Note

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THE FINANCIAL MARKET

You are fully aware that business units have to raise short-term as well as long-term funds to meet their working and fixed capital requirements from time to time. This necessitates not only the ready availability of required funds but also a transmission mechanism with the help of which the providers of funds (investors/ lenders/depositors) can interact with the borrowers/users (business units as well as non-business units) and transfer the funds to them as and when required. This aspect is taken care of by the concept called financial markets which provide a place/mechanism/system through which the transfer of funds by investors/lenders to the business units is adequately facilitated.

LEARNING OUTCOMES

- describes the role and importance of financial market and capital market; and
- identifies different types of financial instruments available for trade in capital market and money market.

13.1 FINANCIAL MARKET

We know that, money always flows from surplus sector to deficit sector. That means persons/institutions having excess of money lend it to those who need money to fulfill their requirement. Similarly, in business sectors the surplus money flows from the investors or lenders to the businessmen for the purpose of production or sale of goods and services. So, we find two different groups, one who invest money or lend money and the others, who borrow or use the money.

Now you consider how these two groups meet and transact with each other. The financial markets act as a link between these two different groups. It facilitates this function by acting as an intermediary between the borrowers and lenders of money. So, **financial market may be defined as a transmission mechanism between investors (or lenders) and the borrowers (or users) through which transfer of funds is facilitated'.** It consists of individual investors, financial institutions and other intermediaries who are linked by formal trading rules and communication network for trading the various financial assets and credit instruments.

Before reading further let us have an idea about some of the credit instruments relating to money markets.

A **bill of exchange** is an instrument in writing containing an unconditional order, signed by the maker (creditor), directing a certain person (debtor) to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument.

Suppose Gopal has given a loan of Rs. 50,000 to Madan, which Madan has to return. Now, Gopal also has to give some money to Madhu. In this case, Gopal can make a document directing Madan to make payment of up to Rs. 50,000 to Madhu on demand or after expiry of a specified period. This document is called a bill of exchange, which can be transferred to some other person's name by Madhu.

A promissory note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.

Suppose you take a loan of Rs. 20,000 from your friend Jagan. You can make a document stating that you will pay the money to Jagan or the bearer on demand. Or you can mention in the document that you will pay the amount after three months. This document, once signed by you, duly stamped and handed over to Jagan, becomes a negotiable instrument. Now Jagan can personally present it before you for payment or give this document to some other person to collect money on his behalf. He can endorse it in somebody else's name who in turn can endorse it further till the final payment is made by you to whosoever presents it before you. This type of a document is called a **Promissory Note.**

Let us now see the main functions of financial market.

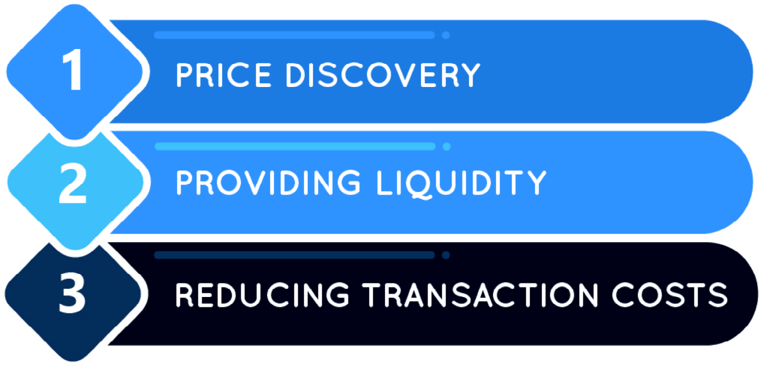

Fig. 13.1 Functions of Financial Markets

Financial markets essentially perform three important functions which are (1) price discovery (2) providing liquidity and (3) reducing transaction costs. We will deal with these functions in detail.

(1) **Price Discovery:** It symbolizes interaction between the buyer and sellers in the financial market which determines the price of the financial instrument/asset. Financial markets also help in allocation of funds by those who want to invest/ lend amongst those who are in need of funds.

(2) **Providing Liquidity:** Presence of financial markets provides liquidity to financial instruments as it provides a platform to the investors to sell their financial instruments as and when needed and hence facilitate liquidity. Liquidity refers to how conveniently a financial asset can be converted into cash. This is an important function performed by financial markets as there can be situations wherein investors might be compelled to sell their financial instruments for meeting their finance and other needs and in the absence of liquidity they have to hold financial instruments till maturity period and thus depriving them of the benefit of the financial instrument they possess.

(3) **Reducing Transaction Costs:** Financial markets reduce costs spent on acquiring information about financial instruments as financial markets provides an organized platform wherein parties to trade (investors, borrowers and lenders) come together and share information about financial products and services which can be used by users of financial services/instruments for their financial purposes.

In addition to the above functions, financial markets also provide facilities for interaction between the investors and borrowers by providing them an organized platform where the information relating to characteristics and nature of financial instruments can be easily shared between borrowers and investors.


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13.2 TYPES OF FINANCIAL MARKET

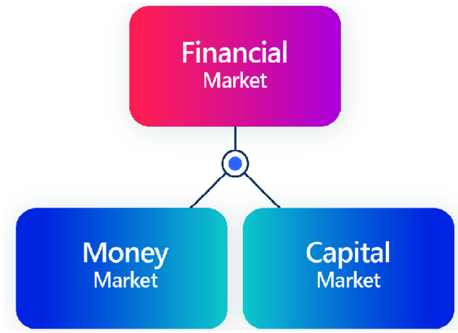


Fig. 13.2 Types of Financial Market

A financial market consists of two major segments:

(a) Money Market

(b) Capital Market

While the money market deals in short-term funds, the capital market handles the medium term and long-term funds.

Evolution and Journey of Money Market in India

The foundation of modern banking in India was started with the setting up of three presidency Banks- Bank of Bengal (1806), Bank of Bombay (1840) and Bank of Madras (1846) which was finally amalgamated to form Imperial bank of India (presently known as state bank of India). The foundation of banking in India paved the way for origin of money markets in India. The money market in India the then was highly unorganised and scattered in nature until the setting up of Reserve Bank of India in 1935. Post independence (in the year 1947) the number of players in money markets such as commercial banks, life insurance companies, princely states and private trusts were active participants. In the post-independence era and before the onset of early nineties, the money market had components such as call money market, commercial bills market, treasury bills market, inter-corporate and inter-bank term deposits. With the financial reforms made in 1990s, money markets in India witnessed deregulation in interest rate structures, removing of ceiling on interest rates, reduction in statutory liquidity ratio (SLR) requirements, introduction of commercial paper and money market mutual funds (MMMFs). Thus from having an unorganised structure in 1950s and to being an underdeveloped market in 1960s-1970s, the money market began to assume an organised shape and formal structure with the onset of 1990s that is the post-economic reform period in India.

Note

13.3 MONEY MARKET

The money market is a market for short-term funds, which deals in financial assets/instruments whose period of maturity is less than or upto one year. It should be noted that money market does not deal in cash or money as such but simply provides a market for short term credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are close substitutes of money. These instruments help the business units, other organisations and the government to borrow the funds to meet their short-term financing requirements. The most active participants in money markets are commercial banks and other financial institutions.

Money market does not imply any specific market place. Rather **it refers to the whole networks of financial institutions dealing in short-term funds,** which provides an outlet to lenders and a source of supply for such funds to borrowers. Most of the money market transactions take place on telephone, fax or Internet. **The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialised financial institutions.** The Reserve Bank of India (RBI) is the regulator of the money market in India. Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC, GIC, UTI, etc. also operate in the Indian money market.

13.3.1 MONEY MARKET INSTRUMENTS

Following are some of the important money market instruments or securities.

(a) **Call Money:** Call money is mainly used by the banks to meet their temporary requirements of cash. They borrow and lend money from each other normally on a daily basis. It is repayable on demand and its maturity period varies between one day to a fortnight. The rate of interest paid on call money loan is known as call rate.

(b) **Treasury Bill:** A treasury bill is a promissory note issued by the RBI to meet the short-term requirement of funds. Treasury bills are highly liquid instruments, which mean, at any time the holder of treasury bills can transfer or get it discounted from RBI. Treasury bills were first introduced in India in October 1917. These bills are normally issued at a price less than their face value; and redeemed at face value. So the difference between the issue price and the face value of the treasury bill represents the interest on the investment. These bills are secure instruments and are issued for a period of not exceeding 364 days. Banks, Financial institutions and corporations normally play a major role in the treasury

Note

bill market. For example on 1st March 2018 Ramesh paid Rs.9200 to buy a one year (or 52 week) treasury bill and on 1st March 2019 the treasury bill was redeemed for Rs.10000, thus effectively paying Rs. 800 as interest (Rs.10000-Rs.9200). The earnings/yield on such bill stood at 8.69% (Rs.800/Rs.9200) [(interest amount)/ (purchase price)].

(c) **Commercial Paper:** Commercial paper (CP) is a popular instrument for financing working capital requirements of business units, more particularly companies. The CP is an unsecured instrument issued in the form of promissory note. This instrument was introduced in 1990 to enable the corporate borrowers to raise short-term funds. It can be issued for period ranging from 15 days to one year. Commercial papers are transferable by endorsement and delivery. The highly reputed companies (Blue Chip companies) are the major players of commercial paper market.

(d) **Certificate of Deposit:** Certificate of Deposit (CD) is a short-term instrument issued by commercial banks and special financial institutions (SFIs), which are freely transferable from one party to another. The maturity period of CDs ranges from 91 days to one year. These can be issued to individuals, co-operatives and companies.

(e) **Trade Bill :** Normally the traders buy goods from the wholesalers or manufactures on credit. The sellers get payment after the end of the credit period. But if any seller does not want to wait or is in immediate need of money he/she can draw a bill of exchange in favour of the buyer. When the buyer accepts the bill it becomes a negotiable instrument and is termed as bill of exchange or trade bill. This trade bill can now be discounted with a bank before its maturity. On maturity the bank gets the payment from the drawee i.e., the buyer of goods. When trade bills are accepted by Commercial Banks,these are known as Commercial Bills. So a trade bill is an instrument, which enables the drawer of the bill to get funds for short period to meet the working capital needs.

Name of the instrument	Duration	Issuer
Treasury Bill	Not exceeding 364 days	RBI
Commercial paper	15 days to one year	Highly reputed companies
Call money	1day to fortnight	banks
Certificate of Deposit	91 days to one year	Banks & Special Financial Institutions
Commercial bill	Within 1 year	seller

13.4 CAPITAL MARKET

Capital Market may be defined as a market dealing in medium and long-term funds. It is an institutional arrangement for borrowing medium and long-term funds and provides facilities for marketing and trading of securities. So, it constitutes all long-term borrowings from banks and financial institutions, borrowings from foreign markets and raising of capital by issue of various securities such as shares, debentures, bonds, etc. In capital market funds are usually raised for meeting expansion and capital expenditure funding requirements by corporations. Let us discuss about the market for trading of securities.

The market where financial securities are traded is known as securities market. It consists of two different segments, namely primary and secondary market. The primary market deals with new or fresh issue of financial securities and is, therefore, also known as **new issue market;** whereas the secondary market provides a place for purchase and sale of existing financial securities and is often termed as **stock market** or **stock exchange.**

13.4.1 PRIMARY MARKET

The Primary Market consists of arrangements which facilitate the procurement of long-term funds by companies by making fresh issue of financial securities (borrowed as well as owned securities). You know that companies make fresh issue of shares and/or debentures at their formation stage and, if necessary, subsequently for the expansion of business. **It is usually done through private placement to friends, relatives and financial institutions or by making public issue through initial public offerings (IPO) or follow-on public offerings (FPO).** In any case,

Note

the companies have to follow a well-established legal procedure and involve a number of intermediaries such as underwriters, brokers, etc. who form an integral part of the primary market. You must have learnt about IPOs made recently by a number of public sector undertakings such as ONGC, GAIL, NTPC and private sector companies like Tata Consultancy Services (TCS), Biocon, Jet-Airways and so on.

13.4.2 SECONDARY MARKET

The secondary market also known as stock market or stock exchange plays an equally important role in mobilising long-term funds by providing the necessary liquidity to holdings in shares and debentures. It provides a place where these securities can be encashed without any difficulty and undue delay. It is an organised market where shares, and debentures are traded regularly with high degree of transparency and security. In fact, an active secondary market facilitates the growth of primary market as the investors in the primary market are assured of a continuous market for liquidity of their holdings. The major players in the primary market are merchant bankers, mutual funds, financial institutions, and the individual investors. In the secondary market you have all these and the stockbrokers who are members of the stock exchange who facilitate trading.

After having a brief idea about the primary market and secondary market let see the difference between them.

13.5 DISTINCTION BETWEEN PRIMARY MARKET AND SECONDARY MARKET

The main points of distinction between the primary market and secondary market are as follows:

1. **Function :** While the main function of primary market is to raise long-term funds through fresh issue of securities, the main function of secondary market is to provide continuous and ready market for the existing long-term securities.

A Brief History of Stock Exchange in India

The history of stock exchanges in India can be traced to 18th century when securities (shares/debentures) of East India Company were being traded mainly in the cities like Mumbai and Kolkata. However growth in stock market activities was observed after passing of Companies Act 1850 which introduced joint stock companies with limited liability. This period also observed rapid growth in the number of business enterprises set up as well as production also gone up. This period also

saw setting up of first stock exchange which was Bombay Stock Exchange in 1875. Post independence in 1947, stock markets in India saw limited activity as role of financial system/institutions were limited. During the 1950s and 1960s there was not much development in stock market because of weak industrial base and low savings rate. However, this period saw various regulations enacted to support and promote stock market activities the positive results of which started coming out in 1970s and by 1980s, number of stock exchanges in India rose significantly. With the onset of 1990s, several reforms were made in stock markets with the repeat of Capital Issues (Control Act) 1947 and setting up of SEBI in 1992 as overall regulator of stock markets in India. After the formation of SEBI, stock market has gone through various transformations and has handled large volumes of transactions.

2. **Participants :** While the major players in the primary market are financial institutions, mutual funds, underwriters and individual investors. The major players in secondary market are all of these and corporations/companies, stockbrokers who are members of the stock exchange.

3. **Listing Requirement:** For securities to be traded in stock market, their listing is mandatory while for primary market issues there are no such requirements.

4. **Determination of Prices :** In case of primary market, the prices are determined by the management with due compliance with SEBI requirement for new issue of securities. But in case of secondary market, the price of the securities is determined by forces of demand and supply of the market and keeps on fluctuating.

13.6 DISTINCTION BETWEEN CAPITAL MARKET AND MONEY MARKET

1. **Period of Funds:** Money market is related to short-term funds while the capital market is related to medium and long-term funds.

2. **Nature of Securities:** Money market deals in securities like treasury bills, commercial paper, trade bills, deposit certificates, etc. On the other hand, the capital market deals in shares, debentures, bonds and government securities.

3. **Participants:** The participants in money market are commercial banks, non-banking financial companies, etc., while the participants in capital market are stockbrokers, underwriters, mutual funds, financial institutions, and individual investors.

Note

4. **Regulator:** Money market is regulated by Reserve Bank of India while the Capital market is regulated by Securities Exchange Board of India (SEBI).

INTEXT QUESTIONS 13.1

1. Define financial market.

2. Complete the table given below.

(a) Distinction between Primary Market and Secondary Market.

Points of Difference	Primary Market	Secondary Market
1. Function	(i)	To provide continuous and ready market for existing long-term securities.
2. Participants	Financial Institutions, mutual funds, underwriters and individual investors.	(ii)
3. Listing Requirement	Listing is not required for dealing in the primary market.	(iii)
4. Determination of Prices	(iv)	Prices are determined by forces of demand and supply and keep on fluctuating.

(b) Differentiate between Money Market and Capital Market.

Point of Distinction	Money Market	Capital Market
1. Time period / Term		
2. Instruments dealt in		
3. Participants		
4. Regulatory body		

Note

13.7 STOCK EXCHANGE

As indicated above, stock exchange is the term commonly used for a secondary market, which provides a place where different types of existing securities such as shares, debentures and bonds, government securities can be bought and sold on a regular basis. A stock exchange is generally organised as an association, a society or a company with a limited number of members. It is open only to these members who act as brokers for the buyers and sellers. The Securities Contract (Regulation) Act has defined assisting, regulating and controlling business of buying, selling and dealing in securities stock exchange as an " association, organisation or body of individuals, whether incorporated or not, established for the purpose". Considering the role played by stock exchange in the economic growth of the country it is often referred as barometer of the economic health/situation of the country.

The Main Characteristics of a Stock Exchange are:

1. It is an organised market.
2. It provides a place where existing and approved securities can be bought and sold easily.
3. In a stock exchange, transactions take place between its members or their authorised agents.
4. All transactions are regulated by rules and by laws of the concerned stock exchange.
5. It makes complete information available to public in regard to prices and volume of transactions taking place every day.

13.7.1 FUNCTIONS OF A STOCK EXCHANGE

The functions of stock exchange can be enumerated as follows:

1. **Provides a Ready Market for Securities:** By providing a place where listed securities can be bought and sold regularly and conveniently, a stock exchange ensures a ready and continuous market for various shares, debentures, bonds and government securities. This lends a high degree of liquidity to holdings in these securities as the investors can encash their holdings as and when they want.
2. **Provides Information about Prices and Sales of Securities:** A stock exchange maintains complete record of all transactions taking place in different securities every day and supplies regular information on their prices and sales

volumes to press and other media. In fact, now-a-days, you can get information about minute to minute movement in prices of selected shares on various business TV channels. This enables the investors in taking quick decisions on purchase and sale of securities in which they are interested. Not only that, such information helps them in ascertaining the trend in prices and the worth of their holdings. This enables them to seek bank loans, if required.

3. **Provides Safety to Securities Dealings and Investment:** Transactions on the stock exchange are conducted only amongst its members with adequate transparency and in strict conformity to its rules and regulations which include the procedure and timings of delivery and payment to be followed. This provides a high degree of safety to dealings at the stock exchange. There is little risk of loss on account of non-payment or non-delivery. Securities and Exchange Board of India (SEBI) also regulates the business in stock exchanges in India and the working of the stock brokers.

   Not only that, a stock exchange allows trading only in securities that have been listed with it; and for listing any security, it satisfies itself about the genuineness and soundness of the company and provides for disclosure of certain information on regular basis. Though this may not guarantee the soundness and profitability of the company, it does provide some assurance on their genuineness and enables them to keep track of their progress.

4. **Facilitates Mobilisation of Savings and Capital Formation:** Efficient functioning of stock market creates a conducive climate for an active and growing primary market. Good performance and outlook for shares in the stock exchanges imparts buoyancy to the new issue market, which helps in mobilising savings for investment in industrial and commercial establishments. Not only that, the stock exchange provides liquidity and profitability to dealings and investments in shares and debentures. It also educates people on where and how to invest their savings to get a fair return. This encourages the habit of saving, investment and risk-taking among the common people. Thus, it helps mobilising surplus savings for investment in corporate and government securities and contributes to capital formation.

5. **Barometer of Economic and Business Conditions :** Stock exchanges reflect the changing conditions of economic health of a country, as the shares prices are highly sensitive to changing economic, social and political conditions. It is observed that during the periods of economic prosperity, the share prices tend to rise. Conversely, prices tend to fall when there is economic stagnation and the business

Note

activities slow down as a result of depression. Thus, the intensity of trading at stock exchanges and the corresponding rise or fall in the prices of securities reflects the investors' assessment of the economic and business conditions in a country, and acts as the barometer which indicates the general conditions of the atmosphere of business.

6. **Efficient Allocation of Funds:** As a result of stock market transactions, funds flow from the less profitable to more profitable enterprises and they avail of the greater potential for growth. Financial resources of the economy are thus, better allocated.

18.7.2 ADVANTAGES OF STOCK EXCHANGES

Having discussed the functions of stock exchanges, let us look at the advantages of stock exchanges which can be outlined from the point of view of (a) companies, (b) investors, and (c) the society as a whole.

(a) To the Companies

(i) The companies whose securities have been listed on a stock exchange enjoy a better goodwill and credit-standing than other companies because they are supposed to be financially sound.

(ii) The market for their securities is enlarged as the investors all over the world become aware of such securities and have an opportunity to invest.

(iii) As a result of enhanced goodwill and higher demand, the value of their securities increases and their bargaining power in collective ventures, mergers, etc. is enhanced.

(iv) The companies have the convenience to decide upon the size, price and timing of the issue.

(b) To the Investors

(i) The investors enjoy the ready availability of facility and convenience of buying and selling the securities at will and at an opportune time.

(ii) Because of the assured safety in dealings at the stock exchange, the investors are free from any anxiety about the delivery and payment problems.

(iii) Availability of regular information on prices of securities traded at the stock exchanges helps them in deciding on the timing of their purchase and sale.

Note

(iv) It becomes easier for them to raise loans from banks against their holdings in securities traded at the stock exchange because banks prefer them as collateral on account of their liquidity and convenient valuation.

(c) To the Society

(i) The availability of lucrative avenues of investment and the liquidity thereof induces people to save and invest in long-term securities. This leads to increased capital formation in the country.

(ii) The facility for convenient purchase and sale of securities at the stock exchange provides support to new issue market. This helps in promotion and expansion of industrial activity, which in turn contributes to increase in the rate of industrial growth.

(iii) The stock exchanges facilitate realisation of financial resources to more profitable and growing industrial units where investors can easily increase their investment substantially.

(iv) The volume of activity at the stock exchanges and the movement of share prices reflect the changing economic health.

(v) Since government securities are also traded at the stock exchanges, the government borrowing is highly facilitated. The bonds issued by governments, electricity boards, municipal corporations and public sector undertakings (PSUs) are found to be on offer quite frequently and are generally successful.

13.7.3 LIMITATIONS OF STOCK EXCHANGES

Like any other institution, the stock exchanges too have their limitations. One of the common evils associated with stock exchange operations is the excessive speculation. You know that speculation implies buying or selling securities to take advantage of price differential at different times. The speculators generally do not take or give delivery and pay or receive full payment. They settle their transactions just by paying the difference in prices. Normally, speculation is considered a healthy practice and is necessary for successful operation of stock exchange activity. But, when it becomes excessive, it leads to wide fluctuations in prices and various malpractices by the vested interests. In the process, genuine investors suffer and are driven out of the market. Excess speculation may drive the stock markets into instability mode which is harmful for the economy.

Another shortcoming of stock exchange operations is that security prices may fluctuate due to unpredictable political, social and economic factors as well as on account of rumours spread by interested parties. This makes it difficult to assess the movement of prices in future and build appropriate strategies for investment in securities. However, these days good amount of vigilance is exercised by stock exchange authorities andSEBI to control activities at the stock exchange and ensure their healthy functioning,about which you will study later.

13.8 SPECULATION IN STOCK EXCHANGES

The buyers and sellers at the stock exchange undertake two types of operations, one of speculation and the other of investment. Those who buy securities primarily to earn a regular income from such investment and possibly make some long-term gain on account of price rise in future are called investors. They take delivery of the securities and make full payment of the price. Such transactions are called investment transactions. But, when the securities are bought with the sole object of selling them in future at higher prices or these are sold now with the intention of buying at a lower price in future, these are called speculation transactions. The main objective of such transactions is to take advantage of price differential at different times. The stock exchange also provides for settlement of such transactions even by receiving or paying, as the case may be, just the difference in prices.

For example, Rashmi bought 200 shares of Moser Baer Ltd. at Rs. 210 per share and sold them at Rs. 235 per share. She does not take and give delivery of the shares but settles the transactions by receiving the difference in prices amounting to Rs. 5,000 minus brokerage. In another case, Mohit bought 200 shares of Seshasayee Papers Ltd. at Rs. 87 per share and sold them at Rs. 69 per share. He settles these transactions by simply paying the difference amounting to Rs. 3600 plus brokerage. However, now-a-days stock exchanges have a system of rolling settlement. Such facility is limited only to transactions of purchase and sale made on the same day, as no carry forward is allowed.

Rolling Settlement: Earlier trading in the stock exchange was held face-to-face (called pit-trading) without the use of computers and the advanced computer software as it is today. In those times, transactions were settled (i.e., actual delivery of shares, through share certificates, by the seller and payment of money by the buyer) in the stock exchange, only on a fixed day of the week, say on a Saturday, or a Wednesday irrespective of which day of the week the shares were bought and sold. This was called 'Fixed Settlement'. In India, rolling settlement was introduced in Indian equity market from 1st April 2003.

Today, with the electronic / computer based system of recording and carrying out of share transactions, stock exchanges go in for 'rolling settlement'. That means, transaction are settled after a fixed number of days of the transaction rather than on a particular day of the week. For example, if a stock exchange goes in for 'T+2' days of rolling settlement, the transaction is settled within two working days of occurring of the transaction, 'T' being the day of the transaction. In **T+7'** days of rolling settlement, the transaction is settled on the 7th day after the transaction. This is facilitated through electronic transfer of shares, through Dematerialised Account or **Demat Account i.e., the share does not have a physical form of a paper document,** but is a computerised record of a person holding a share, and through transfer of money electronically or through cheques payment is settled.

Though speculation and investment are different in some respects, in practice it is difficult to say who is a genuine investor and who is a pure speculator. Sometimes even a person who has purchased the shares as a long-term investment may suddenly decide to sell to reap the benefit if the price of the share goes up too high or do it to avoid heavy loss if the prices starts declining steeply. But he cannot be called a speculator because his basic intention has been to invest. It is only when a person's basic intention is to take advantage of a change in prices, and not to invest, then the transaction may be termed as speculation. In strict technical terms, however, the transaction is regarded as speculative only if it is settled by receiving or paying the difference in prices without involving the delivery of securities. It is so because, in practice, it is quite difficult to ascertain the intention.

Some people regard speculation as nothing but gambling and consider it as an evil. But it is not true because while speculation is based on foresight and hard calculation, gambling is a kind of blind and reckless activity involving high degree of chance element. Not only that, speculation is a legal activity duly recognised as a prerequisite for the success of stock exchange operations while gambling is regarded as an evil and a punishable activity. However, reckless speculation may take the form of gambling and should be avoided.

INTEXT QUESTIONS 13.2

1. Enumerate the main characteristics of a stock exchange.

2. Identify which of the following statements about stock exchanges are 'True' or 'False'. If the statement is 'False', rewrite it in the correct form.

   (a) Stock Exchange provides a ready market for sale and purchase of gold and silver. ( )

(b) In the stock exchange, transactions take place between companies and their shareholders directly. ( )

(c) Stock exchange transactions facilitate flow of funds from less profitable to more profitable enterprises. ( )

(d) It becomes difficult for investors to raise loans from banks against collateral of their holdings in securities traded at the stock exchange. ( )

(e) Speculation is the same thing as gambling. ( )

3. State two limitations of stock exchanges.

13.9 STOCK EXCHANGES IN INDIA

The first organised stock exchange in India was started in Mumbai known as Bombay Stock Exchange (BSE). It was followed by Ahmedabad Stock Exchange in 1894 and Kolkata Stock Exchange in 1908. The Security Contracts (Regulation) Act was passed in 1956 for recognition and regulation of Stock Exchanges in India. At present we have 7 stock exchanges in the country. Of these, the most prominent stock exchange that came up is National Stock Exchange (NSE). It is based in Mumbai and was promoted by the leading financial institutions in India. It was incorporated in 1992 and commenced operations in 1994. This stock exchange has a corporate structure, fully automated screen-based trading and nation-wide coverage. One of the most notable feature which was found in stock exchanges belonging to pre-independence period was of using open outcry system/method for buying and selling of securities. **In open outcry system buyers and sellers of securities faced each other and information was exchanged.** In this system, interested parties employed verbal and hand signal communication for trading and pricing of securities.

Another stock exchange that needs special mention is **Over The Counter Exchange of India (OTCEI).** It was also promoted by the financial institutions like UTI, ICICI, IDBI, IFCI, LIC etc. in September 1992 **specially to cater to small and medium-sized companies with equity capital of more than Rs.30 lakh and less than Rs.25 crore.** It helps entrepreneurs in raising finances for their new projects in a cost-effective manner. It provides for nation-wide online ringless trading with 20 plus representative offices in all major cities of the country. On this stock exchange, securities of those companies can be traded which are exclusively listed on OTCEI only. In addition, certain shares and debentures listed with other stock exchanges in India and the units of UTI and other mutual funds are also allowed to be traded on OTCEI as permitted securities. It has been noticed that, of late, the turnover at this stock exchange has considerably reduced and steps have been afoot to revitalise it. In fact, as of now, BSE and NSE are the two Stock Exchanges, which enjoy nation-wide coverage and handle most of the business in securities in the country.

13.10 REGULATIONS OF STOCK EXCHANGES

As indicated earlier, the stock exchanges suffer from certain limitations and require strict control over their activities in order to ensure safety in dealings thereon. Hence, as early as 1956, the Securities Contracts (Regulation) Act was passed which provided delete space for recognition of stock exchanges by the Central Government. It had also the provision of framing of proper bylaws by every stock exchange for regulation and control of their functioning subject to the approval by the Government. All stock exchanges are required to submit information relating to its affairs as required by the Government from time to time. The Government was given wide powers relating to listing of securities, make or amend bylaws, withdraw recognition to, or supersede the governing bodies of stock exchange in extraordinary/abnormal situations. Under the Act, the Government promulgated the Securities Regulations (Rules) 1957, which provided inter alia for the procedures to be followed for recognition of the stock exchanges, submission of periodical returns and annual returns by recognised stock exchanges, inquiry into the affairs of recognised stock exchanges and their members, and requirements for listing of securities.

13.11 ROLE OF SEBI

As part of economic reforms programme started in June 1991, the Government of India initiated several capital market reforms, which included the abolition of the office of the Controller of Capital Issues (CCI) and granting statutory recognition to Securities Exchange Board of India (SEBI) in 1992 for:

(a) protecting the interest of investors;

(b) promoting the development of securities market;

(c) regulating the securities market and

(d) matters connected therewith or incidental thereto.

SEBI has been vested with necessary powers concerning various aspects of capital market such as:

(i) regulating the business in stock exchanges and any other securities market;

(ii) registering and regulating the working of various intermediaries and mutual funds;

(iii) promoting and regulating self-regulatory organisations;

(iv) promoting investors' education and training of intermediaries;

(v) prohibiting insider trading and unfair trade practices;

(vi) regulating substantial acquisition of shares and take over of companies;

(vii) calling for information, undertaking inspection, conducting inquiries and audit of stock exchanges, and intermediaries and self regulation organisations in the stock market; and

(viii) performing such functions and exercising such powers under the provisions of the Capital Issues (Control) Act, 1947 (now capital Issues (Control) Repeal Act, 1992) and the Securities Contracts (Regulation) Act, 1956 as may be delegated to it by the Central Government.

As part of its efforts to protect investors' interests, SEBI has initiated many primary market reforms, which include:

1. improved disclosure standards in public issue documents,

2. Introduction of prudential norms and simplification of issue procedures.

3. Companies are now required to disclose all material facts and risk factors associated with their projects while making public issue. All issue documents are to be vetted by SEBI to ensure that the disclosures are not only adequate but also authentic and accurate.

4. SEBI has also introduced a code of advertisement for public issues for ensuring fair and truthful disclosures.

5. Merchant bankers and all mutual funds including UTI have been brought under the regulatory framework of SEBI. A code of conduct has been issued specifying a high degree of responsibility towards investors in respect of pricing and premium fixation of issues.

6. To reduce cost of issue, underwriting of issues has been made optional subject to the condition that the issue is not under-subscribed. In case the issue is under-subscribed i.e., it was not able to collect 90% of the amount offered to the public, the entire amount would be refunded to the investors.

7. The practice of preferential allotment of shares to promoters at prices unrelated

Note

to the prevailing market prices has been stopped and private placements have been made more restrictive.

8. All primary issues have now to be made through depository mode. The initial public offers (IPOs) can go for book building for which the price band and issue size have to be disclosed. Companies with dematerialised shares can alter the par value as and when they so desire. SEBI defines book building as a process undertaken by which a demand for securities proposed to be issued by a body corporate is elicited and build-up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda of offer document."

As for measures in the secondary market, it should be noted that all statutory powers to regulate stock exchanges under the Securities Contracts (Regulation) Act have now been vested with SEBI through the passage of securities law (Amendment) Act in 1995. Measures in the secondary market are:

1. SEBI has duly notified rules and a code of conduct to regulate the activities of intermediaries in the securities market and then registration in the securities market and then registration with SEBI is made compulsory.

2. It has issued guidelines for composition of the governing bodies of stock exchanges so as to include more public representatives.

3. Corporate membership has also been introduced at the stock exchanges.

4. It has notified the regulations on insider trading to protect and preserve the integrity of stock markets and issued guidelines for mergers and acquisitions.

5. SEBI has constantly reviewed the traditional trading systems of Indian stock exchanges and tried to simplify the procedure, achieve transparency in transactions and reduce their costs.

6. To prevent excessive speculations and volatility in the market, it has done away with badla system, and introduced rolling settlement and trading in derivatives

7. All stock exchanges have been advised to set-up clearing corporation / settlement guarantee fund to ensure timely settlements.

8. SEBI organises training programmes for intermediaries in the securities market and conferences for investor education all over the country from time to time.

13.12 NATIONAL STOCK EXCHANGE OF INDIA (NSEI)

National Stock Exchange of India was recognised in 1992 and started working in 1994. Ringless trading takes place in NSEI i.e., the trading of securities takes place through network of computers. NSEI provides a nationwide transparent market for different types of securities.

Objective of NSEI

1. To provide a nationwide transparent market for all types of securities.
2. To ensure access to investors all over the country through an appropriate communication network.
3. To provide an efficient securities market using electronic trading systems.
4. To make available shorter settlement cycles and book entry settlement system.
5. To meet international standards.

13.12.1 TRADING PROCEDURE ON A STOCK EXCHANGE

Now-a-days trading of securities has shifted from the floor of a stock exchange to the broker's office. Securities are bought and sold with the help of brokers who are members of a stock exchange. They act as intermediaries between buyers and sellers of securities.

Companies have to get their securities listed in the stock exchange for the purpose of trading through stock exchange. Trading procedure involves the following steps :

1. **Selection of Broker :** Firstly, investor chooses the broker through whom he will buy or sell the securities.
2. **Placement of Order :** After fixing the broker, the investor places the orderstating the name of the company, number of shares to be bought or sold the price at which the transaction has to be made.
3. **Trade by the Broker :** Broker makes the deal if the desired price is quoted by any buyer/seller in his computer. Transactions on a stock exchange can be on cash basis or carry over basis (badla).
4. **Information to Investor :** The broker informs the investor about the deal. The buyer makes arrangement for payment.
5. **Settlement :** All transactions are settled through the clearing house through electronic book entry.

Note

13.13 DEPOSITORY SERVICES

The Depositories Act 1996, introduced the depository service system in India. Under the depository system, physical securities are converted into electronic form through the process of dematerialisation.

The constituents of the depository system are :

1.	Depository	2.	Depository Participants (DP)
3.	Issuing Company	4.	Investors

Depository is like a bank in which an investor can deposit and withdraw his shares. Depository Participant (DP) is an agent of the depository. Investors interact only with DPs. Any financial institution can become DP after registration with SEBI. The company whose shares are to be transacted in electronic form must be registered with a depository.

Investors who want to get securities in electronic form open a Demat Account. Demat account is the abbreviation of dematerialised account. Demat account refers to an account which an Indian citizen must open with the DPs to trade in listed securities in electronic form. From this account one can hold shares of various companies in the dematerialised/electronic form.

The services provided by a depository are termed as 'Depository Services'. The name of two depositories in India are NSDL and CDSL. [National Securities Depository Ltd. and Central Depository Services Ltd.].

13.13.1 SERVICES PROVIDED BY DEPOSITORY

1. Dematerialisation (demat) that is converting physical certificates into electronic form.
2. Rematerialisation (remat) that is getting physical certificates from the electronic securities. This is the reverse of demat.
3. Transfer of securities.
4. Settlement of trade.

Working of Depository System

Investor must submit Demat Request Form (DRF) along with the certificate to DP

(Depository Participant). DP submits the DRF and share certificates to the issuing company and intimates the depository. The company verifies the DRF and share certificates. Then the company confirms the dematerialisation to the depository. Depository informs the same to DP. DP then credits investor's Demat account with the shares. DP sends a statement of account to the investor.

Note

13.13.2 BENEFITS OF DEPOSITORY SERVICES

Depository services are beneficial because of the following reasons:

1. Sale and purchase of shares and stocks of any company on any stock exchange is facilitated by depository services.
2. Saves time.
3. No paperwork.
4. Lower transaction costs.
5. Ease in trading.
6. Transparency in transactions.
7. Physical presence of investor is not required in stock exchange.
8. Risk of loss and mutilation of security certificate is eliminated.

INTEXT QUESTIONS 13.3

1. State any three main objectives for which SEBI was granted statutory recognition in 1992.
2. Give a specific term/name for the following:
   (a) The prominent stock exchange enjoying nation wide coverage that commenced operations in 1994. ( )
   (b) The stock exchange that specially caters to small and medium-sized companies. ( )
   (c) The first organised stock exchange in India. ( )
   (d) The Act passed in the year 1956 for providing recognition of stock exchanges by the central government. ( )
   (e) The regulatory body of stock exchanges in our country granted statutory recognition in the year 1992. ( )

Note

3. List any three primary market reforms initiated by SEBI.

4. Complete the following sentences with the correct choice:

   (i) NSDL is the name of _____________.

   a) Depository b) Company

   c) Investor d) None of the above

   (ii) Investor who wants to keep his securities in electronic form opens a ________ account with a Depository Participant.

   a) Savings b) Current

   c) Demat d) Both (a) and (b)

TERMINAL EXERCISE

Very Short Answer Questions

1. What do you mean by 'Financial Market'?
2. Give four examples of credit instruments of money market.
3. State the meaning of capital market.
4. List any two advantages of stock exchanges to companies.
5. Mention the organisations that are part of the organised money market in India.
6. What do you mean by 'Depository'?

Short Answer Questions

1. Define money market and explain its importance in a modern economy.
2. What is capital market? How does it differ from money market?
3. Distinguish between primary market and secondary market.
4. How does the stock exchange help in mobilizing savings and capital formation?
5. Describe the measures taken by SEBI to regulate the secondary market.
6. What is meant by a 'Demat' account?
7. Anil wants to invest money in share market. As a financial advisor what will you suggest him to do?

Note

Long Answer Questions

1. Define stock exchange and explain its functions.
2. Explain the importance of stock exchanges from the point of view of companies and investors.
3. Explain the role played by SEBI in protecting investors' interests and controlling the business at stock exchange.
4. Give explanatory notes on (a) stock exchange in India; and (b) Regulations of stock exchanges.
5. Describe the two components of the securities market in detail.

ANSWERS TO INTEXT QUESTIONS

13.1

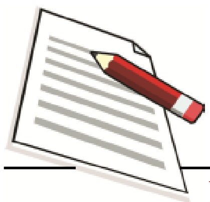
1. It is a market that facilitates transfer of funds between investors/lenders and borrowers/users. It deals in financial instrument like bills of exchange, shares, debentures, bonds etc.
2. (a)

   (i) To raise long-term funds through fresh issue of securities

   (ii) Stock brokers who are members of the stock exchange and mutual funds, financial institutions, and individual investors.

   (iii) Listing in stock exchange is required to deal in a security in the stock exchange.

   (iv) Prices are determined by the company/institution's management, with due confirmation with SEBI.


Note

(b)

Point of Distinction	Capital Market	Money Market
1. Time period / Term	Deals with Long term funds	Deals in short-term funds.
2. Instrument Dealt In	Deals in shares, debenture, bonds and government securities.	Deals in securities like treasury bills, commercial paper, bills of exchange, certificate of deposits etc.
3. Participants	Stock brokers, underwriters, mutual funds, financial institutions	Participants are commercial banks, non-banking finance companies, chit funds etc. and individual investors.
4. Regulatory body	SEBI (Securities and	RBI (Reserve Bank of India) Exchange Board of India.)

13.2

2. (a) **False:** Stock Exchange provides a ready market for sale and purchase of various shares, debentures, bonds and government securities.

   (b) **False:** In the stock exchange, transactions take place between its members or their authorised agents.

   (c) **True**

   (d) **False:** It becomes easy for investors to raise loans from banks against collateral of their holdings in securities traded at the stock exchange.

   (e) **False:** Speculation is different from gambling.

3. (a) Excessive speculation

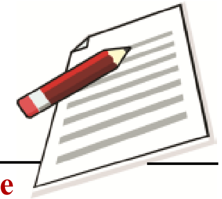
   (b) Fluctuation in security prices due to unpredictable political, social and economic factors as well as on account of rumours spread.

13.3

1. (a) protecting interest of investors

   (b) promoting development of securities market

   (c) regulating the securities market.



Note

2. (a) National Stock Exchange (NSE)
   (b) Over The Counter Exchange of India (OTCEI)
   (c) Bombay Stock Exchange (BSE)
   (d) Securities Contracts (Regulation) Act.
   (e) Securities and Exchange Board of India (SEBI)
3. (i) Improved disclosure standards in public issue documents.
   (ii) Introduction of prudential norms.
   (iii) Simplification of the issue procedures.
4. (i) a (ii) c

DO AND LEARN

1. Identify any two persons in your vicinity who are associated with the financial market/ stock exchanges, either as an investor or as a stockbroker. Talk to them and find out (i) how sale and purchase of securities takes place; (ii) what are the popular instruments traded in the market and (iii) about recent SEBI/ government guidelines that may have affected their transactions.

2. Read the Business Section of a daily newspaper or a specialised Business Newspaper. Locate the segment where share prices of important stock exchanges are given. Select any five companies and record their share prices everyday for a period of three weeks. Observe their price movement and see how major events in the economic, political or social environment affect the prices of these shares. You may even get information about these share prices from the television.

ROLE PLAY

1. Ria and Sandeep are very good friends. Ria depends on Sandeep for financial matters.

   She wants to open a resort in an island for which she is seeking finance. Sandeep offers her 5 crore for the same, but her company requires more finance. Sandeep suggests her to go for different option and advises her to first convert her private company into Public Ltd Company. And advises her to raise funds after acquiring the status of public Ltd company.

Note

Keeping this situation in mind enact a role play explaining her the different methods of raising finance.

2. Sunita and Kavita are good friends. Kavita is very god-fearing kind, while Sunita was an enterprising person, having practical approach. Read the following conversation.

Kavita : Hi, Sunita! What are you doing?

Sunita : Hi, I am reading the newspaper - financial market page that gives us information about the share prices.

Kavita : Shares, that is an area of big gambles.

Sunita : No, not really! You must understand how it works.

Kavita : Frankly speaking, I think this Capital market is all a gambling game and I don't see any use of them.

Sunita : No, you are seriously mistaken; you do not know the importance of capital market. I will tell how it is needed for an individual and an economy.

You are required to play the role of Sunita and continue the conversation.

WHAT HAVE YOU LEARNT