CHAPTER – 10 – FINANCIAL MARKETS

INTRODUCTION
A business needs finance for both the working capital requirements such as payments for raw materials and salaries to its employees, and fixed capital expenditure such as the purchase of machinery or building or to expand its production capacity.

This chapter provides a brief description of the mechanism through which finances are mobilised by a business organisation for both short term and long term. It also explains the institutional structure and regulatory measures for different financial markets.

CONCEPT AND NATURE OF FINANCIAL MARKETS
A business is a part of an economic system that consists of two main sectors – households which save funs and business firms which invest the funds.

Financial markets are a crucial link in the saving investment process. They serve to transfer money capital or financial resources from savers to the entrepreneurial borrowers.

Thus, financial markets bring together borrowers and lenders, making available funds to those willing pay for their use.

Consequences at the time allocation of funds:
a) The rate of return offered households would be higher.
b) Scarce resources are allocated to those firms which have the highest productivity for the economy.

Mechanism of allocation of funds:

Draw diagram on page no.270 of NCERT

There are two major alternative mechanisms through which allocation of funds can be done: via banks or via financial markets. Households can deposit their surplus funds with banks, who in turn could lend these funds to business firms, alternatively households can buy the shares and debentures offered to the business using financial markets. The process by which allocation of funds is done is called financial intermediation. Banks and financial intermediaries in the financial system, and give households a choice of where they want to place their savings.
FUNCTIONS OF FINANCIAL MARKET

1. **Mobilising of Savings and Channelising them into the most Productive Uses:** A financial market facilitates the transfer of savings from savers to investors. It gives savers the choice of different investments and thus helps to channelising surplus funds into the most productive use.

2. **Facilitate Price Discovery:** In financial market, the households are suppliers of funds and business firms represent the demand. The interaction between them helps to establish a price for the financial asset which is being traded in that particular market.

3. **Provide Liquidity to Financial Assets:** Financial markets facilitate easy purchase and sale of financial assets. Holders of assets can readily sell their financial assets through the mechanism of the financial market.

4. **Reduce the Cost of Transactions:** Financial markets provide valuable information about securities being traded in the market. It helps to save time, effort and money that both buyers and sellers of a financial asset would have to otherwise spend to try and find each other.

CLASSIFICATION OF FINANCIAL MARKETS

Financial markets consist of two major segments: (i) **Money market:** the market for short term funds; (i) **Capital market:** the market for medium and long term funds.
MONEY MARKET

Money market is the market for short term funds meant for use for a period of up to one year. Money market provides means for raising funds for meeting short term requirements of cash on one and, and the development of surplus funds for short period on the other.

Transactions in the money market include lending and borrowing of cash and also sale and purchase of securities having a term up to one year. It is market where low risk unsecured and short term debt instruments that are highly liquid are issued and actively traded everyday. 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, Commercial Banks, Non-Banking Finance Companies, State government, Large Corporate Houses and Mutual Funds.

MONEY MARKET INSTRUMENTS

(i) 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. Commercial banks have to maintain a minimum cash balance known as cash reserve ratio. Call money is a method by which banks borrow from each other to be able to maintain the cash reserve ratio. The interest 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. There is inverse relationship between call rates and other short term money market instruments such as certificates of deposits and commercial paper.

(ii) Treasury Bills (t-bills): Treasury Bills (or T-bills) are issued by reserve bank of India in behalf of the government of India as a short term liability, and sold to banks and to the public. The issue period ranges from 14 to 364 days. T-bills are negotiable instruments, i.e. they are freely transferable. They are also called as Zero Coupon bonds and issued in the form of a promissory note.

They are highly liquid and have assured yield and negligible risk of default. 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. Treasure bills are available for a minimum amount of Rs.25,000 and in multiple thereof.

(iii) Commercial Bill: A commercial bill is a bill of exchange used to finance the working capital requirements of business firms. It is a short-term negotiable, self-liquidating instrument which is used to finance the credit sales of firms. These bills can be discounted with a bank if the seller needs funds before the bill matures. When a trade bill is accepted by commercial bank it is known as a commercial bill.

(iv) Commercial Paper (CP): The commercial paper was introduced in India as a money market instrument in 1990. A commercial paper is an unsecured promissory not, issued by a corporate with a fixed maturity period...
which varies from 3-12 months. Since, a commercial paper is unsecured, it be issued only by highly credit worthy, reputed leading firms. The issuance of commercial paper is an alternative to bank borrowing for large companies that are generally considered to be financially strong. It is sold at a discount and redeemed at par. The original purpose short terms funds for seasonal and working capital needs.

(v) Certificate of deposit (CD): It is a time deposit or fixed deposit which can be sold in the secondary market. Certificates of deposit 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. The tenure ranges from 91 days to one year. Banks are not permitted to discount or negotiate these instruments.

### COMPARATIVE VIEW OF DIFFERENT MARKET MONEY MARKET INSTRUMENTS

<table>
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<th>CALL MONEY</th>
<th>T-BILLS</th>
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<td>1. Meaning</td>
<td>The day to day surplus funds, mostly of banks are treated as call money.</td>
<td>T-bills are short term negotiable instruments which are issued by the Reserve Bank of India on behalf of the Government of India at discount and are sold t banks and to the public.</td>
<td>A bill of exchange is an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money.</td>
<td>A CP is an unsecured promissory note, issued by a corporate enterprise with a fixed maturity period.</td>
<td>It is time deposit which is issued at discount by banks against deposits kept by companies and institutions.</td>
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<td>2. Period</td>
<td>Call money is provided for very short period usually ranging from 1 day to 7 days.</td>
<td>These are issued for a period of 14 to 364 days.</td>
<td>These are generally issued for a period of 90 days.</td>
<td>The period ranging from 3 to 12 months.</td>
<td>The period ranging from 91 days to one year.</td>
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**CAPITAL MARKET**

The capital market is the market for medium and long-term funds. The business enterprises utilise this market to procure finances for long-term investments, such as buying plant and machinery, buildings etc. Capital market can be described as the aggregate of financial institutions and those serving as intermediaries for long-term financial assets. It is the mechanism which makes components of capital market are: (i) Primary market and (ii) Secondary Market or Stock Exchange.

**NATURE/FEATURES OF CAPITAL MARKET**
1. It deals in long-term securities such as equity shares, bonds and debentures. It matches the savings with investment opportunities for long term purposes.
2. It links those who save their income and those who want to invest in productive avenues.
3. It includes both individual investors and institutional investors like UTI, LIC, and IDBI etc.
4. It involves different types of intermediaries like brokers, underwriters, transfer agents, bankers etc.
5. It works as per government rules and policies.

**IMPORTANCE OF CAPITAL MARKET**
1. Capital market helps business entities to raise long term resources through various means.
2. It makes available not only the domestic but also foreign funds through global issues and placement.
3. IT mobilizes idle savings of the society for investment in productive channels.
4. It improves and stimulates savings, investment and thus capital formation.
5. It facilitates industrial growth by arranging necessary long term funds.
6. It acts as a link between those who save and those who need funds to invest profitably and effectively.
**PRIMARY MARKET (NEW ISSUE MARKET)**

This is the market for new long-term capital. The primary market is the market in which a security is sold for the first time. The essential features of the primary market are that the purchaser buys newly issued securities. In a primary issue, the securities are issued by the company directly to investors.

Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business. The new issue market does not include certain other source of new long term external finance, such as loans from financial institutions. Borrowers in the new issue market may be raising capital into public capital; this is known as ‘going public’ capital.

These securities may be issued in the primary market in any of the following methods which are:

i) Initial public offer;
ii) Rights issue; and
iii) Preferential issue.

**Initial Public Offer (IPO):** As the name suggest, the IPO is the first time sale of securities by a company. The IPO can be through any of the following methods:

(a) **Public Issue Through Prospectus:** Under this method, the company wanting to raise capital issues a prospectus to inform and attract the investing public. It invites prospective investors to apply for the securities. The prospectus provides the details regarding the purpose for which funds are being raised, past financial performance of the company, and background and experience of promoters.

   Public issue requires the company to reach out to the public at large and involves a large number of intermediaries, such as bankers, brokers and underwriters.

(b) **Offer for Sale:** Under this method the new securities are offered to the investing public not by the issuing company but an intermediary who buys over the entire lot of securities at a fixed price and resells to the public at a higher price. The intermediaries are generally firms of stock brokers.

   The advantage of this method is that the issuing company is saved the tedious process involved in making a public issue.

(c) **Private Placement:** In private placement the entire lot of new securities is purchased by an intermediary at a fixed price, and sold not to the public, but to selected clients at a higher price. Thus, a finance company may purchase at an agreed price the whole of a new issue of shares or debentures of a company.

   Under this method, there is no prospectus issued by companies as the issue is sold mainly to sophisticated institutional investors like Unit Trust of India (UTI), life Insurance corporation of India (LIC), General Insurance Corporation of India (GIC), etc.
Private placement of securities is preferred as it is an extremely finance as compared to a public issue. Small companies cannot afford to raise resources from the public issue. They therefore choose to go to the private placement market.

d) e-IPO's: 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. The issuer company can apply for listing of its securities on any exchange other than the exchange through which it has offered its securities. The lead manager coordinates all the activities amongst intermediaries connected with the issue.

Rights issue (for existing companies):
This is the offer of new shares by a company to the existing shareholders. Each shareholder has the right to subscribe to the new shares in holds. The shareholders may either accept the offer for him or assign a part or all of his right to another. Such rights are valuable to shareholders as they are at a price below the current market price. The right issue is an inexpensive and convenient way of raising additional capital, particularly if the amount required is moderate as compared to the amount already issued. A right issue to the amount already issued. A right issue to the existing shareholders is a mandatory requirement.

Preferential issue:
This is the practice followed by a company to make preferential allotment of securities to selected persons, who are normally the promoters, etc. at a price unrelated to the prevailing market price. The advantage is that funds are obtained at a minimal issue or the private placements method. However, preferential allotments have been sometimes misused by companies.

SECONDARY MARKET (STOCK EXCHANGE)
The stock exchange represents the secondary market for securities. The secondary market is the market for the sale and purchase of previously issued securities. In this market, existing securities are traded. The company is not involved in the transaction at all.

The secondary market is the place where an investor holding the security of a company can convert it into cash at will. Likewise an investor desirous of placing his funds with a certain company can buy the previously issued securities of that company. The secondary market or the stock market is meant to serve the interest of such buyers and sellers. The indenting buyer and seller need not know each other. Brokers on the stock exchange are needed to serve as intermediaries between them.

STOCK EXCHANGE
The stock exchange is a market in which existing securities are bought and sold. The securities contract (regulation) Act, 1956 defines a stock exchange as an association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities.

Brokers serve as intermediaries between buyers and sellers. They receive orders from clients and execute them at the ring. In the traditional mode of operating on the ring, the trading resembles an auction. Brokers intending to sell shares receive bids for the security offered. Similarly, brokers intending to buy a security receive bids for the security sought. Selling brokers strive to obtain the highest possible price for their clients. Buying brokers strive to obtain the lowest possible price for their clients.

Stock exchanges are given trading rights in certain specified areas only. In India there are 24 such regional exchanges, in which the oldest is the Bombay Stock Exchange. Alternatively, there may be stock exchange with a national presence, which is not limited to the jurisdiction of a particular area. India has two such All India stock exchanges: National stock exchange of India: and over the counter Exchange of India.
Functions of stock exchange:

(i) **Liquidity:** The main function of stock market is to provide a ready and continuous market for the sale and purchase of securities. The presence of a continuous market is an assurance to investors that their investments can be converted into cash when required by them.

(ii) **Valuation of securities:** The stock market helps to correctly value and price securities. Profitable and growth-oriented companies are valued higher by buyers and sellers as compared to average performing companies. This valuation is useful from the point of view of investors, creditors and the government.

(iii) **Spreading of Equity Cult:** the stock exchange can play a vital role in ensuring wider share ownership by regulating new issues, better trading practices and taking effective steps in educating the public about investments.

(iv) **Providing scope for speculation:** The stock exchange provides sufficient scope within the provisions of law for speculative activity in a restricted and controlled manner. It is generally accepted that a certain degree of healthy speculation is necessary to ensure liquidity and price continuity in the stock market.

(v) **Safety of dealing:** Stock exchange is subjects to serve rules and regulations. Companies whose securities are trade here have to undergo strict scrutiny before they are permitted to transact dealings. This ensures safety of dealings.

(vi) **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.

**TRADING PROCEDURE ON A STOCK EXCHANGE**

In modern times, trading has shifted from the stock market floor to the brokers’ 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 individuals, partnership firms or corporate bodies. They are the intermediaries between the buyers and sellers. In earlier times, the ownership and management of stock exchanges by brokers often led to a conflict of interest between the brokers and their clients. This led to *demutualisation* of stock exchanges.

**Demutualization** separates the ownership and control of stock exchanges from the trading rights of members. This reduces the conflict of interest between the exchange and the brokers and the chances of brokers using stock exchanges for personal gains.

**Process**

# A company’s securities can be traded on a stock exchange only if they are listed or quoted on it.
# Transactions on stock exchange may be carried out on either cash basis or a carry over basis. The carry over basis is also called **badla** and is a unique feature of Indian Stock markets, particularly the BSE.
# A stock exchange year is divided into periods called ‘**accounts**’ which vary from a fortnight to a month. All transactions made during one account are to be settled by payment for purchases and by delivery of share certificates.
A share certificate is proof of ownership of securities by an individual. Purchase and sale transactions in securities involved the exchange of money in return for the share certificate. This led to problems of theft, forgery, transfer delays and time involved in paperwork. To eliminate these problems an electronic book entry form of holding and transferring securities has been introduced. This is referred to as ‘dematerialisation of securities’.

SECURITIES EXCHANGE BOARD OF INDIA (SEBI)

Meaning
SEBI was set up in 1988 to regulate the functions of the securities market with a view to promote their orderly and healthy development, to provide adequate projection to investor and to, thus create an environment to facilitate mobilization of adequate resources through the securities market. Latter in May 1992, SEBI was granted legal status. It is a body corporate having separate legal existence and perpetual succession.

REASONS FOR ESTABLISHMENT OF SEBI
Investor’s faith and confidence in capital market was shaken up due to various unfair trading practices and malpractices like price rigging, non-adherence of provisions of the Companies Act etc. in the absence of proper penal provisions in the existing laws, the Government was unable to redress the investor’s problems. Therefore SEBI was set up as a separate regulatory body to protect the interests of the investors in securities.

PURPOSE OF SEBI
The basic purpose of SEBI is to create an environment to facilitate efficient mobilization 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.

ROLE OF SEBI
SEBI provides environment which fulfills the needs of following three groups:

a) Issuers: To promote fair dealings by the issuers of securities and to ensure a market place whereby they can raise funds at a relatively low cost.

b) Investors: To provide a degree of protection to the investors and safeguard their rights and interests so that there is steady flow of savings into the market.

c) Intermediaries: To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers, etc. with a view to making them competitive and professional.

OBJECTIVES
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.
4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc. with a view to making them competitive and professional.

FUNCTIONS OF SEBI
Development functions of SEBI are:
a) Investor education
b) Training of intermediaries
c) Promotion of fair practices and code of conduct of all SRO’s
d) Conducting research and publishing information useful to all market participants.

Regulatory functions of SEBI are:
a) It registers and regulates the working of stock brokers, sub-brokers, share transfer agents, underwriters, etc. and other intermediaries who may be associated with securities market in any market.
b) It registers and regulates the working of mutual funds technique.
c) Regulation of stock bankers and portfolio exchanges, and merchant bankers.
d) It conducts inquiries and audits of the stock exchanges.
e) Prohibition of fraudulent and unfair trade practices.
f) Controlling of insider trading and takeover bids and imposing penalties for such practices.

Protective functions of SEBI are:
(i) SEBI prohibits fraudulent and unfair trade practices in securities market like rigging and making misleading statements.
(ii) It prohibits insider trading
(iii) It undertakes steps to educate investors.
(iv) It prometers fair practices and code of conduct in securities market.

Insider: An insider is any person connected with the company who is reasonably expected to have access to price sensitive information, which is not available to the public at large. Directors, promoters etc. are the insiders. When such directors, promoters etc. of the company use privileged information that they alone have access to by virtue of their being insiders to make individual profits, it is referred to as insiders trading.

Price rigging: Making manipulations with the sole objective of influencing or depressing the market price of securities. Such practices are prohibited by the law because they can defraud or cheat investors. The term commonly used to describe this is “price rigging”

THE ORGANISATION STRUCTURE OF SEBI
# As SEBI is a statutory body there has been a considerable expansion in the range and scope of its activities.
# Accordingly, SEBI has been restructured and rationalized in tune with its expanded scope. It 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
a) The Primary Market Advisory Committee and
b) 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.
# The committees are however non-statutory in nature and the SEBI is not bound by the advise of the committee. These committees are a part of SEBI’s constant Endeavour to obtain a feedback from the market players on various issues relating to the regulations and development of the market.
DEPOSITORY

Depository Services – ‘Depository’ is an institution/organisation which holds securities (e.g. shares, debentures, bonds, mutual funds etc.) in electronic form, in which trading is done. The services provided by a Depository are termed as ‘Depository Services’. At present there are two depositories in India: NSDL (National Securities Depository Ltd.) and CSDL (Central Depository Services Ltd.).

Services provided by Depository

- Dematerialisation (usually known as demat) is converting physical certificates to electronic form.
- Rematerialisation, known as remat, is reverse of demat, i.e. getting physical certificates from the electronic securities.
- Transfer of securities, change of beneficial ownership
- Settlement of trades done on exchange connected to the Depository.

DEMAT ACCOUNT

Demat account is the abbreviation of ‘Dematerialized Account’. Demat (Dematerialized) account refers to an account which an Indian citizen must open with the depository participant (banks, stock brokers) to trade in listed securities in electronic form wherein one can hold shares of various companies in the Dematerialized [electronic] form.

Benefits of Depository Services and Demat Account

- Sale and Purchase of shares and stocks of any company on any stock exchange.
- Saves time
- No paperwork
- Lower transaction costs
- Ease in trading
- Transparency in transactions.
- No counterfeiting of security certificate
- Physical presence of investor is not required in stock exchange.
- Risk of mutilation and loss of security certificate is eliminated.

NOTES

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