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DETERMINATION-DEDICATION-DEVOTION

Takeovers Are No Child's Play

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Golden Parachute, Poison Pill, White Knight, Shark Repellant.... These may sound like board games children play on picnics or power ups on your latest video game. However, in the real world they are buzzwords for defense mechanisms used by companies to guard against hostile takeovers, often giving them a new lease of life or protective shield to survive another day in board room battles and corporate games of their own brought on by ambitious investors and competitors. The various defenses against hostile takeovers, or 'shark repellants' are –

Poison Pill

A Poison Pill is a strategy in which a hostile takeover bid is upset by way of the whole process of takeover being made more problematic. Such a strategy may include rights issue i.e. shareholders can purchase shares of the company at a substantial discount or at a two for one scheme. This rights issue will be triggered only if a particular shareholder buys a certain percentage of shares, whereby he becomes a potential takeover bidder. The potential bidder himself is prohibited from exercising these rights.

Such a Rights Issue can be introduced and revoked only by the Board of Directors and thus the potential bidder would have to negotiate directly with the Board, otherwise the hostile takeover would become very expensive and tedious as shareholding would be diluted further.In such negotiations, the bidder and the company being targeted may agree on a mutually acceptable acquisition price which is high and can maximize shareholders' wealth or the takeover bid may fail altogether if the company is keen on retaining its current ownership and management structure.

Poison Pills are unlawful without shareholder approval in some jurisdictions and lawful if done in a transparent manner but not a well-received tactic in others. Sometimes, from the point of view of a shareholder, a takeover may be financially rewarding.

Poison Pills in Action - The term 'Poison Pill' was coined by investment banker Martin Siegel and was advocated by corporate lawyer Martin Lipton and became popular when the Delaware Supreme Court in the United States of America upheld its usage in *Moran vs. Household International* in 1985. The Court upheld the intention of the poison pill as a defense mechanism, to prevent hostile acquirers from achieving control by virtue of their deep pockets, rather than ballots, which is basically democracy in the corporate world.

More recently, in 2012, Netflix Incorporations, a company involved in video-streaming and DVD-by-mail, based in the USA, adopted an anti-takeover plan to prevent investor, Carl Icahn from increasing his nearly 10% stake in the company. Under the plan, Netflix's shareholders, other than the person acquiring more than 10%, were given the right to acquire more stock if any individual investor acquired more than a 10% stake in the company.

Blank Check

In the USA, "blank check preferred stock" (preference shares) can be issued and it involves sale to a particular investor and would become redeemable upon a change of control. These may have special voting, conversion or control rights which can make a takeover more difficult.

Greenmail

The term 'greenmail' is derived from the words 'blackmail' and 'greenback' (which refers to early American dollars). It is a measure adopted by a target company to reverse a potential takeover by an entity who has purchased a substantial stake.

The target company purchases its own shares back from the purchasing entity, at a premium, which is also called a 'bon voyage bonus' or a 'goodbye kiss'. In return for the greenmail payment, the purchasing entity, who has now made a substantial profit, ideally stops pursuing the takeover and agrees to refrain from purchasing that company's shares for a specified number of years. Thus the target company is free from the threat of a hostile takeover, but at a cost, as it may lead to increased debt for the target company trying to protect itself and reduced cash reserves. Greenmails may also result in increased promoter shareholding or capital reduction as a result of repurchasing the shares. However, the company gets to retain its management and employees and other assets which otherwise would have been compromised had the hostile takeover gone through.

Regulatory requirements and heavy tax obligations in certain jurisdictions have made greenmails less common nowadays.

Pac-man Defense

In this type of defense, the target company, counter purchases the shares of the acquirer company, reminding us of the manner in which Pac-man (in the video game) chases and overpower his enemies, the ghosts, after consuming a 'Power Pellet' dot. The company would have to have enough cash to acquire the shares required to halt the advances of the acquirer or in case the target company cannot acquire shares, the company or persons affiliated to the company may adopt other means of influence such as debt etc. The acquirer company is now faced with the hard choice of pursuing the takeover bid and risking control over its own company, or buying out the target company's share in itself, at a higher price. At the end of the day, whether the defense is successful or otherwise, the target company would be exhausted of a significant amount of its cash reserves which it could have put to better alternative use.

In the case of Martin Marietta Corporation in 1982, the company (MMC) borrowed $ 1 billion to finance a retaliatory acquisition by Bendix Corporation. The company ultimately had to sell off some of its divisions to repay the heavy debt as well as buy back some of the stock that had fallen into the acquirer's hands.

Golden Parachute

A Golden Parachute would refer to agreements between employers and high level managers on with respect to hefty compensation packages on termination of employment. Termination of employment would be specified to mean termination as a result of takeover or merger. Therefore, as a result of a takeover, the company's management would leave the company and the acquirer company would have to pay this increased cost. Similarly, a tin Parachute would refer to compensations payable to mid-level managers. The increased cost and loss of talent may deter acquirers.

Staggered Board

A Staggered Board is one in which only a fraction of the members of the board are voted into office each time instead of all the directors having the same one year office. Therefore, if an acquirer wishes to capture a board in order to reverse the poison pill provision, it would have to wait for 2 cycles of directors to retire by rotation before it can gain control of the entire board. With a staggered board, an acquirer cannot win a proxy fight either (where the acquirer convinces shareholders to vote out members of the board of directors in a meeting).

India already has such a concept in place (Section 152 of the Companies Act, 2013) whereby only one-third of the directors are liable to retire every year. Also, at least two-thirds of the board should consist of directors who retire by rotation. The remaining one-third is appointed in the manner as stated in the Articles of Association. However, Section 169 of the Companies Act, 2013 allow shareholders to remove a director by an ordinary resolution. In such a case, an acquirer may be successful in its proxy fight. A staggered board combined with a poison pill provision is a potent combination against hostile takeovers.

Macaroni Defense

When adopting this defense mechanism, the company issues a large number of bonds on the condition that they must be redeemed at a higher price if the company is taken over. It is called Macaroni Defense because if the company is under threat of being taken over, the redemption price of the bond expands in the same manner as macaroni pasta does in boiling water.

White Knight

A White Knight may be a company or an individual that acquires a target company at a fair consideration in which the target company acquired is facing a hostile acquisition from another potential acquirer (Black Knight). White Knights are preferred as acquirers as they act in good faith and may not replace the management, unlike hostile bidders whose intention is to take over the management and steer the company in a different direction. They arrive to rescue the target company from the hostile bidder by offering a more lucrative bid or more agreeable terms to the management. However, very ambitious Black Knight acquirers may allow the deal between the target company and the White Knight to go ahead and then may launch a hostile takeover bid on the White Knight itself, resulting in a corporate checkmate.

A White Knight could also refer to the acquirer of a struggling firm that may not be under any threat of a hostile takeover but which is financially weak and possibly undergoing liquidation.

For instance, in 2009, Fiat took over Chrysler to save it from liquidation. In 2011, Google acquired Motorola Mobility (Motorola's cell phone division). Around 2000-2001, Gesco Corporation Limited along with Mahindra Realty & Infrastructure Developers together thwarteda takeover bid by the Dalmia Group on Gesco Corporation. Although Gesco and Mahindra were successful, Gesco eventually merged into Mahindra. Reliance Industries' acquisition of stake in EIH Limited to counter a possible bid by another major shareholder, ITC Limited is another example of White Knights in action in India in the past.

Grey Knight

A Grey Knight is an acquiring entity that enters a bid for a hostile takeover and is perceived as more favourable than the Black Knight (but less favourable than the White Knight).The position of a Grey Knight is odd in the sense that it is neither welcome nor unwelcome in the acquisition bid. It is more a question of choosing the lesser of the evils, when faced with a difficult situation such as a hostile takeover.

Also interesting to note is the term, Yellow Knight. It refers to a company that was once making a takeover attempt but results in discussing a merger with the target company, probably due to the target company's ability to fend off the takeover. The colour yellow refers to its association with cowardice, since the company has backed out of a takeover attempt and is now willing to listen to the target company's terms.

Asset Stripping or Selling off the Crown Jewels

Here, the target company sells off its most attractive and advantageous assets to a friendly third party or spins off the assets into a separate entity, thus converting itself into a sort of 'shell company' that is unattractive to the acquirer. In case of a spin off, the existing shareholders would get shares in the new entity. Alternatively, the target company could take up heavy loans that would be due after the takeover, thus increasing the acquirer's financial responsibility. In reality, it would be difficult to implement such a strategy as shareholders' resolution is required for disposal of a company's assets and they are unlikely to pass such a resolution as it would result in diluting the value of their shares.

Dual Capitalization

This involves issuing another class of shares with differential voting rights i.e. a new class of shares is issued which has superior voting rights but inferior dividends, in addition to the current regular class. Current shareholders can exchange their old shares for these new ones. For example, the differential voting rights shares may have 10 voting rights per share but the regular shares may have one voting right per share.

Adopting a defense mechanism such as the ones mentioned above seem to be Pyrrhic victories for the companies adopting them as although the company is victorious in warding off the threat of a hostile takeover, it is harming its own shareholders' rights and value in the process either by making the investment more unattractive or by diluting shareholding pattern.This was probably the reason for the term 'Poison Pill' as such a pill not only harms the bidder or the aggressor, but also the target or the victim taking the pill. Thus, most defense mechanisms are 'no-win situations'. A corporate should evaluate the takeover offer in an unbiased manner, prioritizing its shareholders, over its management's own ego and long term plans i.e. if a takeover can unlock value in a corporate, get rid of lazy or bad management, utilize its idle cash reserves, then they should consider a deal with the bidder.

Being a takeover target is inevitably beneficial for shareholders, as the stock price goes up, increasing shareholders' wealth. The target company management may try and adopt measures such as buy back or rights issue in order to ward off the takeover and these are again beneficial for the shareholders. If the takeover is successful, the new management would make changes in operations or financial management, thereby enhancing the wealth for the shareholders.

As the proverb goes, when the going gets tough the tough get going. On the other hand, some companies, particularly family businesses, would want to protect their business from uninvited acquirers at any cost and would adopt such measures even if it meant rebuilding the company from its roots, if ravaged by a takeover war.

The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 controls but does not make takeovers albeit hostile ones, difficult. The Takeover Code applies only to listed companies. Regulation 6 prescribes that only an acquirer, who together with persons acting in concert with him, holds shares or voting rights in a target company entitling them to exercise 25% or more but less than the maximum permissible non-public shareholding (currently 75%), shall be entitled to voluntarily make a public announcement of an open offer for acquiring shares. It is also provided that a voluntary offer can be made only by a person who has not acquired any shares in the target company in the preceding 52 weeks prior to the offer. Also, during the offer period, such acquirer shall not be entitled to acquire any shares otherwise than under the open offer. The acquirer is prohibited from acquiring any shares of the target company after the open offer for a period of 6 months except under another voluntary offer. Regulation 3 prescribes that an acquirer shall not acquire shares enabling him to exercise more than 25% of voting rights in a target company unless he makes a public announcement of an open offer for acquiring shares of such target company. As per Regulation 29(1), any acquirer who acquired shares in a target company aggregating to 5% or more of the target company's shares will have to disclose their aggregate shareholding to the target company. As per Regulation 7, the minimum offer size for an open offer is 26% of the total shares of the target company. This all makes silent acquisitions difficult and the target company can thus safeguard themselves against hostile takeovers as they can see the storm approaching. Thus, in India, there is scope for poison pills and other such shark repellants. Staggered Boards are compulsory by law in India and while poison pills and others are not explicitly illegal, it might be prudent to have them in place in case a corporate raider comes calling.

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A poem written by CA.V. MURALI, Chairman, BOS of ICAI
Dedicated to the CA Students

BLESSINGS AND WISHES

May there always be Light to guide your way;
May the Lord shower His choicest blessings on you, I pray;
May there be roses strewn in your path;
May you reach your desired destination fast.

I wish that the sun shines bright on your dreams;
And you are able to translate them to reality;
I wish that all obstacles and hurdles melt like chaff;
And be ever blessed, happy with your life full of laughs.

Always try to do your best;
Whether it is life or exam or any test;
Aim for satisfaction and see;
That life's best things will come to thee.

Always keep a smile on your face;
Despite the trials and tribulations in your workplace;
Try to do your utmost with sincerity;
And will find yourself rewarded amply.

Have faith and trust in your competence;
Study with full commitment and diligence;
Aim to win, to be at the top of the game;
You will garner laurels and fame;
And the coveted letters 'CA' before your name!

Wishing you a Wonderful Life and a Fulfilling Future!

Good Bye and Good Luck

If Money Could Grow on Trees

You would have often heard people saying that if they had a tree that produced money, life would have been very easy. They could easily pluck money and spent it on the things they wanted to possess. Put it in another way, since the country is free to print any number of notes it wants, why doesn't it produce billions of rupees and distribute it among people and end all the poverty in one go? Have you ever wondered if everyone had a money tree or money making machine, or the country produced unlimited money what would happen? Would life become easy for everyone as nobody would be poor in the world? But this is easier said than done. There would be more chaos in the world. Too much money and too few goods could lead to only one thing: Inflation. There would be hyper inflation everywhere because people would be having money but there would not be sufficient goods to buy. This exactly happened in Germany way back after World War I. It borrowed heavily to pay its war costs. And in order to pay off its debts, it suspended the standard of backing cash with gold and started printing more and more money. This led to inflation in the economy. In 1914, at the start of World War I, the dollar was worth 4.20 marks. From then on, the German currency steadily declined, and in the fall of 1922 it went into a freefall. By November 1923 the dollar was at 4.2 trillion marks. Millions of the German people found that their life's savings would not even buy a postage stamp. Of late, Zimbabwe faced a similar situation and experienced 3.5 million percent monthly inflation rate in 2008 with an egg costing 50 billion Zimbabwean dollars. A loaf of bread then cost as much as 12 new cars could have cost 10 years before.

It is to be noted that money doesn't have any intrinsic value of its own. It is just a proxy to the available resources in a country. A hypothetical example would make it clear. Suppose in a family, there are five members and it has 50 kilograms of silver. It is decided to distribute the silver equally among all members of the family. One member would get 10 kgs of silver. Now suppose, instead of giving silver, it is decided to give everyone a coupon that one could get 10 kgs of silver in exchange for. So 1 coupon = 10 kgs of silver; 5 coupons = 5 x 10 kgs of silver = 50 kgs of silver.

Now, suppose each of the members marries and brings a spouse into the family. Now, there are 10 members. However, the silver is still 50 kgs. In order to divide the silver equally among all 10 members, the family decides to print 5 more coupons and hand them over to the new members of the family, while informing everyone that a coupon now can only be exchanged for 5 kg of silver. Therefore, after spouses come in: 1 coupon = 5 kgs of silver; 10 coupons = 10 x 5 kgs of silver = 50 kgs of silver. It should be noted that 'wealth' of the family has not increased: it is still 50 kgs of silver. Only more coupons have been printed. However, if somehow the family acquires more silver, the family's wealth would increase.

A country also functions in the same manner where the currency note functions as a coupon. Merely printing more currency notes will not make a country wealthy. The value of currency notes increases only when the 'wealth' of the country increases. And the wealth of the country increases when more goods and services are produced in the country. The more wealth a country creates and accumulates, the more valuable its currency notes become.

It is to be noted that here, we are assuming that there is full employment in the country and people spend whatever they get, while in actual situation this may not be true. If the country is operating at less than full employment, increased money supply will lead to more production, employment and income etc. Another assumption being made here is that whatever money is printed by the government, it automatically reaches the common people. However, this is not so. When the central bank prints money, it buys securities of private sector banks and gives them money in return. This expands the base of what we'll call high-powered money. Now, private sector banks are required to keep a certain proportion of this money in the form reserves and give out the rest to the borrowers etc. Suppose they have money worth ₹ 100, they are mandated to keep a reserve of say, 10% of this i.e. ₹ 10. That means ₹ 90 can be released by banks in the form of loans etc. The entrepreneur or business person now finds that banks are willing to give more loans; he goes to the bank, takes out a loan, uses the money to pay his workers, his suppliers etc. This is how money makes its way to the people. The central bank's increase of high-powered money provides the incentive for banks to make more loans.

This is what India's Central Bank - Reserve Bank of India (RBI) does as well. Now, the question is that how RBI or for that matter any country's monetary authority determines this amount? There was a time when countries used to follow Gold Standard i.e. they based their currency on the amount of gold reserves they had. Over a period of time, this was given up by most of the countries. Now most of the countries have their own system of printing currency. In India, for printing currency, the RBI considers the economic growth of the country, or simply India's Gross Domestic Product (GDP). Although GDP is also not the exact measure of growth, for simplicity it is assumed that GDP is the exact measure of growth for any country. In addition to this estimated demand due to growth in economy, the amount of money that needs to be printed also includes replacement of damaged notes, reserve requirements, circulation purposes, etc. While making the decision as regard the amount to be printed, the RBI has to carefully consider various economic and non economic variables. Depending upon the conditions in the national and international economies, the monetary authority could have any of the goals - stable prices, gradual rise in prices or fall in prices - with regard to prices in the economy. Apart from this, the objectives of Exchange-rate Stability, Attainment of Full Employment, Rapid Economic growth or Social Justice could become important and define or alter the monetary decisions of the RBI. ■

“Merely printing more currency notes will not make a country wealthy. The value of currency notes increases only when the ‘wealth’ of the country increases. And the wealth of the country increases when more goods and services are produced in the country.”

ANNOUNCEMENT

Online Mentoring Sessions Recordings Now Available

The Board of Studies is pleased to announce availability of Recordings of topic-wise Online Mentoring Sessions taken by BOS Faculty on ICAI Cloud Campus (http://cloudcampus.icai.org) through the tab "Recorded Online Mentoring" to enable students to view these sessions even after the event date and time, at their convenience.

The Online Mentoring sessions provide topic specific guidance to the students for better preparation for their examinations and also answer their relevant questions/ queries. The students who missed the LIVE sessions at the designated date and time, may also take benefit of the queries answered.

Students are encouraged to make good use of this facility to have a better understanding of the subjects and enhance preparation for their forthcoming examinations.

Director
Board of Studies

How Yoga and Spirituality can Help in Studies

Sri Sri Ravishankar
Spiritual leader
and founder of Art of Living

Ancient India has been the source of innumerable, almost magical for that time in history scientific advances. We knew how to make rust proof iron. We could peer into the vastness of space and make out that a faint blur was actually a twin star system. We performed plastic surgery. We gave the world zero. We calculated the value of Pi to 21 decimal places. The ayurvedic system of medicine is still widely and effectively used. The knowledge of science and arts was surprisingly deep.

Throughout history, India has perhaps been the only country and civilization where science and religion were never at loggerheads with each other. In fact, all our scientists were saints!

Through spiritual practices of pranayama, yoga and meditation, these great seers managed to look into the furthest reaches of space and probe into the microscopic world of atoms as well. Sage Vasishtha in the Yoga Vasishtha, tells the young Prince Rama very matter of factly that the world appearance is an illusion, just like the blueness of the sky! The general population knew that the blueness of the sky was an illusion - 10,000 years ago.

Fortunately a lot of the yogic practices and this knowledge were passed on through the generations more or less intact. They survived the Islamic invasions as well as the onslaught of the British. This precious Knowledge is now easily available to anyone who will care to learn, practice and apply these principles in their lives.

How would these ancient techniques of Yoga, Spirituality and meditation help a contemporary person struggling with their studies?

Recently, Prime Minister Narendra Modi mentions in his address to the US Congress that there are more Americans

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A huge component of being able to study effectively is the ability to keep the mind focused for long periods of time on the task at hand. Regular practice of meditation grants you this ability.

who bend their bodies to do Yoga than play with a curved ball!! Yoga, meditation, pranayama and Indian Spirituality have become truly global. An intelligent student will grab the opportunity to learn and practice these techniques to perform better than he could imagine in his studies.

A huge component of being able to study effectively is the ability to keep the mind focused for long periods of time on the task at hand. Regular practice of meditation grants you this ability.

Numerous studies at many many prestigious Universities all over the world have repeatedly shown the immense benefits of yoga and meditation. Some have shown that the brain actually changes its physical shape when one meditates over a prolonged period of time. This new shape makes it especially suited to learning new things. It sharpens the intellect and greatly boosts the power of the memory.

Learning happens through the neurons in our brains. We have 100 billion neurons in our brains. Each neuron can grow up to 10,000 very thin filaments that are called dendrites. These dendrites can interact with the each other in billions and billions of permutations and combinations through a process called synapses. So many, that they are more than the number of elementary particles in the universe.

As we read our study material, there are electrical impulses that travel along our dendrites and make connections. When we write, re read or practice what we have learned, these connections become stronger. If we discuss or teach this material to others, then the connections acquire a sheath of a substance called myelin, which makes the connection super strong and effectively makes it a long term memory.

The catch here is that the neurons in the brain work best in a stress free environment.

When you are not feeling threatened and are feeling safe, the body is suffused with serotonin among other "good" hormones. The neurons in the brain love this environment and can function at peak efficiency.

On the other hand stress, both external and internal, causes the secretion of cortisol and other "danger" hormones - the ones that trigger the fight or flight systems of the body. When the body is on high alert like this, it becomes almost impossible to study anything new and the chances of forgetting material you have already covered becomes greatly increased. These dangerous hormones can destroy the delicate connections of the dendrites that you may have carefully cultivated.

Meditation is known to cause the release of serotonin and stop the release of cortisol. This creates an environment in the body and the brain that is super conducive to learning and remembering.

"There are many who know their subjects, but simply don't know how to communicate effectively. The combined package of yoga, meditation, knowledge and spirituality will greatly enhance your ability to express yourself and become a team player."

Yoga is a form of relaxed exercising. Dopamine is the hormone released by exercising and this prevents anxiety and depression from setting into the system. A bit of time spent doing Yoga everyday will shield you from mental fatigue and grant you immense stamina and flexibility in your body.

Pranayama and meditation will make you mentally alert and grant you the ability to remain focused until your work gets done.

Quite a few times while studying, you have to assimilate all the things you have learned and manage to come up with something new. Throughout history, the greatest of discoveries and inventions have been "accidents". They have happened when the person after wrestling with a problem for a long time, decided to relax. Then some event happened which triggered a powerful insight. Newton and Gravity, Kekule and the Benzene Ring structure, Archimedes and his Law of displacement come to mind.

After a gruelling session of mental activity, the brain needs to wind down. The mind needs to relax. Meditation does exactly this. After a lot of taxing work, in deeper states of relaxation, fortuitous connections among the dendrites may happen and valuable insights could be gained.

There are many who know their subjects, but simply don't know how to communicate effectively. The combined package of yoga, meditation, knowledge and spirituality will greatly enhance your ability to express yourself and become a team player.

Learn and practice yoga and meditation for achieving an unbeatable edge over others. A few words of caution here – Only doing Yoga and meditation will not help you pass that exam. You will have to study as well.

All the very Best!

How to Access Distance Education for CA Course on ICAI Cloud Campus

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- Students can join LIVE Online Mentoring to the students to clear their doubts
- Recordings of Online Mentoring Sessions are also available to enable students to view these sessions even after the event date and time, at their convenience.

Short Selling: A Game Changer

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Security market is part of financial market which is concerned with issue, subscription, selling and buying of Equity Instruments, Debt instrument etc. in order to provide finance for business and for trading in securities. Security market is divided into two streams i.e. Primary Market and Secondary Market. While the Primary Market deals with issue of new securities by the company and their subscription, their further sales and purchases take place at secondary market. One of the important terms associated with secondary market is 'Short Selling.' This article discusses the meaning and various other aspects related to it.

What is Short Selling?

Short selling is the sale of a security that is not owned by the seller, or that the seller has borrowed. Short selling is motivated by the belief that a security's price will decline, enabling it to be bought back at a lower price to make a profit. The various steps involved in Short Selling are as follows:

- Borrow the security.
- Receive the money by selling the borrowed securities.
- When prices of security decline, purchase the security as needs to be returned.
- Return the securities to the lender of security on settlement date.
- Difference between the prices of selling the security and buying the same, after adjusting borrowing fees, is profit arises out of short selling.

This process can also be understood with the help of following example.

Example

Mr. B borrows 1000 shares (having a price of ` 100 per share) from Mr. A in exchange of a premium of 3% of the value of share. Mr. B sold these shares at above price in the market and buys them back when price comes down to ` 90. Overall Profit resulting all these transactions is ` 7,000 as shown below:

Particulars	**Amount (`)**
Proceeds from sales of 1000 shares	1,00,000.00
Less: Amount paid for purchasing securities	90,000.00
Less: Fees paid for borrowing the securities	3,000.00
Profits from Short Sales	` 7,000.00

Thus from above it is clear that the pay off of selling short is opposite to long position. A short seller will make money if the stock goes down in price, while long position make money when stock goes up.

Further two terms associated with 'Short Selling' are as follows:

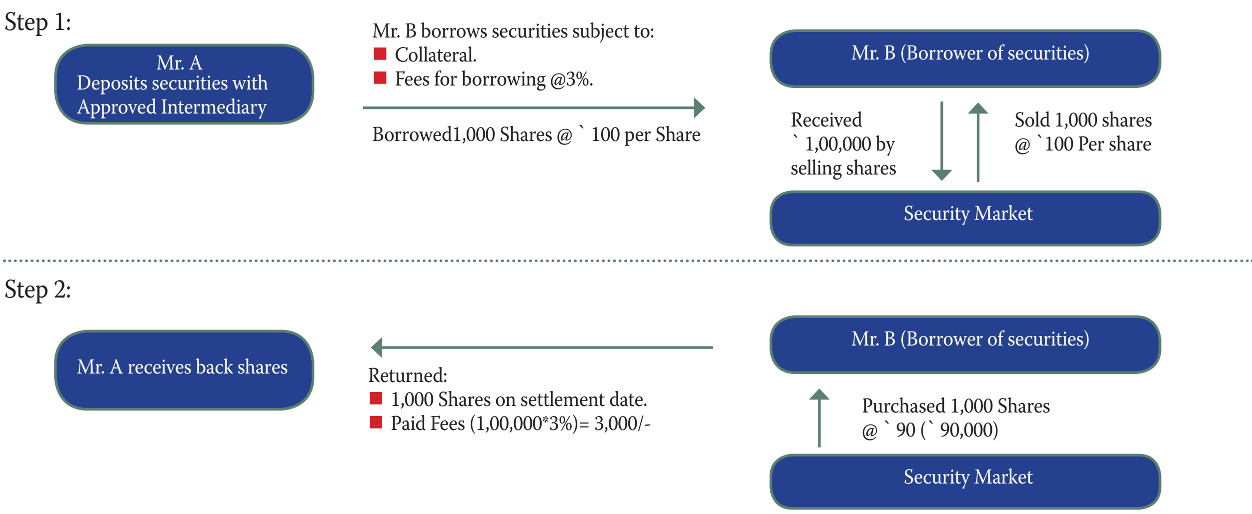
(1) **Approved Intermediary:** Approved Intermediary is a person duly registered with the Securities and Exchange Board of India (SEBI) under the Security Lending and Borrowing Scheme, 1997 through whom the lender will deposit the securities for lending and the borrower will borrow the securities. SEBI does not allow any direct agreement between the lender and borrower of securities:

- Lender for lending his securities shall deposit the same with approved intermediary and will receive fees on lending, subject to the terms agreed upon in contract with approved intermediary
- Borrower for borrowing securities needs to approach approved intermediary and can borrow the securities subject to payment of fees and collateral for borrowing.

(2) **Collateral:** Since short selling involves selling of borrowed securities, it comprises of risk that borrowed securities may not be returned by the borrower on settlement date. In order to ensure that the borrowed securities are returned in the future for the entire borrowings, borrower needs to give collateral to the approved intermediary. It may be in the form of Cash, Bank Guarantee, Government Securities or other securities as may be agreed upon with the approved intermediary.

"The way to love anything is to realize that it may be lost" — Gilbert K. Chesterton

The whole process of Short Selling can also be understood with the help of following diagram.



Short Selling Vs. Naked Short Selling

Short Selling should be distinguished from Naked Short Selling. Naked short selling is selling the shares which are actually not in existence. Such kind of activities manipulate the market by increasing the sales of securities which actually does not exist and finally results in lowering the share prices by creating artificial supply of securities. Therefore naked short selling is prohibited in Indian context.

SEBI imposed a partial ban on short selling in March 2001 following a crash in stock prices and allegation that confidential information acquired by Bombay Stock Exchange had been used by the insiders for making gains. However, in early 2008, institutional investors were allowed to short selling shares again.

Costs and Risk involved in Short Selling

On the face, Short Selling appears to be attractive as a short-cut to make riskless profit. However, it involves few costs as well as many risk factors.

- **Costs**
  - Stock borrowing costs: When securities are borrowed the specific rate of fees as required by the Approved Intermediary has been charged on the borrowed securities. Such borrowing cost adds up the cost of short selling transaction. Such Fees charged on securities is generally high.
  - Dividend and other payments: Short seller is responsible for making payment of every dividend paid on the shares to the lender. Also for the other events associated with the shorted stock like stock splits, bonus issues borrower is responsible for making payment to lender for such unpredictable events.

- **Risks**
  - *High Volatility:* As defined above short sales is done with a view of bearish price of borrowed security. At the time of purchasing the borrowed security there exists a high uncertainty of getting declined price of security in near future. The decline in prices is expected only on the basis of market studies and trend analysis, but it is not necessary that the estimates will survive and leads to profit always.
    In case of sudden jump in the security prices, one may have to purchase the security on increased prices in order to fulfill the obligation of returning security on time.
  - *No Ceiling on Losses:* There is no ceiling on how much a short seller can lose in a trade. Short selling comprise of the possibility of infinite risk. The prices of stock may keep on escalating and the short seller has to pay the prevailing stock price to buy back the shares. On the other hand, gains have a ceiling as the prices of the stock cannot go below zero.
  - *Regulatory Risk:* Short selling also involves regulatory risks. Regulators may sometimes impose bans on short sales in order to get the prices stable and to avoid immense selling pressure. This leads to sudden increase in prices forcing the short sellers to cover short position at huge losses.
  - *Situation of Short Squeezes:* When stock prices go up, short seller losses higher, as a result of the same short sellers rush to buy the stock to cover their positions. This rush creates demand of stock and leads to increased prices; such situation is known as short squeeze. Short squeeze is a great way to lose a lot of money very quickly.

SEBI Guidelines on Short Selling

As per the guidelines issued by SEBI, short selling is allowed in NSE & BSE by all the classes of investors Viz. retail and institutional investors (Mutual Funds, Banks, Insurance Companies, etc.). However the institutional investors can short sell subject to the condition that no institutional investor shall be allowed to do day trading i.e. square off their transaction intraday.

The institutional investors are required to disclose that the transaction is short sell at the time of placement of the order. However, in case of retail investors, the same is being disclosed on the transaction date. Brokers are mandated to collect the details on scrip wise short sell positions, collect the data and upload it to stock exchange before the commencement of trading on the following day.

> "Short Selling should be distinguished from Naked Short Selling. Naked short selling is selling the shares which are actually not in existence. Such kind of activities manipulate the market by increasing the sales of securities which actually does not exist."

Does Short Selling contributes to manipulation in Market or not

The short selling is a highly debatable topic. On one hand, this advanced trading activity is considered as reasons of destabilization of market and on the other hand, it is considered as necessary element of security market. Due to increased sales, short selling leads to lowering down the market price of securities. However, this is the only way of trading those securities which are concentrated in the hands of few people for a long period of time. Short selling makes an important contribution to the market by:

- Lowering down the prices of overpriced securities in the market.
- Contributing significantly to market liquidity by increasing sale & purchase in security market.
- Increasing overall efficiency of market by quickening price adjustments.

Manipulations arise due to misconduct and it can arise in any field of work. A genuine short selling does not leads to manipulation till the evidences of market misconduct are available against the same. Manipulations arise in the other forms of trading also but the same can be cured by defining the regulatory framework for such manipulative trading practices.

Conclusion

Despite all the risk factors, if short selling is done in a regulated frame work, it contributes positively to the security market. Along with time, a short selling technique attracts many market players and had proven its significance. In the current scenario, short selling is considered a legitimate investing activity and therefore allowed in most of the countries. From the view point of short seller, it may lead to huge profits or infinite losses. ■

Toppers of Chartered Accountants Final Examination: May-2016

		
Sri Ram S. **First Rank** Salem	**K.N.V.V. Upendra** **Second Rank** Vijayawada	**Yash Manojkumar Goyal** **Third Rank** Jamnagar

Our Hearty Congratulations

How to prepare for and answer Case Law based questions?

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First Rank Holder - CA Final, November 2015

It is pertinent for the students to know "How to answer a question which is based on a case law?". It is definitely not a rocket science. However, many students are still little unsure as to how to answer a case law based question. In this article, I would like to share my thoughts on answering case studies.

Where are the questions taken from?

The Institute publishes a separate book titled "Select Cases in Direct and Indirect Tax Laws- an essential reading for Final Course" which contains the summary of recent case laws which are of utmost importance to enable students to appreciate critical issues in interpretation and applying provisions to practical situations. The relevant book for the November 2016 CA Final exams is the August 2015 edition. Apart from this, some additional significant cases are published as part of Annexure to the RTP.

How to prepare for case law based questions?

Case law based questions are not exactly theory questions. They involve understanding the facts, analysing, applying the judgement and synthesising. When preparing, students must read the facts of the case and identify the subject matter of litigation. After identifying, the facts must be correlated with the applicable law to reach a logical and rational conclusion.

When reading case laws, students must also read the relevant sections dealt with by the particular case. This not only helps them understand the judgement better but also leads to appreciating the interpretations made and the judgement reached thereon.

Students must read the cases a couple of times, to understand the facts and decision rather than trying to memorise it. Only when they understand and appreciate the rationale of the Court ruling, they will be able to apply it effectively in problem solving.

> "When preparing, students must read the facts of the case and identify the subject matter of litigation."

While preparing students must try to remember the names of the parties involved, i.e. the appellant and defendant name and whether it is decided by Supreme Court, High Court or AAR. Though it is not compulsory to quote the name, it is highly recommended. Whenever there is doubt, it is advisable not to quote than to quote a fictitious name or the wrong case. When a student quotes the name, it gives him/her the advantage of answering a question with authority i.e. with the backing of a decided case.

How to answer case law based questions?

An ideal answer for a case study can be in the following form:

First Paragraph

In the first Para, the name of case law and a gist of the provisions of the law on which the question is based need to be mentioned. For this, students must be able to recollect the relevant case law and the applicable provisions of the Act on reading the question. For example, they can begin their answer by stating "The facts of the case are similar to the case of _____". Further, they must briefly discuss on the interpretation of the provisions by the deciding authority and the crux of the decision. When certain principles have been laid down in the decided case, they must briefly state the principles. Quoting the case will earn brownie points, however, they should be cautious not to quote a wrong or a fictitious case. If they do not remember the correct citation, they can alternatively state the facts and the judgment and begin their answer as follows; "In a decided case, the Supreme Court / High Court has held that ____".

> Quoting the case will earn brownie points, however, students should be cautious not to quote a wrong or a fictitious case.

Second Paragraph

In the second Para, the issue of the given case must be connected with that of the decided case and a justification must be provided for reaching the said decision in light of the provisions of law or interpretation made by the Court.

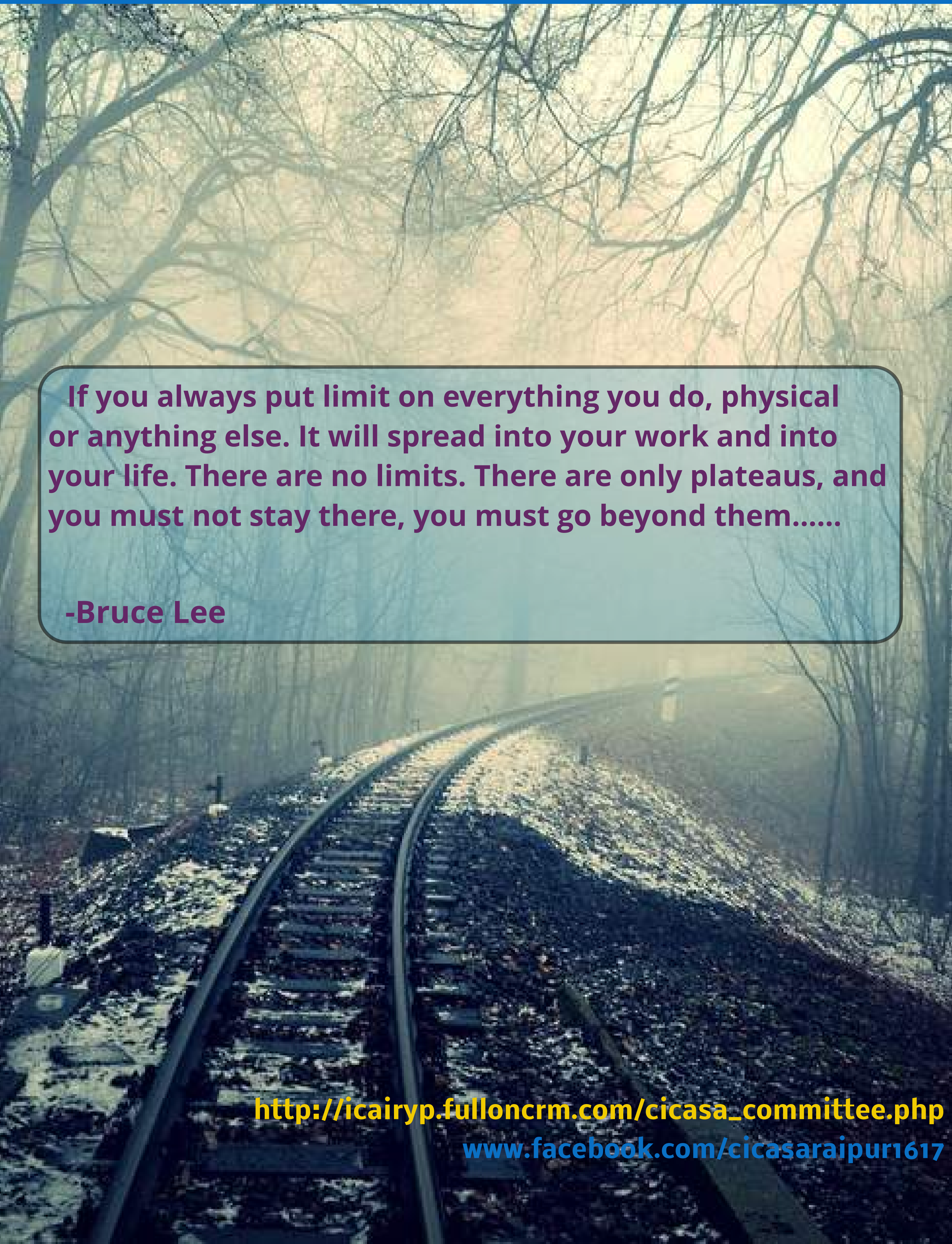
Third Paragraph

In the third Para, students must conclude the answer by stating whether or not the contention of the assessee/ Revenue is valid. For example, "Based on the decision of the Apex Court in the case of ________, the contention of the assessee is tenable/valid" or "In view of the decision held in the case of _____, the process carried out by XYZ amounts to manufacture". Generally, the question clearly states the matter on which students need to advice, based on which they can draft their conclusion.

General Tips

- Always support your answers with proper reasoning like provisions of the law or judicial decisions.
- Wherever, possible quote the section number and case law provided you are confident about it. It certainly adds value to your answer. However, when in doubt, do not quote sections/ case laws.
- Tax laws undergo frequent changes. Ensure that you stay updated with the amendments applicable to your examination.
- Be clear with the concepts and make short summary of cases as they help you during your last minute revisions.
- Always answer to the point. Answers must be commensurate with the marks.
- Avoid short forms like AC, DC, CEA, CER, CCR, etc. as they are not acceptable and may cause confusion.
- As law can be interpreted differently, ensure that when you answer in your own words, the meaning does not change. A reasonable command over English is required to convey our thoughts in a like manner to the examiner.
- Read suggested answers, practice manuals and revision test papers to get familiar with the pattern in which answers should be written and the expectations of the examiner. Also, read the examiner comments, to avoid common mistakes made in the past.
- No matter from which book you read, nothing can replace the bare Act. Refer to bare act to understand the flow of provisions and to gain clarity.
- Ensure that you read all the Institute's publications [Study Material, Practice Manuals, RTP, Supplementary Material, Select Case Laws and Mock Test Papers]
- Appear/ solve mock test papers to gain writing practice and speed.
- Case law based questions certainly help you save time as they can be answered in comparatively lesser time.
- Answer the question that you know the best at first as it boosts your confidence and creates a good impression.
- Revise as many times as possible before the exams. ■

(Disclaimer: The views expressed or implied in the article are that of the author and may not necessarily represent the views of the Institute.)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-Bruce Lee
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