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CHAPTER 10

FINANCIAL MARKET

CONCEPT OF FINANCIAL MARKET

A financial market is a market for the creation and exchange of financial assets.

FUNCTIONS OF FINANCIAL MARKET

Financial markets play an important role in the allocation of scarce resources in an economy by performing the following four important functions.

1. Mobilisation of Savings and Channeling them into the most Productive Uses: **A financial market facilitates the transfer of savings from savers to investors.**

2. Facilitating Price Discovery: **The forces of demand and supply help to establish a price for a commodity or service in the market. The interaction between them helps to establish a price for the financial asset which is being traded in that particular market.**

3. Providing Liquidity to Financial Assets: **Financial markets facilitate easy purchase and sale of financial assets. In doing so they provide liquidity to financial assets, so that they can be easily converted into cash whenever required.**

4. Reducing the Cost of Transactions: **The financial market is thus, a common platform where buyers and sellers can meet for fulfillment of their individual needs.**

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MONEY MARKET

The money market is a market for short term funds which deals in monetary assets whose period of maturity is up to one year.
These assets are close substitutes for money.
It is a market where low risk, unsecured and short term debt instruments that are highly liquid are issued and actively traded every day.
It has no physical location, but is an activity conducted over the telephone and through the internet.
The major participants in the market are the Reserve Bank of India (RBI), Commercial Banks, Non- Banking Finance Companies, State Governments, Large Corporate Houses and Mutual Funds.

MONEY MARKET INSTRUMENTS

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1. Treasury Bill: A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than one year.

They are issued by the Reserve Bank of India on behalf of the Central Government to meet its short-term requirement of funds. Treasury bills are issued in the form of a promissory note.

They are issued at a price which is lower than their face value and repaid at par.

The difference between the price at which the treasury bills are issued and their redemption value is the interest receivable on them and is called discount.

Treasury bills are available for a minimum amount of Rs. 25,000 and in multiples thereof.

2. Commercial Paper: Commercial paper is a short-term unsecured promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period.
It usually has a maturity period of 15 days to one year.
It is sold at a discount and redeemed at par.
The original purpose of commercial paper was to provide short-terms funds for seasonal and working capital needs.

3. Call Money: Call money is short term finance repayable on demand, with a maturity period of one day to fifteen days, used for inter-bank transactions.
Call money is a method by which banks borrow from each other to be able to maintain the cash reserve ratio.
The interest rate paid on call money loans is known as the call rate. It is a highly volatile rate that varies from day-to-day and sometimes even from hour-to-hour.

4. Certificate of Deposit: Certificates of deposit (CD) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions.

They can be issued to individuals, corporations and companies during periods of tight liquidity when the deposit growth of banks is slow but the demand for credit is high.

They help to mobilise a large amount of money for short periods.

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5. Commercial Bill: A commercial bill is a bill of exchange used to finance the working capital requirements of business firms.
When goods are sold on credit, the buyer becomes liable to make payment on a specific date in future. The seller could wait till the specified date or make use of a bill of exchange. The seller (drawer) of the goods draws the bill and the buyer (drawee) accepts it. On being accepted, the bill becomes a marketable instrument and is called a trade bill. These bills can be discounted with a bank if the seller needs funds before the bill matures. When a trade bill is accepted by a commercial bank it is known as a commercial bill.

CAPITAL MARKET

The term capital market refers to facilities and institutional arrangements through which long-term funds, both debt and equity are raised and invested. It consists of a series of channels through which savings of the community are made available for industrial and commercial enterprises and for the public in general. It directs these savings into their most productive use leading to

growth and development of the economy. The capital market consists of development banks, commercial banks and stock exchanges.

The Capital Market can be divided into two parts: a. Primary Market b. Secondary Market

DISTINCTION BETWEEN CAPITAL MARKET AND MONEY MARKET

The major points of distinction between the two markets are as follows:

(i) Participants: The participants in the capital market are financial institutions, banks, corporate entities, foreign investors and ordinary retail investors from members of the public. Participation in the money market is by and large undertaken by institutional participants such as the RBI, banks, financial institutions and finance companies.

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(ii) Instruments: The main instruments traded in the capital market are – equity shares, debentures, bonds, preference shares etc. The main instruments traded in the money market are short term debt instruments such as T-bills, trade bills reports, commercial paper and certificates of deposit.

(iii) Duration: The capital market deals in medium and long term securities such as equity shares and debentures. Money market instruments have a maximum tenure of one year, and may even be issued for a single day.

(iv) Safety: Capital market instruments are riskier both with respect to returns and principal repayment. Issuing companies may fail to perform as per projections and promoters may defraud investors. But the money market is generally much safer with a minimum risk of default.

(v)Expected return: The investment in capital markets generally yield a higher return for investors than the money markets.

PRIMARY MARKET

The primary market is also known as the new issues market. It deals with new securities being issued for the first time. The essential function of a primary market is to facilitate the transfer of investible funds from savers to entrepreneurs seeking to establish new enterprises or to expand existing ones through the issue of securities for the first time. The investors in this market are banks, financial institutions, insurance companies, mutual funds and individuals.

METHODS OF FLOATATION

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There are various methods of floating new issues in the primary market:

1. Offer through Prospectus: Offer through prospectus is the most popular method of raising funds by public companies in the primary market. The issues may be underwritten and also are required to be listed on at least one stock exchange.

2. Offer for Sale: Under this method securities are not issued directly to the public but are offered for sale through intermediaries like issuing houses or stock brokers.

3. Private Placement: Private placement is the allotment of securities by a company to institutional investors and some selected individuals. It helps to raise capital more quickly than a public issue.

4. Rights Issue: This is a privilege given to existing shareholders to subscribe to a new issue of shares according to the terms and conditions of the company. The shareholders are offered the ‘right’ to buy new shares in proportion to the number of shares they already possess.

5. e-IPOs: A company proposing to issue capital to the public through the on-line system of the stock exchange has to enter into an agreement with the stock exchange. This is called an Initial Public Offer (IPO). SEBI registered brokers have to be appointed for the purpose of accepting applications and placing orders with the company. The issuer company should also appoint a registrar to the issue having electronic connectivity with the exchange.

SECONDARY MARKET

The secondary market is also known as the stock market or stock exchange. It is a market for the purchase and sale of existing securities. It helps existing investors to disinvest and fresh investors to enter the market. It also provides liquidity and marketability to existing securities. It also contributes to economic growth by channelising funds towards the most productive investments through the process of disinvestment and reinvestment.

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STOCK EXCHANGE

A stock exchange is an institution which provides a platform for buying and selling of existing securities. As a market, the stock exchange facilitates the exchange of a security (share, debenture etc.) into money and vice versa. Stock exchanges help companies raise finance, provide liquidity and safety of investment to the investors and enhance the credit worthiness of individual companies.

MEANING OF STOCK EXCHANGE

According to Securities Contracts (Regulation) Act 1956, stock exchange means anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying and selling or dealing in securities.

FUNCTIONS OF A STOCK EXCHANGE

The following are some of the important functions of a stock exchange.

1. Providing Liquidity and Marketability to Existing Securities: The basic function of a stock exchange is the creation of a continuous market where securities are bought and sold. It gives investors the chance to disinvest and reinvest. This provides both liquidity and easy marketability to already existing securities in the market.

2. Pricing of Securities: Share prices on a stock exchange are determined by the forces of demand and supply.

3. Contributes to Economic Growth: A stock exchange is a market in which existing securities are resold or traded. Through this process of disinvestment and reinvestment savings get channelised into their most productive investment avenues. This leads to capital formation and economic growth.

4. Providing Scope for Speculation: It is generally accepted that a certain degree of healthy speculation is necessary to ensure liquidity and price continuity in the stock market.

TRADING AND SETTLEMENT PROCEDURE

Till a few years ago trading on a stock exchange took place through auction system. This has been replaced by screen based electronic trading system as almost all exchange have become electronic. Trading has, therefore, shifted from the stock market floor to the broker's office where trades are executed through a computer. Brokers are members of a stock exchange through whom trading of securities is done. Brokers may be individual, partnership firms or corporate bodies. They are intermediaries between the buyers Earlier these member owned, controlled and managed the exchanges.

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The ownership and management of stock exchanges by broke is often led to a conflict of interest between the brokers and their clients. This led to demutualisation of stock exchange. Demutualisation separates the ownership and control of stock exchanges from trading rights of members. This reduces the conflict of interest between the exchange, sellers and the brokers. A company's securities can be traded on stock exchange only if they are listed or quoted on it. Companies have to fulfill a set of requirements to get their securities listed on a stock exchange. This ensures that the interest of the shareholders is adequately looked after. Transaction on a stock exchange may be carried out either cash basis or o carry over basis. The carry over basis is also called badla and is a unique feature of Indian stock market Particularly the BSE. A stock market year is divided into periods called 'accounts' which vary from a fortnight to a month. All transaction made during on account are to be settled by payment for purchases and by delivery of share Certificate in case of sales on notified days of the clearing programme of a given stock exchange .
A Share Certificate is proof of ownership of securities by an individual. Purchase and sale of transactions in securities involved the exchange of money in return for the share certificate. This led to problem of theft, forgery, transfer delays and time involved in paper work. To eliminate these problems and it electronic book entry form of holding and transferring has been introduced. This is referred to as ' dematerialisation of securities'

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WORKING OF THE DEMAT SYSTEM

1. A DEPOSITORY PARTICIPANT (DP), either a bank, broker, or financial services company, may be identified.

2. An account opening form and documentation (PAN card details, photograph, and power of attorney) may be completed.

3. The physical certificate is to be given to the DP along with a dematerialisation request form.

4. If shares are applied in a public offer, simple details of DP and demat account are to be given and the shares on allotment would automatically be credited to the demat account.

5. If shares are to be sold through a broker, the DP is to be instructed to debit the account with the number of shares.

6. The broker then gives instruction to his DP for delivery of the shares to the stock exchange.

7. The broker then receives payment and pay the person for the shares sold.

8. All these transactions are to be completed within 2 days, i.e., delivery of shares and payment.

DEPOSITORY

Just like a bank keeps money in safe custody for customers, a depository also is like a bank and keeps securities in electronic form on behalf of the investor. In the depository a securities account can be opened, all shares can be deposited, they can be withdrawn/ sold at any time and instruction to deliver or receive shares on behalf of the investor can be given. It is a technology driven electronic storage system. It has no paper work relating to share certificates, transfer, forms, etc. All transactions of the investors are settled with greater speed, efficiency and use as all securities are entered in a book entry mode.

In India, there are two depositories. National Securities Depositories Limited (NSDL) is the first and largest depository presently operational in India. It was promoted as a joint venture of the IDBI, UTI, and the National Stock Exchange.

The Central Depository Services Limited (CDSL) is the second depository to commence operations and was promoted by the Bombay Stock Exchange and the Bank of India.

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NATIONAL STOCK EXCHANGE OF INDIA (NSE)

The National Stock Exchange is the latest, most modern and technology driven exchange. It was incorporated in 1992 and was recognised as a stock exchange in April 1993. It started operations in 1994, with trading on the wholesale debt market segment. NSE has set up a nationwide fully automated screen based trading system.

The NSE was set up by leading financial institutions, banks, insurance companies and other financial intermediaries. It is managed by professionals, who do not directly or indirectly trade on the exchange.

OBJECTIVES OF NSE

NSE was set up with the following objectives:

a. Establishing a nationwide trading facility for all types of securities.

b. Ensuring equal access to investors all over the country through an appropriate communication network.

c. Providing a fair, efficient and transparent securities market using electronic trading system.

d. Enabling shorter settlement cycles and book entry settlements.

e. Meeting international benchmarks and standards.

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MARKET SEGMENTS OF NSE

The Exchange provides trading in the following two segments.

(i) Whole Sale Debt Market Segment: This segment provides a trading platform for a wide range of fixed income securities that include central government securities, treasury bills, and state development loans, bonds issued by public sector undertakings, floating rate bonds, zero coupon bonds, index bonds, commercial paper, certificate of deposit, corporate debentures and mutual funds.

(ii) Capital Market Segment: The capital market segment of NSE provides an efficient and transparent platform for trading in equity,

preference, debentures, exchange traded funds as well as retail Government securities.

SOME COMMON STOCK MARKET TERMS

BOURSES **is another word for the stock market**

BULLS and BEARS –A Bullish phase refers to a period of optimism and a Bearish phase to a period of pessimism on the Bourses.

BADLA –It is a facility that allows the postponement of the delivery or payment of a transaction from one settlement period to another.

ODD LOT TRADING –Trading in multiples of 100 stocks or less.

PENNY STOCKS –These are securities that have no value on the stock exchange but whose trading contributes to speculation.

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BSE (BOMBAY STOCK EXCHANGE LTD.)

BSE Ltd (formerly known as Bombay Stock Exchange Ltd) was established in 1875 and was Asia's first Stock Exchange. It was granted permanent recognition under the Securities Contract (Regulation) Act, 1956. It has contributed to the growth of the corporate sector by providing a platform for raising capital. It is known as BSE Ltd but was established as the Native Share Stock Brokers Association in 1875. Even before the actual legislations were enacted, BSE Ltd already had a set of Rules and Regulations to ensure an orderly growth of the securities market.

It has the following objectives:

(a) To provide an efficient and transparent market for trading in equity, debt instruments, derivatives, and mutual funds.

(b) To provide a trading platform for equities of small and medium enterprises.

(c) To ensure active trading and safeguard market integrity through an electronically-driven exchange.

SECURITIES AND EXCHANGE BOARD OFINDIA (SEBI)

The Securities and Exchange Board of India was established by the Government of India on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. It was to function under the overall administrative control of the Ministry of Finance of the Government of India. The SEBI was given a statutory status on 30 January 1992 through an ordinance. The ordinance was later replaced by an Act of Parliament known as the Securities and Exchange Board of India Act, 1992.

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REASONS FOR THE ESTABLISHMENT OF SEBI

These malpractices and unfair trading practices have eroded investor confidence and multiplied investor grievances. The Government and the stock exchanges were rather helpless in redressing the investor's problems because of lack of proper penal provisions in the existing legislation. In view of the above, the Government of India decided to set-up a separate regulatory body known as Securities and Exchange Board of India.

PURPOSE AND ROLE OF SEBI

The basic purpose of SEBI is to create an environment to facilitate efficient mobilisation and allocation of resources through the securities markets.

It also aims to stimulate competition and encourage innovation.

This environment includes rules and regulations, institutions and their interrelationships, instruments, practices, infrastructure and policy framework.

This environment aims at meeting the needs of the three groups which basically constitute the market, viz, the issuers of securities (Companies), the investors and the market intermediaries.

To the issuers, it aims to provide a market place in which they can confidently look forward to raising finances they need in an easy, fair and efficient manner.

To the investors, it should provide protection of their rights and interests through adequate, accurate and authentic information and disclosure of information on a continuous basis.

To the intermediaries, it should offer a competitive, professionalised and expanding market with adequate and efficient infrastructure so that they are able to render better service to the investors and issuers.

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OBJECTIVES OF SEBI

The overall objective of SEBI is to protect the interests of investors and to promote the development of, and regulate the securities market. This may be elaborated as follows:

1. To regulate stock exchanges and the securities industry to promote their orderly functioning.

2. To protect the rights and interests of investors, particularly individual investors and to guide and educate them.

3. To prevent trading malpractices and achieve a balance between self-regulation by the securities industry and its statutory regulation.

FUNCTIONS OF SEBI

Keeping in mind the emerging nature of the securities market in India, SEBI was entrusted with the twin task of both regulation and development of the securities market. It also has certain protective functions.

Regulatory Functions

1. Registration of brokers and sub-brokers and other players in the market.

2. Registration of collective investment schemes and Mutual Funds.

3. Regulation of stock brokers, portfolio exchanges, underwriters and merchant bankers and the business in stock exchanges and any other securities market.

4. Regulation of takeover bids by companies.

5. Calling for information by under-taking inspection, conducting enquiries and audits of stock exchanges and intermediaries.

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Development Functions

1. Training of intermediaries of the securities market.

2. Conducting research and publishing information useful to all market participants.

3. Undertaking measures to develop the capital markets by adapting a flexible approach.

Protective Functions

1. Prohibition of fraudulent and unfair trade practices like making misleading statements, manipulations, price rigging etc.

2. Controlling insider trading and imposing penalties for such practices.

3. Undertaking steps for investor protection.

4. Promotion of fair practices and code of conduct in securities market.

THE ORGANISATION STRUCTURE OF SEBI

SEBI has decided its activities into five operational departments. Each department is headed by an executive director. Apart from its head office at Mumbai, SEBI has opened regional offices in Kolkata, Chennai, and Delhi to attend to investor complaints and liaise with the issuers, intermediaries and stock exchanges in the concerned region.

The SEBI also formed two advisory committees. They are the Primary Market Advisory Committee and the Secondary Market Advisory Committee. These committees consist of the market players, the investors associations recognised by the SEBI and the eminent persons in the capital market. They provide important inputs to the SEBI's policies.

The objectives of the two Committees are as follows:

a. To advise SEBI on matters relating to the regulation of intermediaries for ensuring investors protection in the primary market.

b. To advise SEBI on issues related to the development of primary market in India.

c. To advise SEBI on disclosure requirements for companies.

d. To advise for changes in legal framework to introduce simplification and transparency in the primary market.

e. To advise the board in matters relating to the development and regulation of the secondary market in the country.

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