

J.K. SHAH[®]

**TEST
SERIES**



SUGGESTED SOLUTION

CS PROFESSIONAL

Subject – Corporate Funding & Listing

Topic – Funding Chp-07 to 12

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Answer to Q1.A.

Factoring is a financial transaction where an entity sells its receivables to a third party called a 'factor', at discounted prices. Factoring is a financial option for the management of receivables. In simple definition it is the conversion of credit sales into cash. In factoring, a financial institution (factor) buys the accounts receivable of a company (Client) and pays up to 80% (rarely up to 90%) of the amount immediately on formation of agreement.

Factoring company pays the remaining amount (Balance 20%-finance cost-operating cost) to the client when the customer pays the debt. Collection of debt from the customer is done either by the factor or the client depending upon the type of factoring. The account receivable in factoring can either be for a product or service. Examples: factoring against goods purchased, factoring for construction services (usually for government contracts where the government body is capable of paying back the debt in the stipulated period of factoring. Contractors submit invoices to get cash instantly), factoring against medical insurance etc.

Advantages for the Seller:

- The Seller gets funds immediately after the sale is effected and on presentation of accepted sales invoices and Promissory notes.
- Major part of paperwork and correspondence is taken care of by the factor. The follow-up, for recovery of funds, is done mainly by the factor.
- The Interest rates are not as high as normal discounting.
- There is an increased cash flow to meet payroll.
- There is an Immediate funding arrangement, No additional debt is incurred on balance sheet.
- Other assets are not encumbered and approval is not based on seller's credit rating.

(5 MARKS)

Answer to Q1.B.

TYPES OF LETTER OF CREDIT-

1) **Sight Credit** – Under this letter of credit, documents are payable at sight/ upon presentation, i.e., Payment is made to the seller immediately (maximum within 7 days) after the required documents have been submitted.

2) **Acceptance Credit/ Time Credit** – The Bills of Exchange which are drawn, payable after a period, are called usance bills. Under acceptance credit usance bills are accepted upon presentation and eventually honoured on due dates. The documents of title to goods (R/R, L/R, MTR, Bill of Lading etc.) are delivered to the applicant (importer / buyer) on acceptance of Bill of exchange drawn under LC by the Seller / exporter. To that extent these LCs are unsecured.

3) **Revocable and Irrevocable Credit** – A revocable letter of credit is a credit, in which the terms and conditions of the credit can be amended/cancelled by the Issuing bank, any

time and without prior notice to the beneficiaries. If the negotiating bank makes a payment to the beneficiary prior to receiving notice of cancellation / amendments, it is obligatory for issuing bank to make payment to reimburse the negotiating bank. An irrevocable letter of credit is a credit, the terms and conditions of which can neither be amended nor cancelled without the consent of the beneficiary. Hence, the opening bank is bound by the commitments given in the letter of credit. If nothing is stated, the LC is treated as irrevocable.

4) Confirmed Credit – Only Irrevocable letter of credit can be confirmed. A confirmed letter of credit is one when a banker other than the Issuing bank, adds its own confirmation to the credit. In case of confirmed letter of credits, the beneficiary's bank would forward the LC to the confirming banker with a request to add their confirmation. The liability of the confirming bank is same as the issuing bank.

5) Back-to-Back Letter of Credit – Back-to-Back Letter of Credit is a negotiable instrument in which the seller gets a Letter of Credit from the buyer and the seller further transfers the Letter of Credit to its supplier. In simple words, the seller first gets the Letter of Credit from the buyer to ensure timely payment and further the same seller hands over the Letter of Credit to someone from whom he buys goods or materials. There are various advantages and disadvantages of Letter of Credit. Let us take an example to under the concept of Back-to-Back Letter Of Credit.

6) Transferable Credit – While a letter of credit is not a negotiable instrument, the Bills of Exchange drawn under it are negotiable. A Transferable letter of credit is one in which a beneficiary can transfer his rights to third party / parties in whole or in part (in that case the unused portion can be transferred back to the original beneficiary) . Such letter of credit should clearly indicate that it is a 'Transferable' letter of credit. Transferable Letter of Credit is transferrable only once.

7) Red Clause Letter of Credit – Red clause letter of credit is an advance payment letter of credit. Under the red clause letter of credit, the issuing bank will make an advance payment to the exporter i.e. the seller before the seller ships the goods to the importer i.e. buyer. This is usually done to provide aid to the seller in the form of working capital to purchase raw material, processing and packaging of goods, etc. The advance payment will be done against documentary requirement under the red clause letter of credit. Generally, documents required are written undertaking and receipts.

8) Green Clause Letter of Credit – Green clause letter of credit is an extension of red clause letter of credit. Which means it provides the advance not only for the purchase of raw materials, processing, and packaging of goods, etc. but also for pre-shipment

warehousing at the port of origin and insurance expense. In usual cases, the advance under this letter of credit is granted only after the purchased goods are stored in bonded warehouses. This type of letter of credit is usually used in transactions related to commodity market such as wheat, rice, gold, etc

9) Standby letter of credit – In certain countries there are restrictions to issue guarantees, as a substitute these countries use standby credit. In case the guaranteed service is not provided, the beneficiary can claim under the terms of the standby credit. In case of Standby letter of credits, the documents required are proof of non-performance or a simple claim form.

10) Revolving Credit – Here the amount of drawings made would be reinstated and made available to the beneficiary again and again for further drawings during the currency of credit provided. At times an overall turnover cap is also stipulated.

(5 MARKS)

Answer to Q1.C.

According to the “Issue of Foreign Currency Exchangeable Bonds (FCEBs) Scheme, 2018, FCEB means:

- a bond expressed in foreign currency.
- the principal and the interest in respect of which is payable in foreign currency.
- issued by an issuing company, being an Indian company.
- subscribed to by a person resident outside India.
- Exchangeable into equity shares of another company, being Offered company in any manner.
- Either wholly or partly or on the basis of any equity related warrants attached to debt instruments.
- May be denominated

Pricing of FCEB:

At the time of issuance of FCEB the exchange price of the offered listed equity shares shall not be less than the higher of the following two:

- (i) The average of the weekly high and low of the closing prices of the shares of the offered company quoted on the stock exchange during the six months preceding the relevant date; and
- (ii) The average of the weekly high and low of the closing prices of the shares of the offered company quoted on a stock exchange during the two week preceding the relevant date.

(5 MARKS)

Answer to Q1.D.

A person cannot make a public offer of securitized debt instruments or seek listing for such securitized debt instruments unless –

- (a) it is constituted as a special purpose distinct entity;
- (b) all its trustees are registered with the SEBI under the SEBI (Issue and Listing of Securitized Debt Instruments and Security Receipts) Regulations, 2008; and
- (c) it complies with all the applicable provisions of these regulations and the SEBI Act.

The requirement of obtaining registration is not applicable for the following persons, who may act as trustees of special purpose distinct entities:

- (a) any person registered as a debenture trustee with SEBI;
- (b) any person registered as a securitization company or a reconstruction company with the RBI under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- (c) the National Housing Bank established by the National Housing Bank Act, 1987;
- (d) the National Bank for Agriculture and Rural Development established by the National Bank for Agriculture and Rural Development Act, 1981.
- (e) any scheduled commercial bank other than a regional rural bank;
- (f) any public financial Institution as defined under clause (72) of section 2 of the Companies Act, 2013; and
- (g) any other person as may be specified by SEBI. However, these persons and special purpose distinct entities of which they are trustees are required to comply with all the other provisions of the SEBI (Public Offer and Listing of Securitized Debt Instruments and Security Receipts) Regulations, 2008.

An applicant seeking registration to act as a trustee shall:–

- (a) have a networth of not less than two crore rupees.
- (b) have in its employment, a minimum of two persons who, between them, have atleast five years experience in activities related to securitization and atleast one among them shall have a professional qualification in law from any university or institution recognised by the Central Government or any State Government or a foreign university.

The application for registration shall be made by the Trustee in the prescribed format along with the prescribed fees.

(5 MARKS)

Answer to Q2.A.

Difference between Hire-Purchase and Hypothecation

For a long time, Hypothecation was not defined legally in India, until it was defined by SARFAESI Act in 2002. It is a charge on any movable asset/property of a borrower for which bank has extended it's finance. It is an equitable charge on the assets in favour of the financing bank where the asset is owned by the borrower as well as possession is with him on behalf of the bank. If a borrower fails to repay the finance extended for the movable asset the bank

can repossess the asset with the consent of the borrower. If the borrower surrenders the asset to the bank, bank has a legal right to sell the asset without the intervention of the court and adjust the proceeds towards the loan dues. Under SARFAESI Act bank also has got the right to sell the movable asset of a defaulted borrower without the intervention of a court subject to following rules laid down in this regard.

Under Hire Purchase Agreement, as explained above the ownership of the financed assets remains with the lender till it is purchased by the borrower at the end of the hire purchase period as per agreed terms between the financing agency and the borrower. Under Hire Purchase the financing entity may get the benefit of depreciation as well as ownership of the asset financed.

Banks cannot take advantage of Hire Purchase Arrangement, as ownership aspect of the asset will result in violating permitted line of activity under the banking license granted by RBI.

For example if a bank finances a public transport vehicle under Hire Purchase, it implies that the bank as the owner of the public transport vehicle, is involved in the business of public transportation which is against permitted activities under the Banking license. Also in a Hire Purchase arrangement, if an accident takes place, bank will be a party to the claim suit filed by the injured passengers which will involve monetary loss and as well as damage to the image of the bank.

(5 MARKS)

Answer to Q2.B.

Difference between Letter of Guarantee and Bank Guarantee:

- 1) A letter of credit, sometimes referred to as a documentary credit, acts as a promissory note from a bank. It represents an obligation taken on by a bank to make a payment once certain criteria are met. Once these terms are completed and confirmed, the bank will transfer the funds. The letter of credit ensures the payment will be made as long as the services are performed.
- 2) For example, an Indian wholesaler receives an order from a US company. The wholesaler has no way of knowing whether the buyer can fulfill his payment obligations, and requests a letter of credit be provided in their contract. The purchasing company applies for a letter of credit at a bank where it already has funds (LOC). After the goods have been shipped, the bank would pay the wholesaler its due as long as the terms of the sales contract are met, such as delivery before a certain time or confirmation from the buyer that the goods were received undamaged. The letter of credit substitutes the bank's credit for that of its client, ensuring correct and timely payment.
- 3) Letters of credit are especially important in international trade due to the distance involved and potentially differing laws in the countries of the businesses involved. In these transactions, it is not always possible for the parties to meet in person. The bank

issuing the letter of credit holds payment on behalf of the buyer until it receives confirmation that the goods in the transaction have been shipped.

- 4) While letters of credit are used mostly in international trade agreements, bank guarantees are often used in real estate contracts and infrastructure projects. Bank guarantees represent a more significant contractual obligation for banks than letters of credit do. A bank guarantee, like a letter of credit, guarantees a sum of money to a beneficiary; however, unlike a letter of credit, the sum is only paid if the opposing party does not fulfill the stipulated obligations under the contract. This can be used to essentially insure a buyer or seller from loss or damage due to non-performance by the other party in a contract.
- 5) Bank guarantees insure both parties in a contractual agreement from credit risk. For instance, a construction company and its cement supplier may enter into a new contract to build a mall. Both parties may have to issue bank guarantees to prove their financial stance and capability. In a case where the supplier fails to deliver cement within a specified time, the construction company would notify the bank, which then pays the company the amount specified in the bank guarantee.
- 6) Both bank guarantees and letters of credit work to reduce financial risk. The seller takes on less risk when a letter of credit or bank guarantee is active, and would be more likely to agree to the transaction. These agreements are particularly important and useful in what would otherwise be risky transactions for the seller, such as certain real estate and international trade contracts. Banks, since they are agreeing to take on risk, thoroughly screen buyers interested in one of these transactions. After the bank has determined that the buyer is a reasonable risk, a monetary limit is placed on the agreement. The bank agrees to be obligated up to, but not exceeding, the limit. This protects the bank by providing a specific threshold of risk.

(5 MARKS)

Answer to Q2.C.

Conditions for issue of depository receipts

Rule 4 lays down the following conditions to be fulfilled by a company for issue of depository receipts:

- 1) The Board of Directors of the company intending to issue depository receipts shall pass a resolution authorising the company to do so.
- 2) The company shall take prior approval of its shareholders by a special resolution to be passed at a general meeting. However, a special resolution passed under section 62 of Companies Act, 2013 for issue of shares underlying the depository receipts, shall be deemed to be a special resolution for the purpose of section 41 of Companies Act, 2013 as well.
- 3) The depository receipts shall be issued by an overseas depository bank appointed by the company and the underlying shares shall be kept in the custody of a domestic custodian bank.

- 4) The company shall ensure that all the applicable provisions of the Scheme and the rules or regulations or guidelines issued by the Reserve Bank of India are complied with before and after the issue of depository receipts.
- 5) The company shall appoint a merchant banker or a practising chartered accountant or a practising cost accountant or a practising company secretary to oversee all the compliances relating to issue of depository receipts and the compliance report taken from such merchant banker or practising chartered accountant or practising cost accountant or practising company secretary, as the case may be, shall be placed at the meeting of the Board of Directors of the company or of the committee of the Board of directors authorised by the Board in this regard to be held immediately after closure of all formalities of the issue of depository receipts.

However, that the committee of the Board of directors referred to above shall have at least one independent director in case the company is required to have independent directors.

(5 MARKS)

Answer to Q2.D.

Merits of Commercial Paper

- 1) It provides more funds compared to other sources. The cost of commercial paper to the issuing firm is lower than the cost of commercial bank loans.
- 2) It is freely transferable in nature, therefore it has high liquidity also. Additionally, SEBI vide its circulars dated October 22, 2019 and December 24, 2019 prescribed framework for listing of Commercial Papers which will provide additional liquidity to the investors of CPs.
- 3) It produces a continuing source of funds. This is because their maturity can be tailored to suit the needs of the issuing firm. It is highly secure and does not contain any restrictive conditions.

Demerits of Commercial Paper

- 1) **Only financially secure and highly rated** organizations can raise money through commercial papers. New and moderately rated organizations are not in a position to raise funds by this method.
- 2) The amount of money that can be raised through commercial paper is limited to the deductible liquidity available with the suppliers of funds at a particular point.
- 3) The duration of commercial paper cannot be extended.

(5 MARKS)

Answer to Q3.A.

In pursuance to provisions of Section 186(2) of the Act, no company shall directly or indirectly – give any loan to any person or other body corporate, – give any guarantee or provide security in connection with a loan to any other body corporate or person and acquire by way of subscription, purchase or otherwise, the securities of any other body corporate exceeding 60% of its paid-up share capital plus free reserves plus

securities premium account or 100% of its free reserves plus securities premium account, whichever is more.

This section mandates a company to make investment only through two layers of investment companies. It is the investor company which shall be held liable in case of any violation of the section; therefore, It is prudent and advisable that the investee company to seek a declaration from the investor company whether the investment made by the investor is coming from more than two layers up.

Section 186(2) shall not apply on Specified IFSC public and private company if a company passes a resolution either at a meeting of the Board of Directors or by circulation.

(5 MARKS)

Answer to Q3.B.

OBLIGATIONS OF THE ISSUER AND THE INTERMEDIARIES

1. The issuer shall disclose all the material facts in the offer documents issued or distributed to the public and shall ensure that all the disclosures made in the offer document are true, fair and adequate and there is no mis-leading or untrue statements or mis-statement in the offer document.
2. The Merchant Banker shall verify and confirm that the disclosures made in the offer documents are true, fair and adequate and ensure that the issuer is in compliance with these regulations as well as all transaction specific disclosures.
3. Each rating obtained by an issuer shall be reviewed by the registered credit rating agency atleast once a year and any revision in the rating shall be promptly disclosed by the issuer to the stock exchange(s) where the non-convertible redeemable preference shares are listed. Any change in rating shall be promptly disseminated to investors and prospective investors in such manner as the stock exchange where such securities are listed may determine from time to time.
4. The issuer shall treat the applicants in a public issue of non-convertible redeemable preference shares in a fair and equitable manner as per the procedures as may be specified by SEBI.
5. The intermediaries shall be responsible for the due diligence in respect of assignments undertaken by them in respect of issue, offer and distribution of securities to the public.
6. No person shall employ any device, scheme or artifice to defraud in connection with issue or subscription or distribution of non-convertible redeemable preference shares which are listed or proposed to be listed on a recognized stock exchange.

(5 MARKS)

Answer to Q3.C.

- 1) Securitization is the transformation of financial assets into securities. Securitization is used by financial entities to raise funding other than what is available via the traditional methods of on-balance-sheet funding.

- 2) In other words, Securitization is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors.
- 3) The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets.
- 4) The pool of assets collateralizes securities. These assets are generally secured by personal or real property (e.g. automobiles, real estate, or equipment loans), but in some cases are unsecured (e.g. credit card debt, consumer loans).
- 5) There are four steps in a securitization:
 - (i) Special Purpose Distinct Entity (SPDE) is created to hold title to assets underlying securities;
 - (ii) the originator or holder of assets sells the assets (existing or future) to the SPDE;
 - (iii) the SPDE with the help of an investment banker, issues securities which are distributed to investors; and
 - (iv) the SPDE pays the originator for the assets with the proceeds from the sale of securities.

(5 MARKS)

Answer to Q3.D.

An issuer may list its non-convertible redeemable preference shares issued on private placement basis on a recognized stock exchange subject to the following conditions:

- a. the issuer has issued such non-convertible redeemable preference shares in compliance with the provisions of the Companies Act, 2013 rules prescribed thereunder and other applicable laws;
- b. credit rating has been obtained in respect of such non-convertible redeemable preference shares from at least one credit rating agency registered with SEBI. where credit ratings are obtained from more than one credit rating agencies, all the ratings shall be disclosed in the offer document;
- c. the non-convertible redeemable preference shares proposed to be listed are in dematerialized form;
- d. the disclosures as provided in Regulation 18 of the SEBI NCRPS Regulations have been made;
- e. the minimum application size for each investor is not less than ten lakh rupees;
- f. the issuer shall create a capital redemption reserve in accordance with the provisions of the Companies Act, 2013 ;
- g. the issuer shall not issue non-convertible redeemable preference shares for providing loan to or acquisition of shares of any person who is part of the same group or who is under the same management, other than to subsidiaries of the issuer; and
- h. where the application is made to more than one recognised stock exchange, the issuer shall choose one of them as the designated stock exchange.

The issuer shall comply with conditions of listing of such non-convertible redeemable preference shares as specified in the Listing Agreement with the stock exchange where such non-convertible redeemable preference shares are sought to be listed.

(5 MARKS)