already the holder of a licence under the patent and no person shall be estopped from alleging that the reasonable requirements of the public with respect to the patented invention are not satisfied or that the patented invention is not worked in the territory of India or that the patented invention is not available to the public at a reasonably affordable price by reason of any admission made by him, whether in such a licence or otherwise or by reason of his having accepted such a licence.

The Controller on being satisfied that the reasonable requirements of the public with respect to the patented invention have not been satisfied or the patented invention is not worked in the territory of India or the patented invention is not available to the public at a reasonably affordable price, may grant a licence upon such terms as he may deem fit.

Answer 1(ii)

The factors which are required to be taken into account by the Controller while considering the application for Compulsory License are as under:

- (i) the nature of the invention, the time which has elapsed since the sealing of the patent and the measures already taken by the patentee or any licensee to make full use of the invention;
- (ii) the ability of the applicant to work the invention to the public advantage;
- (iii) the capacity of the applicant to undertake the risk in providing capital and working the invention, if the application were granted;
- (iv) as to whether the applicant has made efforts to obtain a licence from the patentee on reasonable terms and conditions and such efforts have not been successful within a reasonable period as the Controller may deem fit.

However, the Controller is under no obligation to take into account matters subsequent to the making of the application. It has been clarified that the reasonable period shall be construed as a period not ordinarily exceeding a period of six months.

Answer 1(iii)

Section 90 of Patents Act, 1970 provides that in settling the terms and conditions of a compulsory licence, the Controller shall endeavour to secure that —

- (i) the royalty and other remuneration, if any, reserved to the patentee or other person beneficially entitled to the patent, is reasonable, having regard to the nature of the invention, the expenditure incurred by the patentee in making the

invention or in developing it and obtaining a patent and keeping it in force and other relevant factors;

- (ii) the patented invention is worked to the fullest extent by the person to whom the licence is granted and with reasonable profit to him;
- (iii) the patented articles are made available to the public at reasonably affordable prices;
- (iv) the licence granted is a non-exclusive licence;
- (v) the right of the licensee is non-assignable;
- (vi) the licence is for the balance term of the patent unless a shorter term is consistent with public interest;
- (vii) the licence is granted with a predominant purpose of supply in the Indian market and the licensee may also export the patented product if need be in accordance with section 84(7)(a)(iii) of the Act.
- (viii) in the case of semi-conductor technology, the licence granted is to work the invention for public non-commercial use.
- (ix) in case the licence is granted to remedy a practice determined after judicial or administrative process to be anti-competitive, the licensee shall be permitted, if need be, to export the patented product.

Section 90(2) provides that no licence granted by the Controller shall authorise the licensee to import the patented article or an article or substance made by a patented process from abroad where such importation would, but for such authorisation, constitute an infringement of the rights of the patentee. However in terms of Sub-section (3) the Central Government may direct the Controller to authorise any licensee in respect of a patent to import the patented article or an article or substance made by a patented process from abroad (subject to such conditions as it considers necessary to impose relating among other matters to the royalty and other remuneration, if any, payable to the patentee, the quantum of import, the sale price of the imported article and the period of importation), if it is necessary to do so in public interest and thereupon the Controller shall give effect to the directions.

Answer 1(iv)

This has been an important point in dispute. The Controller is of the view that the patented product will be considered to be worked in India only if the patentee manufactures the patented product in India within reasonable time. But an issue arises as to whether the import of a patented product can also be considered as working the patent in the territory of India.

Article 27 of the TRIPS provides that there would be no discrimination in respect of patented product whether legally manufactured or imported. The same view is also apparent from Form 27 prescribed under the Act and the Patent Rules. Patentee has to file a statement in Form 27 with the Controller regarding the working of the patent in India. In the aforesaid form the patentee while giving details of working of patented drug in India, has to make declaration of working in India of the patented product under two classifications namely manufacture in India and imported from other countries.

The working of a patented invention in the territory of India has to be considered by reading section 83 of the Act which provides for legislative guidelines to predict the meaning of the words "worked in the territory of India". The following guidelines of section 83 are germane to the discussion:

- (a) the patent is not granted to enable the Patentee to enjoy a monopoly for the importation of the patented article;
- (b) the technological knowledge must be transferred and disseminated to the mutual advantage of producers and users of technological knowledge;
- (c) the patent right should not be abused by the patentee by indulging in activities that unreasonably restrain trade or adversely affect the international transfer of technology.

Reading the above guidelines, the legal position is that the patentee is required to make some efforts to manufacture the patented product within the territory of India. Manufacture in India is not the sole method of working a patent in India. A patent can be worked in India by importing the patented article in adequate quantity and supplying it. However, working by import can be accepted only after the patentee provides satisfying reasons for not manufacturing the patented product in India.

Answer 1(v)

Section 92 A of the Patents Act, 1970 inserted by The Patents (Amendment) Act, 2005 postulates compulsory licence for export of patented pharmaceutical products in certain exceptional circumstances. It states that CL shall be available for manufacture and export of patented pharmaceutical products to any country having insufficient or no manufacturing capacity in the pharmaceutical sector for the concerned product to address public health problems, provided CL has been granted by such country or such country has, by notification or otherwise, allowed importation of the patented pharmaceutical products from India. Sub-section (2) authorises the Controller, on receipt of an application in the prescribed manner, to grant, on such terms and conditions as he may specify, a CL solely for manufacture and export of the concerned pharmaceutical product to such country under such terms and conditions as may be specified and published by him. Explanation appended to section 92A defines the pharmaceutical products as to mean any patented product, or product manufactured through a patented process, of the pharmaceutical sector needed to address public health problems and shall be inclusive of ingredients necessary for their manufacture and diagnostic kits required for their use.

Question 2

- (a) *TV stations in Chennai and Mumbai published weekly TV guides covering their programmes exclusively and claimed copyright protection. Arch TV Guide wanted to publish a comprehensive guide of TV programmes of both the stations but was prevented by TV stations, Chennai and Mumbai on the ground of copyright infringement. By preventing this, the TV stations sought to ensure that third parties did not reproduce their programme listing. Arch TV Guide complained to the Competition Commission of India (CCI) citing the Competition Act, 2002 and arguing that the TV stations, Chennai and Mumbai were indulging in an anti-competitive practice of refusal to deal. The TV stations drew the attention of the CCI to section 3(5) of the Competition Act, 2002 and argued that the said section*

did not restrict the right of any person to restrain any infringement of or to impose reasonable conditions, as may be necessary for protecting any of the rights conferred upon them under IPR statutes. TV stations Chennai and Mumbai contended that section 3(5) of the Competition Act, 2002 provided protection of their IPR, namely, copyright and prayed that the CCI should restrain Arch TV Guide from publishing the comprehensive guide. Arch TV Guide urged that the said anti-competitive practice should not be condoned while providing protection to IPRs, in this case, copyright. It prayed that it may be allowed to publish the comprehensive guide in customers' interest and public interest.

In the light of the facts provided, if you were the CCI, what would be your decision? (20 marks)

(b) *State the relationship between the 'TRIPS agreement' and the 'pre-existing international conventions' covered under it. (10 marks)*

Answer 2(a)

In terms of section 3(5) of Competition Act, 2002, only those restrictions on freedom of competition inherent in protection of IPR could be permitted. Refusal of the TV stations based on their reliance on copyright provisions prevents the creation of a new product (Arch TV Guide's) for which there is customer demand. The TV stations by such refusal to deal excluded competition in the market. Section 3(5) of the Competition Act, allows only 'reasonable conditions' for protecting IP Rights. If unreasonable conditions exist in a situation, they fall under the ambit of Competition Act and such 'unreasonable conditions' cannot be condoned in offering protection of IP rights. Copyright of the TV stations Chennai and Mumbai cannot be protected in the light of their refusal to allow Arch TV Guide to publish the comprehensive guide, which would be in the interests of customers and the public. Consequently, Arch TV Guide should be allowed to publish the comprehensive guide.

Answer 2(b)

The TRIPS Agreement says WTO member countries must comply with the substantive obligations of the main conventions of WIPO the Paris Convention on industrial property, and the Berne Convention on copyright (in their most recent versions).

With the exception of the provisions of the Berne Convention on moral rights, all the substantive provisions of these conventions are incorporated by reference. They therefore become obligations for WTO member countries under the TRIPS Agreement – they have to apply these main provisions and apply them to the individuals and companies of all other WTO members.

The TRIPS Agreement also introduces additional obligations in areas which were not addressed in these conventions or were thought not to be sufficiently addressed in them.

The TRIPS Agreement is therefore sometimes described as a "Berne and Paris-plus" Agreement.

The text of the TRIPS Agreement also makes use of the provisions of some other international agreements on intellectual property rights:

- WTO members are required to protect integrated circuit layout designs in

accordance with the provisions of the Treaty on Intellectual Property in Respect of Integrated Circuits (IPIC Treaty) together with certain additional obligations.

- The TRIPS Agreement refers to a number of provisions of the International Convention for the Protection of Performers, Producers of Phonograms and Broadcast in Organizations (Rome Convention), without entailing a general requirement to comply with the substantive provisions of that Convention.

Article 2 of the TRIPS Agreement specifies that nothing in Parts I to IV of the agreement shall derogate from existing obligations that members may have to each other under the Paris Convention, the Berne Convention, the Rome Convention and the Treaty on Intellectual Property in respect of integrated circuits.

Question 3

How is computer software protected in India ?

(5 marks)

Answer 3

Modern society relies heavily on computer technology. Without software, a computer cannot operate. Software and hardware work in tandem in today's information society. Intellectual property protection of software is crucial not only for the software industry, but for other businesses as well.

Indian Patent Act offers patent protection to products or processes (if they satisfy various requirements of patentability) as long as they do not fall under non-patentable subject matter. Sections 3 and 4 of the Indian Patent Act specify a list of subject matter that is not patentable, in particular "a mathematical or business method or a computer program per se or algorithms" is of specific importance to software innovation.

The Indian Patent Law does not contain any specific provision regarding the protection of computer software. Computer software on the other hand is protected by copyright as applicable to literary and aesthetic works. A computer program is therefore dealt with as a literary work and the law and practice in relation to literary works will apply to computer programs.

The Indian Patent Act, as of now, excludes only 'computer programs per se' from patentability. The issue of whether computer programs tied to certain hardware can be patented is a controversial one. Still, an invention shall not become unpatentable in India merely because it was implemented with software.

The definition of "Literary work" under section 2 (o) of the Copyright Act, 1957, includes computer programmes, tables and compilations including computer data bases. Like the unauthorised copying of literary works, unauthorised copying of computer programmes also attracts the same legal consequences under the Copyright law.

Question 4

What rights are conferred by registration of a Trade Mark ?

(5 marks)

Answer 4

Registration of a Trade Mark confers the following rights on the registered proprietor:

- It confers on the registered proprietor the exclusive right to the use of the Trade

Mark in relation to the goods or services in respect of which the Trade Mark is registered.

- If the Trade Mark consists of several matters, there is an exclusive right to the use of the Trade Mark taken as a whole.
- It entitles the registered proprietor to obtain relief in respect of infringement of the Trade Mark in the manner provided by the Trade Marks Act, 1999 when a similar mark is used on (a) same goods or services, (b) similar goods or services, (c) in respect of dissimilar goods or services.
- Registration of a Trade Mark forbids every other person (except the registered or unregistered permitted user) to use or to obtain the registration of the same Trade Mark or a confusingly similar mark in relation to the same goods or services or the same description of goods or services in relation to which the Trade Mark is registered.
- After registration of the Trade Mark for goods or services, there shall not be registered the same or confusingly similar trade mark not only for the same goods or services but also in respect of similar goods or services.
- Moreover, after registration of the Trade Mark for goods or services, there shall not be registered the same or confusingly similar trade mark even in respect of dissimilar goods or services.
- Registered Trade Mark shall not be used by any one else in business papers and in advertising. The advertising should not be detrimental to the distinctive character or reputation of the Trade Mark.
- There is a right to restrict the import of goods or services marked with a Trade Mark similar to one's Trade Mark.
- There is a right to restrain use of the Trade Mark as trade name or part of trade name or name of business concern dealing in the same goods or services.

Question 5

Client XYZ has approached you for getting a patent on a drug for curing insomnia. What are the steps involved in registering the patent ? Describe with examples.

(5 marks)

Answer 5

- (a) Prior art on the subject must be examined to find out the "novelty". Patent searches have to be organized.
- (b) Similarly, the innovative part has to be seen along with usefulness.
- (c) Disclosures and publication of the discovery must be in place.
- (d) Claims must be prepared along with detailed specification, drawings and manufacturing process.
- (e) The drug must also be physically available to establish its identity.
- (f) The patent office will examine the claims and publish the results for objections.
- (g) Finally the patent will be granted and duly registered.

Question 6

What do you understand by 'design' ? How is it different from 'copyright' ? What is the Act covering design ? (5 marks)

Answer 6

Design as per Section 2(d) of the Designs Act, 2000 means only the features of shape, configuration, pattern or ornament or composition of lines or colour or combination thereof applied to any article whether two dimensional or three dimensional or in both forms, by any industrial process or means, whether manual, mechanical or chemical, separate or combined, which in the finished article appeal to and are judged solely by the eye, but does not include any mode or principle or construction or anything which is in substance a mere mechanical device, and does not include any trade mark, as defined in clause (v) of sub-section of Section 2 of the Trade and Merchandise Marks Act, 1958, property mark or artistic works as defined under Section 2(c) of the Copyright Act, 1957. Meaning of copyright specified under section 14 of the Copyright Act, 1957.

Design is with reference to the shape and aesthetic aspects of an article. It is different from copyright in the sense that a form of reference to a "hard" and "tangible" creation such as the shape of a cup. A copyright is "soft" defined creative work on paper and other media dealing with knowledge or information. Design does not include any artistic work, as defined in Section 2(c) of the Copyright Act, 1957.

The Design Act, 2000 covering design.

INTERNATIONAL BUSINESS LAWS AND PRACTICES

(Elective Paper 9.5)

Time allowed : 3 hours

Maximum marks : 100

NOTE : Answer **ALL** Questions.

Question 1

Global Competitiveness Report 2014-15

Year 2014–15 marks the time when the global economy seems to be finally leaving behind the worst and longest-lasting financial and economic crisis of the last 80 years. However, this resurgence is moving at a less decisive pace than it has after previous downturns, and heightened risks looming on the horizon could derail the global recovery. Much of the growth in recent years has taken place because of the extraordinary and bold monetary policies in countries such as the United States, Japan, and the United Kingdom. As the economy improves in these countries, a normalisation of monetary policy with tightening financial conditions could have an impact on both advanced and emerging economies.

Overall, growth prospects in advanced economies are better than they have been in recent years, albeit very unevenly distributed. The recovery in the United States seems to be comfortably grounded with strong output and employment figures. Japan's economy, while still needing to translate Abenomics into stronger private demand, seems to be waking up after two decades of stagnation. In Europe, the picture is more mixed, though many countries now recording stronger growth and returning to trend growth rates, some others continue to suffer from weak growth driven by protracted internal demand, high unemployment, and financial fragmentation. Emerging economies are forecasted to grow more modestly than they did in the past. After several years of doing very well and leading global growth, their performance may be affected by a changing environment characterised by greater difficulty accessing capital as well as lower prices for the commodities that fuelled past growth—a trend that is also likely to affect many developing economies.

To a large extent, the improvement of the global economic outlook has been the result of bold monetary policies carried out by the Federal Reserve and Central Banks in countries such as the United Kingdom and Japan to substantially expand the amount of money available in the economy. As the economic situation improves, a normalisation of the monetary policy with a tightening of the financial conditions for both advanced and, most notably, emerging economies could jeopardise the rather positive forecast, especially if productivity-enhancing investment levels do not manage to pick-up. Investment and the recovery more broadly will also be influenced by the fact that low inflation, or even deflation, in key advanced economies remains a tangible risk that could derail recovery because real interest rates may rise, increasing the burden of public debt and leading to a stagnation of consumption and investment rates. In addition, in recent months, a strained geo-political situation has emerged. Tensions in Ukraine with implications for the relationship between Russia and much

of the Western world, as well as between China and Japan, have become more evident. Although the implications of these tensions have not yet fully materialised, they could cause a great deal of disruption in the highly interdependent, global macroeconomic outlook.

Finally, one of the legacies of the economic crisis is the acceleration of income inequality in many countries, which can cause important economic and social tensions if not properly addressed.

Continuing on its downward trend and losing 11 places, India ranks 71st in the GCI. The country's new government faces the challenge of improving competitiveness and reviving the economy, which is growing at half the rate of 2010. India's performance is given below :

India's competitiveness crisis

Despite its immense potential and promise, by many accounts India continues to suffer from poverty. A third of its population still lives in extreme poverty — possibly the highest incidence outside sub-Saharan Africa; and many people still lack access to basic services and opportunities, such as sanitation, healthcare, and quality schooling. Improving the standards of living of the Indian population will require the country to accelerate its growth. Yet, since 2011, India has experienced a slowdown. In 2013, its economy grew by a modest 4.4% (see Figure 1). Improving competitiveness in order to put growth on a more stable footing should therefore be a priority for the new government.

Dropping for the sixth consecutive edition, India ranks 71st (down 11) out of 144 economies in the Global Competitiveness Index (GCI) 2014-15 (see Figure 2). It is the lowest ranked among the BRICS economies. The rank differential with China (28th) has grown from 14 places in 2007 to 43 today; while India's GDP per capita was higher than China's in 1991, today China is four times richer (see Figure 1). This competitiveness divide helps to explain the different trajectories of these two economies.

India's slide in the competitiveness rankings began in 2009, when its economy was still growing at 8.5% (it even grew by 10.3% in 2010). Back then, however, India's showing in the GCI was already casting doubt about the sustainability of this growth. Since then, the country has been struggling to achieve growth of 5%. The country has declined in most areas assessed by the GCI since 2007, most strikingly in institutions, business sophistication, financial market development, and goods market efficiency.

Figure 3 sheds light on the main strengths and weaknesses of India's competitiveness and presents the country's performance along the 12 dimensions of the GCI. Overall, India does best in the more complex areas of the GCI : innovation (49th) and business sophistication (57th). In contrast, it obtains low marks in the more basic and fundamental drivers of competitiveness. For instance, India ranks 98th on the health and primary education pillar. The health situation is indeed alarming : infant mortality and malnutrition incidences are among the highest in the world; only 36% of the population have access to improved sanitation and life expectancy is Asia's second shortest, after Myanmar. On a more positive note, India is on track to achieve universal primary education, although the quality of primary education remains poor (88th) and it ranks a low 93rd in the higher education and training pillar of the GCI. Transport and electricity infrastructure need upgradation (87th). In 2012, a working group appointed by the

Planning Commission of India had recommended that a trillion US dollars or almost 10% of India's GDP be spent on infrastructure by 2017. Given the country's strained public finances, addressing the infrastructure gap will require very strong participation on the part of private and foreign investors through public-private partnerships.

But for these types of investments to materialise, the institutional framework needs to improve. There are encouraging signs though. India has achieved spectacular progress in various measures of corruption and now ranks 65th. Red tape seems to be less of an issue than it had been, and government efficiency is equally improving. However, the overall business environment and market efficiency (95th, down 10 places) are undermined by protectionism, monopolies and various distortionary measures, including subsidies and administrative barriers to entry and operation. The World Bank estimated that it takes 12 procedures (130th) and almost a month to register a business (106th). In addition, it calculated that taxes for a typical registered firm amount, on average, to 63% of its profits (130th). Furthermore, the labour market is inefficient and rigid (112th). These factors contribute to the high cost of integrating more businesses into the formal economy. Some estimates find that the informal sector accounts for half of India's economic output and 90% of its employment. It is, therefore, urgent that the government create the right incentives for businesses to register and contribute their fair share to the provision of public services.

India achieves its lowest rank among the 12 pillars in technological readiness (121st). Despite mobile telephony being almost ubiquitous, India is one of the world's least digitally connected countries. Only 15% of Indians access the internet on a regular basis. Broadband Internet, if available at all, remains the privilege of a very few. India's knack for frugal innovation should contribute to providing cheap solutions for bridging this digital divide.

The financial resources required for delivering basic services, including sanitation and healthcare as well as for improving India's physical and digital connectivity are considerable. But India's fiscal situation remains in disarray, as evidenced by the country's 101st rank in the macroeconomic environment pillar of the GCI. With the exception of 2007, the Central Government has consistently run deficits since 2000. Due to high degree of informality, its tax base is relatively narrow, representing less than 10% of GDP. In addition, over the past several years, India has experienced persistently high, in some years near double-digit inflation, which reached 9.5% in 2013. The Reserve Bank of India is torn between keeping interest rates low to stimulate the faltering economy and tightening monetary policy to stem inflation.

Improving competitiveness will yield India huge benefits. In particular, it will help rebalance the economy and move the country up the value chain so as to ensure more solid and stable growth; this in turn could result in more employment opportunities for the country's rapidly growing population. Despite the abundance of low-cost labour, India has a very narrow manufacturing base. Manufacturing accounts for less than 15% of India's GDP. Agriculture represents 18% of output and employs 47% of the workforce. Low productivity in the sector means very low wages and a life of mere subsistence for many. The services sector accounts for just 28% of employment but for 56% of the economy. Most services jobs are low-skilled and poorly paid ones, though. White collar jobs remain rare. For example, the vibrant business-process outsourcing sector employs 3.1 million workers, or 0.6% of India's 482 million strong labour force (but accounts for 6% of GDP). India needs to create jobs in the 'missing

middle' for the 610 million youths under 25 — half of India's population — who have recently entered or will soon enter the workforce.

In a parliamentary address in June 2014, President Mukherjee outlined the government's economic agenda. It envisages building smart cities, establishing world-class industrial zones and transforming the country into a manufacturing hub. It remains to be seen whether the new administration will succeed in convincing the public opinion, mobilising resources and passing reforms necessary to achieve this vision.

Figure 1: GDP growth and GDP per capita of India and China since 1980

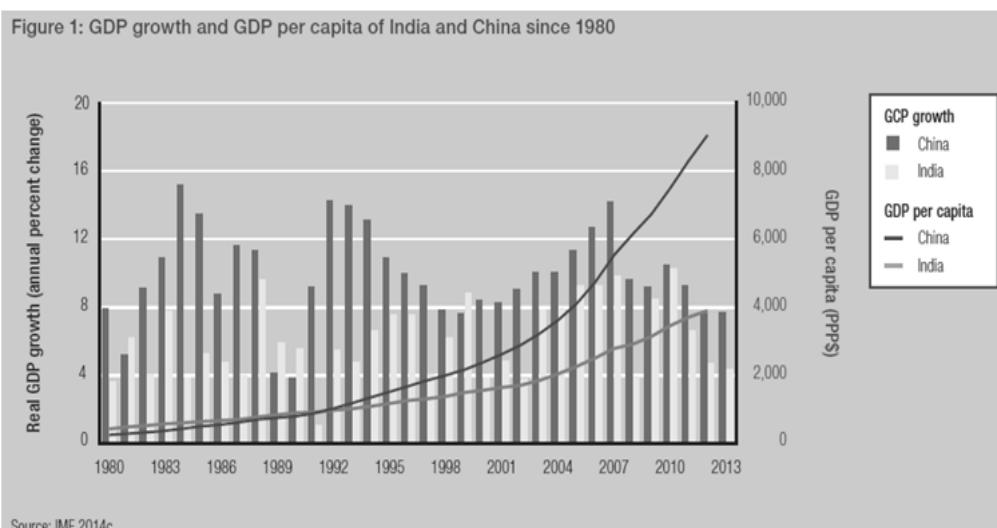
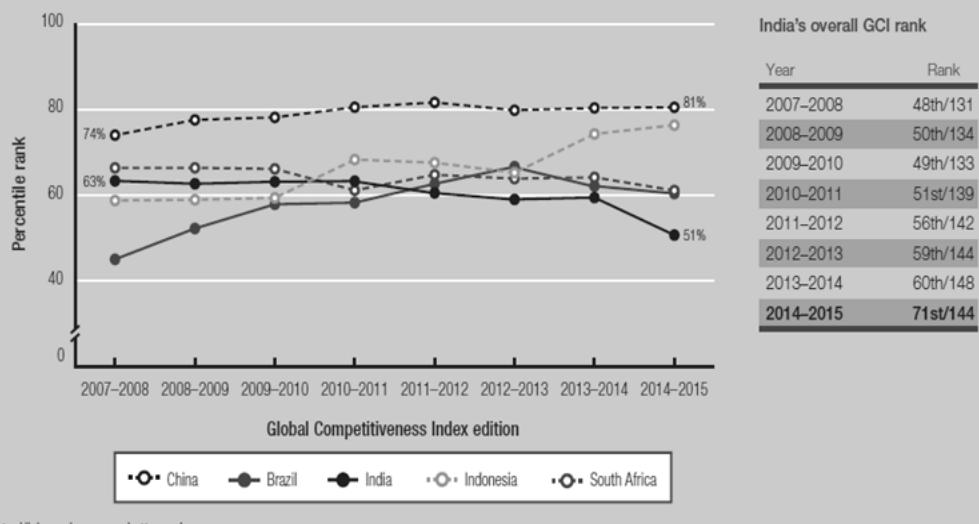
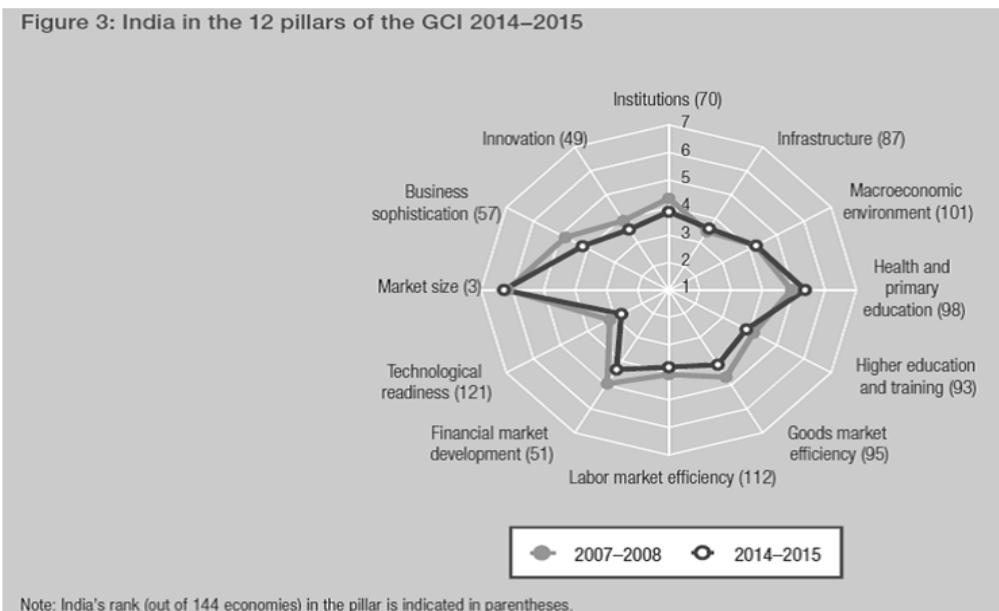


Figure 2: Historical performance of selected countries in the Global Competitiveness Index





Based on the above, answer the following :

- What are the main pillars of competitiveness ? How are they related with each other and also with the stages of economic development of countries ?* (10 marks)
- What are the major improvements in global competitiveness of developed economies according to Global Economic Outlook 2014-15 ?* (10 marks)
- Explain India's competitiveness crisis of 2014-15.* (15 marks)
- What is Global Competitiveness Index (GCI) ? Name the pillars acting as keys for factor driven, efficiency driven and innovation driven sub-index. Highlight India's main strengths and weaknesses with the help of Figure 3.* (15 marks)

Answer 1(a)

Many determinants drive productivity and competitiveness. Many economists have given different interpretations, including Adam Smith's focus on specialization and the division of labor to neoclassical economists' emphasis on investment in physical capital and infrastructure, and, more recently, to interest in other mechanisms such as education and training, technological progress, macroeconomic stability, good governance, firm sophistication, and market efficiency etc. While all of these factors are likely to be important for competitiveness and growth, they are not mutually exclusive i.e. two or more of them can be significant at the same time. This open-endedness is captured within the GCI by including a weighted average of many different components, each measuring a different aspect of competitiveness. These components are grouped into 12 pillars of competitiveness.

- I. *First pillar: Institutions* : The institutional environment is determined by the legal and administrative framework within which individuals, firms, and governments interact to generate wealth. The continuous development of the institutional structure is critical to the competitiveness.
- II. *Second pillar: Infrastructure* : Extensive and efficient infrastructure is critical for ensuring the effective functioning of the economy, as it is an important factor in determining the location of economic activity and the kinds of activities or sectors that can develop in a particular instance. A good infrastructure helps the economy function like a well oiled machinery.
- III. *Third pillar* : Macroeconomic environment: The stability of the macroeconomic environment is important for business and, therefore, is important for the overall competitiveness of a country. The key issues in macroeconomic environment are employment, growth and inflation.
- IV. *Fourth pillar* : Health and primary education: A healthy workforce is vital to a country's competitiveness and productivity. This pillar is very important as it has its affect in the very long term.
- V. *Fifth pillar* : Higher education and training: Quality higher education and training is particularly crucial for economies that want to move up the value chain beyond simple production processes and products. Good education is important for skilling the population, which is imperative for the competitiveness of the Nation.
- VI. *Seventh pillar* : Labor market efficiency: The efficiency and flexibility of the labor market are critical for ensuring that workers are allocated to their most effective use in the economy and provided with incentives to give their best effort in their jobs.
- VII. *Eighth pillar* : Financial market development: The recent economic crisis has highlighted the central role of a sound and well-functioning financial sector for economic activities.
- VIII. *Ninth pillar* : Technological readiness: In today's globalized world, technology is increasingly essential for firms to compete and prosper.
- IX. *Tenth pillar* : Market size: The size of the market affects productivity since large markets allow firms to exploit economies of scale.
- X. *Eleventh pillar* : Business sophistication: There is no doubt that sophisticated business practices are conducive to higher efficiency in the production of goods and services. The way businesses are governed and systems and processes are put in place in the value chain and in the larger integrated supply chain adds a lot to the competitiveness of the firms and economy as a whole at macro level.
- XI. *Twelfth pillar*: Innovation: Innovation can emerge from new technological and non technological knowledge. Non-technological innovations are closely related to the know-how, skills, and working conditions that are embedded in organisations and are therefore largely covered by the eleventh pillar of the GCI. The final pillar of competitiveness focuses on technological innovation.

The interrelation of the pillars : Although these 12 pillars of competitiveness appear separate, it is important to keep in mind that they are not independent: they tend to reinforce each other, and a weakness in one area often has a negative impact in others. For example, a strong innovation capacity (pillar 12) will be very difficult to achieve without

a healthy, well-educated and trained workforce (pillars 4 and 5) that is adept at absorbing new technologies (pillar 9), and without sufficient financing (pillar 8) for R&D or an efficient goods market that makes it possible to take new innovations to market (pillar 6). Although the pillars are aggregated into a single index, measures are reported for the 12 pillars separately because such details provide a sense of the specific areas in which a particular country needs to improve.

The relation with stages of Economic Development : While all the twelve pillars matter to a certain extent for all economies, it is clear that they will affect them in different ways. In line with the economic theory of stages of development, the GCI assumes that economies in the first stage are mainly factor-driven and compete based on their factor endowments—primarily low-skilled labor and natural resources. Companies compete on the basis of price and sell basic products or commodities, with their low productivity reflected in low wages. Maintaining competitiveness at this stage of development hinges primarily on well-functioning public and private institutions (pillar 1), a well-developed infrastructure (pillar 2), a stable macroeconomic environment (pillar 3), and a healthy workforce that has received at least a basic education (pillar 4). As a country becomes more competitive, productivity will increase and wages will rise with advancing development. Countries will then move into the efficiency-driven stage of development, when they must begin to develop more efficient production processes and increase product quality because wages have risen and they cannot increase prices.

Answer 1(b)

According to the Global Economic Outlook 2014-15, the year 2014-15 is a unique year which has witnessed resurgence of global economy and it gives the hope that the worst and the longest lasting financial crisis of last many years is over. The situation that the worst is over is likely to continue although the hint that necessary monetary and fiscal policies need to accompany the reform process cannot be ignored.

Overall, growth prospects in advanced economies are better than they have been in recent years, albeit very unevenly distributed. The recovery in the United States seems to be comfortably grounded with strong output and employment figures. Japan's economy seems to be waking up after two decades of stagnation. In Europe the picture is more mixed, with many countries now recording stronger growth and returning to trend growth rates, while some others continue to suffer from weak growth driven by protracted internal demand, high unemployment and financial fragmentation. Emerging economies are forecasted to grow more modestly than they did in the past.

In the United States, employment figures are settling down and the business output is increasing. Japan's economy, is showing signs of improvement, even though the private demand is less. In Europe, some countries are showing increasing growth rates, some are not. To a large extent, the improvement of the global economic outlook has been the result of bold monetary policies carried out by the Federal Reserve and Central Banks in countries such as the United Kingdom and Japan to substantially expand the amount of money available in the economy.

In recent months, a strained geopolitical situation has emerged. Tensions in Ukraine with implications for the relationship between Russia and much of the Western world, as well as between China and Japan, have become more evident. Although the implications of these tensions have not yet fully materialized, they could cause a great deal of disruptions in the highly interdependent, global macroeconomic outlook.

Overall the countries will have to address the issue regarding normalisation of the monetary policy with the tightening of the financial conditions for not only developed but also emerging economies. Low inflation and at times even deflation in some important advanced countries remains a challenge which can give a set back to the recovery process. Additionally, acceleration of income inequality in many countries can cause economic and social tensions.

Answer 1(c)

India's competitiveness crisis of 2014-15

India has been continuing on its downward trends in Global Competitiveness. Its rank has come down to 71st place out of 144 economies in the Global Competitiveness Index (GCI) 2014-2015. It is the lowest ranked among the BRICS economies. The rank differential in China (28th) has grown from 14 places in 2007 to 43 today; while India's GDP per capita was higher than China's in 1991, today China is four times richer. India faces variety of challenges for improving competitiveness and reviving the economy. Rate of growth in GDP had reached high before 2010 that started decelerating and performance of India in terms of 12 pillars of competitiveness has also gone down. Its rank in terms of health and primary education pillar is very low. Infant mortality rate is very high. Malnutrition is rampant. Life expectancy is also pretty low.

- Despites its immense potential and promise, by many accounts India continues to suffer from poverty. A third of its population still lives in extreme poverty-possibly the highest incidence outside sub – Saharan Africa –and many people still lack access to basic services and opportunities, such as sanitation, healthcare and, quality schooling.
- The health of Indian population is a matter of serious concern with infant mortality and malnutrition figures amongst the worst in the world. More than 50 percent of population does not have access to improved sanitation. Life expectancy in India is Asia's second shortest after Myanmar.
- India scores abysmally low on the primary education. The quality of primary education remains very poor (88th). If that is not enough, India is lowly ranked at 93rd in the higher education and training.
- India's performance in the Transport and electricity infrastructure is ranked 87th in the world as per GCI. As per the recommendation of the working group appointed by the Planning Commission in 2012, India should spend 10% of its GDP on infrastructure.
- In business environment and market efficiency pillar, India's overall rank is 95th, destabilized by protectionism, monopolies and various restrictive measures, including subsidies and administrative barriers to entry and operation. As per the estimates of World Bank, it takes 12 procedures for which India is ranked 130th and almost a month to register a business for which India is ranked 106th. The tax collection for a typical registered firm amounted to 63% of its profits, for which it is ranked 130th. The labor market in India has not been reformed since ages making it inefficient and rigid at 112th rank.
- Informal and unorganized sector accounts for a large volume of India's GDP. The

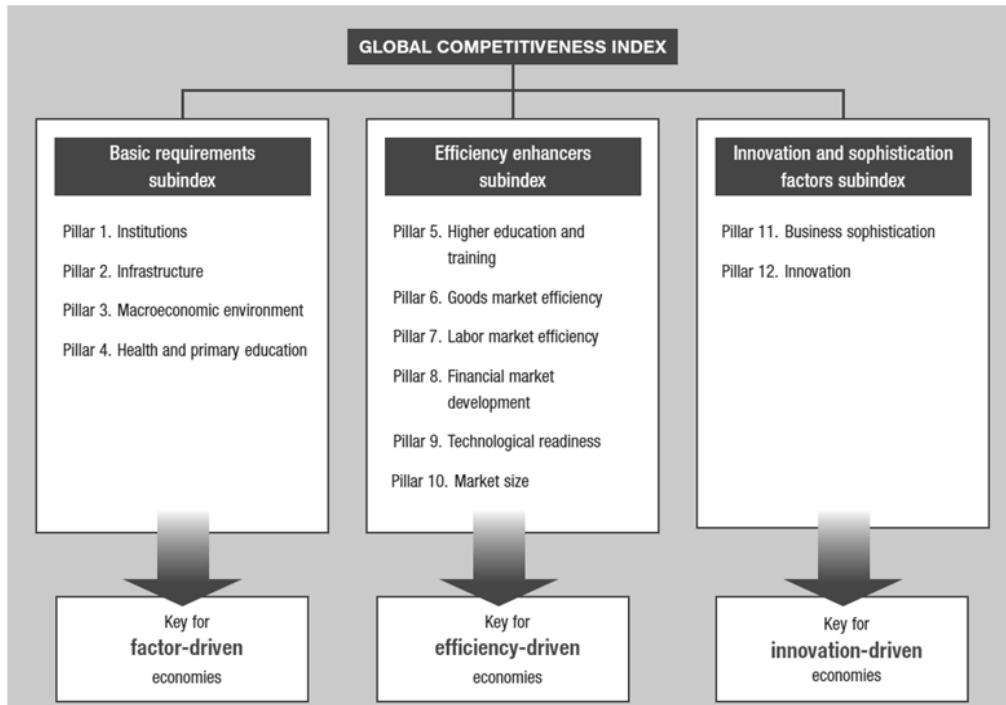
government should create the right incentives for businesses to register and contribute their fair share to the provision of public services.

- India suffers a lot due to its unpreparedness in the area of technology for which it is ranked 121st.
- India's tax base is relatively narrow which represents less than 10% of GDP due to high degree of informality.
- The volatility in inflation is again a problem with the inflation becoming 9.3% in 2013.

Answer 1(d)

Global Competitiveness Index : The World Economic Forum releases annual Global Competitiveness Reports which studies and benchmarks the many factors underpinning national competitiveness. The Report presents the rankings of the Global Competitiveness Index (GCI), developed by the professor Xavier Sala-i-Martin and introduced in 2005. The GCI is based on 12 pillars of competitiveness, providing a comprehensive picture of the competitiveness landscape in countries around the world at different stages of economic development. The Report contains detailed profiles highlighting competitive strengths and weaknesses for each of the 144 economies featured, as well as an extensive section of data tables displaying relative ranking for more than 100 variables.

The pillars acting as keys for factor driven, efficiency driven and innovation driven sub index are given in following figure:



India's main strengths and weaknesses

The figure 3 throws light on the main strengths and weaknesses of India's competitiveness and presents the country's performance along the 12 dimensions of the GCI. Overall, India does best in the more complex areas of the GCI: innovation (49th) and business sophistication (57th). In contrast, it obtains low marks in the more basic and more fundamental drivers of competitiveness. For instance, India ranks 98th on the health and primary education pillar. The health situation is indeed alarming: infant mortality and malnutrition incidence are among the highest in the world; only 36 percent of the population has access to improved sanitation and life expectancy is Asia's second shortest after Myanmar. On a more positive note, India is on track to achieve universal primary education, although the quality of primary education remains poor (88th) and it ranks a low 93rd in the higher education and the training pillar of the GCI. Transport and electricity infrastructure are in need of upgrading (87th). In 2012, a working group appointed by the Planning Commission of India had recommended that a trillion US dollars or almost 10 percent of India's GDP be spent on infrastructure by 2017. Given the country's strained public finances, addressing the infrastructure gap will require very strong participation on the part of private and foreign investors through public-private partnerships.

Question 2

As the Company Secretary of Samarth Ltd., answer the following :

- (a) *Explain the concept and role of logistics management to Samarth Ltd.* (5 marks)
- (b) *Samarth Ltd. wants to transport cement. Which modes of transport can be considered by the company. State their disadvantages, if any ?* (5 marks)
- (c) *How will you advise on inventory management of basmati rice to Samarth Ltd?* (5 marks)
- (d) *Samarth Ltd. is unable to decide whether to enter in export market. Explain to them, why they should get in exports and advise them on the matters to be looked into while entering into export market.* (5 marks)
- (e) *If Samarth Ltd. wants to enter into foreign market, what will be your advice regarding partner selection for strategic alliance ?* (5 marks)
- (f) *Samarth Ltd. wants to start a gems and jewellery unit in Gandhi Nagar. As a SEZ developer, elaborate the incentives and facilities which shall be available to the organisation.* (5 marks)

Answer 2(a)

Concept of logistics management : Logistics management is an integral factor in the success of any manufacturing companies operations and has direct impact on their bottom line. Logistics Management is that part of supply chain management that plans, implements and controls the efficient, effective forward and reverse flow and storage of goods, services and related information between the point of origin and point of consumption in order to meet customers' requirements. It is simply the management of movement of goods. The logistics of physical items usually involves the integration of information flow, material handling, production, packaging, inventory, transportation, warehousing, and often security.

Role of logistics management: Logistics is concerned with proper movement of materials from the source of supply to the place of production and movement of finished product from the factory to the customer. Its purpose is to make the product available to the customer at the right place and at the right time. Logistics is also known as 'Physical Distribution Management (PDM)'. It involves efficient management of materials and finished products, their movement, storage, and control. It helps to provide time utility and place utility to customers. Logistics in an organization are considered as a continuation of marketing. Logistics play a critical role in each of the three critical elements of the marketing concept (customer satisfaction, integrated effort/systems approach and corporate profit) in several ways.

Answer 2(b)

Rail, road, air, water and pipeline are the five modes of transportation to transport material from one place to another. Each of these modes has some advantages and some limitations. Cement, being a bulk commodity, transporting is a costly affair. As a company secretary of Samarth Ltd, one needs to understand the various modes on the basis of priorities, product type, lead time, etc. and then decide the appropriate mode of transportation. The modes of transport that can be used by Samarth Ltd. to transport cement are as follows:

- I. Sea** : Sea transportation is used by businesses for the delivery of goods from distant suppliers. Most sea transportation is conducted in containers. Goods can be grouped into a container and transported. However, sea transportation has following disadvantages:
 - Longer lead/delivery times.
 - Problems arising due to bad weather.
 - Difficult to monitor exact location of goods in transit.
 - Customs and excise restrictions
 - High cost and time consuming.
- II. Rail** : Rail transportation is popular with businesses for the delivery of a wide range of goods including heavy goods like cement. Rail transport is faster and quicker, can carry high capacity, is cost effective, safe and reliable. But rail transport has following disadvantages:
 - Subject to unforeseen delays and/or accidents.
 - Completely governed by timetable and schedule of railways.
 - Suppliers/customers are not always located near a rail freight depot and delivery to/from the depot can be costly and time consuming.
- III. Road** : A very popular mode of transport used by suppliers and businesses to deliver orders. Many transport companies provide scheduled delivery days and next day delivery services, depending upon your needs. Goods can be packed / grouped in box vans or in containers which are also used for sea transportation. Road transportation is cost effective, fast and ideal for any short distances. It is easy to monitor location of goods and to communicate with driver. Some of the disadvantages are-
 - Delays due to traffic jam etc.

- Problems due to vehicle breakdown, accidents, etc.
- Heavy dependability on weather
- Goods susceptible to damage

Answer 2(c)

Effective inventory management is all about knowing what to stock, how much to stock and where to stock. Inventory management is the process of efficiently overseeing the constant flow of units into and out of an existing inventory. As a Company Secretary of Samarth Ltd., I would create a purchasing plan that will ensure that items are available when they are needed and keeping track of existing inventory and its use. The most common inventory-management strategy is the just-in-time method, where companies plan to receive items as they are needed rather than maintaining high inventory levels. For successful inventory management of Basmati Rice in Samarth Ltd. following aspects of inventory management needs consideration:

- The first aspect has to do with time i.e understanding how long it takes for a supplier to process an order and execute a delivery.
- Calculating buffer stock is also important for effective inventory management. Essentially, buffer stock is additional units above and beyond the minimum number required inventory to maintain supply levels.
- Inventory management also involves tracking materials as they are used to create finished goods also helps to identify the need to adjust ordering amounts before the raw materials inventory gets dangerously low or is inflated to an unfavorable level.
- Finally, inventory management has to do with keeping accurate records of finished goods that are ready for shipment. Accurately maintaining figures on the finished goods inventory makes it possible to quickly convey information to sales personnel as to what is available and ready for shipment at any given time.

Answer 2(d)

Exporting a product is a profitable method that helps to expand the business and reduces the dependence in the local market. It also provides new ideas, management practices and techniques to further develop the business. There are many good reasons for exporting. Some of the major reasons why Samarth Ltd. should enter export market are given below:

- The primary reason for export is to earn foreign exchange. The foreign exchange not only brings profit for the exporter but also improves the economic condition of the country.
- Secondly, companies that export their goods have better reputation in the domestic market also as their quality meets international standards.
- Thirdly, free exchange of ideas and cultural knowledge opens up immense business and trade opportunities for a company.
- Fourthly, exporting goods to new countries open an opportunity to explore new customers, state-of-the-art machines and vendors in foreign lands.

- Fifthly, by exporting goods, an exporter also becomes safe from lack of demand for seasonal products.
- Lastly, international trade keeps an exporter more competitive and less vulnerable to the market.

However, before entering into the export market, following point need to be considered:

- Products selected for export
- Modifications, if any, to be made in the product for overseas markets
- Countries targeted for export
- Basic customer profile in countries targeted for export
- Marketing and distribution channels to be used
- Special challenges pertain to each market (competition, cultural differences, import controls, etc.), and strategies to address them
- Product's export price
- Personnel and company resources required etc.

Answer 2(e)

A strategic alliance is a strategic cooperation between two or more organizations, with the aim to achieve a result one of the parties cannot (easily) achieve alone. Any arrangement or agreement under which two or more firms cooperate in order to achieve certain commercial objectives is referred to as strategic alliance. A true strategic alliance is a written arrangement between two companies that complement each other in a particular identified area. It is not a partnership, and neither company has legal power to control or obligate the other. Instead, it is a commitment by the two companies to provide capabilities or cross servicing in certain identified areas.

Partnership selection is perhaps the most important for successful strategic alliance. Partnership should be based on an optimum balance of business strength and ownership amongst partners. The partners to alliance should bring in complementary skills, and capabilities to the alliance. Conflict of interests should be avoided as far as possible. Alliance should be capable of building trust and confidence among partners.

A strategic alliance must be structured so that it is the intent of both parties to succeed. Partner assessment involves analyzing a potential partner's strengths and weaknesses, creating strategies for accommodating all partners' management styles, preparing appropriate partner selection criteria, understanding a partner's motives for joining the alliance and addressing resource capability gaps that may exist for a partner. After analysing all these factors partner should be selected and the alliance should be structured so that the firm's risks of giving too much away to the partner are reduced to an acceptable level.

Answer 2(f)

With a view to overcome the shortcomings experienced on account of the multiplicity of controls and clearances; absence of world-class infrastructure, and an unstable fiscal

regime and with a view to attract larger foreign investments in India, the Special Economic Zones (SEZs) Policy was announced in April 2000. This policy intended to make SEZs an engine for economic growth supported by quality infrastructure complemented by an attractive fiscal package, both at the Centre and the State level, with the minimum possible regulations. Various incentives and facilities offered to the units in SEZs for attracting investments into the SEZs.

The incentives and facilities which shall be available to Samarth Ltd. for starting a gem and jewellery unit in Gandhi Nagar are given below:

- Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units
- 100% Income Tax exemption on export income for SEZ units under Section 10AA of the Income Tax Act for first 5 years, 50% for next 5 years thereafter and 50% of the ploughed back export profit for next 5 years.
- Exemption from minimum alternate tax under section 115JB of the Income Tax Act.
- External commercial borrowing by SEZ units upto US \$ 500 million in a year without any maturity restriction through recognized banking channels.
- Exemption from Central Sales Tax.
- Exemption from Service Tax.
- Single window clearance for Central and State level approvals.
- Exemption from State sales tax and other levies as extended by the respective State Governments.

Question 3

Government of India has set-up many institutions for export promotions. Explain the role of these institutional frameworks for promotion of exports in India. (5 marks)

Answer 3

The institutional framework for promotion of exports in India includes a number of councils and organisations set up for promotion of exports. All such organisations are established for promotion of exports in India.

- (i) Ministry of Commerce
- (ii) Autonomous Bodies under Ministry of Commerce
 - (a) Commodity Boards
 - (b) Marine Products Export Development Authority
 - (c) Agricultural and Processed Food Products Export Development Authority
 - (d) Export Inspection Council
 - (e) Indian Institute of Foreign Trade
 - (f) Indian Institute of Packaging

- (iii) Public Sector Undertakings
 - (a) State Trading Corporation (STC)
 - (b) MMTC Limited
 - (c) PEC Limited
 - (d) Export Credit Guarantee Corporation of India Limited
- (iv) Export Promotion Councils
- (v) Other Organisations under Ministry of Commerce
 - Federation of Indian Export Organisations
 - Indian Council of Arbitration
 - Indian Diamond Institute
 - Footwear Design & Development Institute (FDDI)
 - National Centre for Trade Information
 - Price Stabilization Fund Trust
 - GS1-India
- (vi) Advisory Bodies
 - Board of Trade
 - Inter State trade Council
- (vii) Attached and Subordinate Offices
 - Directorate General of Foreign Trade
 - Directorate General of Supplies and Disposals (DGS & D)
 - Directorate General of Anti-Dumping & Allied Duties (DGAD)
 - Directorate General of Commercial Intelligence and Statistics, Kolkata
 - Special Economic Zones
 - Pay & Account Office (Supply, Commerce & Textiles)
- (viii) Exim Bank of India

Question 4

Why countries impose anti-dumping duty and what are the WTO provisions on anti-dumping duty ? (5 marks)

Answer 4

Anti dumping is a measure to rectify the situation arising out of the dumping of goods and its trade distortive effect. Thus, the purpose of anti dumping duty is to rectify the trade distortive effect of dumping and re-establish fair trade. The use of anti dumping measure as an instrument of fair competition is permitted by the WTO. In fact, anti dumping is an instrument for ensuring fair trade and is not a measure of protection per se for the domestic industry. It provides relief to the domestic industry against the injury caused by dumping. In fact, anti dumping is a trade remedial measure to counteract the trade distortion caused by dumping and the consequential injury to the domestic industry. Only in this sense, it can be seen as a protective measure. It can never be regarded as a protectionist measure.

WTO provisions on anti dumping duty

- The WTO agreement on antidumping focuses on how governments can or cannot react to dumping. It disciplines anti-dumping actions.
- GATT (Article 6) of WTO allows countries to take action against dumping. They allow countries to act in a way that would normally break the GATT principles of not discriminating between trading partners.
- The governments can take actions against dumping where there is genuine ("material") injury to the competing domestic industry.
- The agreement provides three methods to calculate a product's "normal value". The main one is based on the price in the exporter's domestic market or the price charged by the exporter in another country, or a calculation based on the combination of the exporter's production costs, other expenses and normal profit margins. And the agreement also specifies how a fair comparison can be made between the export price and what would be a normal price.
- Anti-dumping measures can only be applied if the dumping is hurting the industry in the importing country. Therefore, a detailed investigation has to be conducted according to specified rules first. If the investigation shows dumping is taking place and domestic industry is being hurt, the exporting company can undertake to raise its price to an agreed level in order to avoid anti-dumping import duty.
- Anti-dumping measures must expire five years after the date of imposition, unless an investigation shows that ending the measure would lead to injury.
- Anti-dumping investigations are to end immediately in cases where the authorities determine that the margin of dumping is insignificantly small (defined as less than 2% of the export price of the product).
- The agreement says member countries must inform the Committee on Anti-Dumping Practices about all preliminary and final anti-dumping actions, promptly and in detail. They must also report on all investigations twice a year.
- When differences arise, members are encouraged to consult each other. They can also use the WTO's dispute settlement procedure.

Question 5

Critically analyse India's foreign trade policy 2009-14. Why do you think that the current foreign trade policy will enhance the India's export in future ? (5 marks)

Answer 5

Critical analysis of Foreign Trade Policy 2009-2014

The Foreign Trade Policy 2009-2014 (FTP), incorporating provisions relating to export and import of goods and services, came into force with effect from 2009. The short term objective of Foreign Trade policy is to arrest and reverse the declining trend of exports and to provide additional support especially to those sectors which have been hit badly by recession in the developed world. By 2014, it expects to double India's exports of goods and services. The long term policy objective for the Government is to double India's share in global trade by 2020.

In order to meet these objectives, the Government had followed a mix of policy measures including fiscal incentives, institutional changes, procedural rationalization, and enhanced market access across the world and diversification of export markets. Improvement in infrastructure related to exports; bringing down transaction costs, and providing full refund of all indirect taxes and levies, were the three pillars, which would support to achieve the target.

However the Foreign Trade Policy 2009-2014 does not meet its objectives of helping labour-intensive sectors, reducing transaction costs and in general helping exporters through the global economic downturn fully. For example, the provisions to reduce transaction costs do not take into consideration the significant linkage between high transaction costs and infrastructural deficiencies. Merely reducing application fees and implementing electronic payment systems will not lead to substantial and beneficial reduction in transaction costs for exporters. More emphasis needs to be placed on the improvement of existing infrastructure such as power, energy and transportation. In addition, the poor selection of markets for providing FPS incentives in regard to specific labour-intensive products without due regard for the opportunities generated through regional trading agreements would reduce the benefits from this initiative.

Initiatives in Foreign Trade Policy which will enhance the India's export in future:

To provide adequate confidence to exporters to maintain their market presence even in a period of stress, a special thrust was provided to employment intensive sectors, especially in the fields of textile, leather, handicrafts, etc. With a view to continuously increasing India's percentage share of global trade and expanding employment opportunities, certain special focus initiatives had been identified which will contribute to enhance India's export:

- New markets have been added under Focus Market Scheme. These include 16 new markets in Latin America and 10 in Asia-Oceania.
- The incentive available under Focus Market Scheme (FMS) has been raised from 2.5% to 3%.
- The incentive available under Focus Product Scheme (FPS) has been raised from 1.25% to 2%.
- A large number of products from various sectors have been included for benefits under FPS.
- Market Linked Focus Product Scheme (MLFPS) has been greatly expanded and benefits are also extended for export to additional new markets for certain products like auto components, motor cars, bicycle and its parts, and apparels among others.
- Higher allocation for Market Development Assistance (MDA) and Market Access Initiative (MAI) schemes is being provided.
- To aid technological upgradation of our export sector, EPCG Scheme at Zero Duty has been introduced.
- To increase the life of existing plant and machinery, export obligation on import of spares, moulds etc. under EPCG Scheme has been reduced to 50% of the normal specific export obligation.

- The Government had made concerted efforts to promote exports in sectors like Agriculture, Handlooms, Handicraft, Gems & Jewellery, Leather, Marine, Electronics and IT Hardware manufacturing Industries, Green products, Exports of products from North-East, Sports Goods and Toys sectors.

Question 6

Explain what are the areas in logistics that can be improved by application of Information Technology (IT). (5 marks)

Answer 6

The application of IT can support logistics and help in resolving several problems. Over and above assisting in managerial tasks such as planning, deciding on the optimal route of transportation and allocation, distribution, etc. IT can play a vital role in logistics.

- (i) *Sales Order Processing and Invoicing* : Many distribution operations serve highly competitive market. Hence, it is essential that the information about sales order is transmitted by sales office to the distribution department in an efficient manner for dispatch. Information technology plays a key role in the controlling the order cycle, dispatch and raising invoice by accounts for customers. Information technology also helps accounting for necessary controls over payments from different customers.
- (ii) *Warehousing and Stock Control* : Integration of stock records, sales order processing, replenishment of stocks and locations of different products at different warehouses are controlled through it. It helps in transfer of stocks from one location to another to reduce inventory and provide customers services in cost effective manner. It also helps in providing the exact information out delivery schedule, and a multi product company at multi-location is able to quickly initiate steps for correlating production and customers requirement.
- (iii) *Fleet Management* : Information technology assists in vehicle routing, scheduling, fleet management, computerized round planning is used to evaluate, distribution, fleet mix, provide costing to evaluate alternative distribution networks. Successful implementation of computerized round planning system realize on accurate and timely information about order processing, cost control, order consolidation, distribution constituents like access restrictions, lunch time closing, etc.
- (iv) *Tracking goods in transit* : One of the major problems in logistics has been lost and untracked parcels thereby affecting inventory policies, etc. Real time tracking of goods throughout the supply chain provides excellent opportunities for improving customer service. Real time information on delivery time supports just-in-time manufacture and retail, enabling organizations to make strategic decisions with full confidence in the availability of goods. Goods' tracking is also important for direct end-customer service. Companies the world over are trying smart tags, specifically, radio frequency identification (RFID) for tracking parcels and other goods.