CHAPTER -10

FINANCIAL MARKETS

CONCEPT SUMMARY

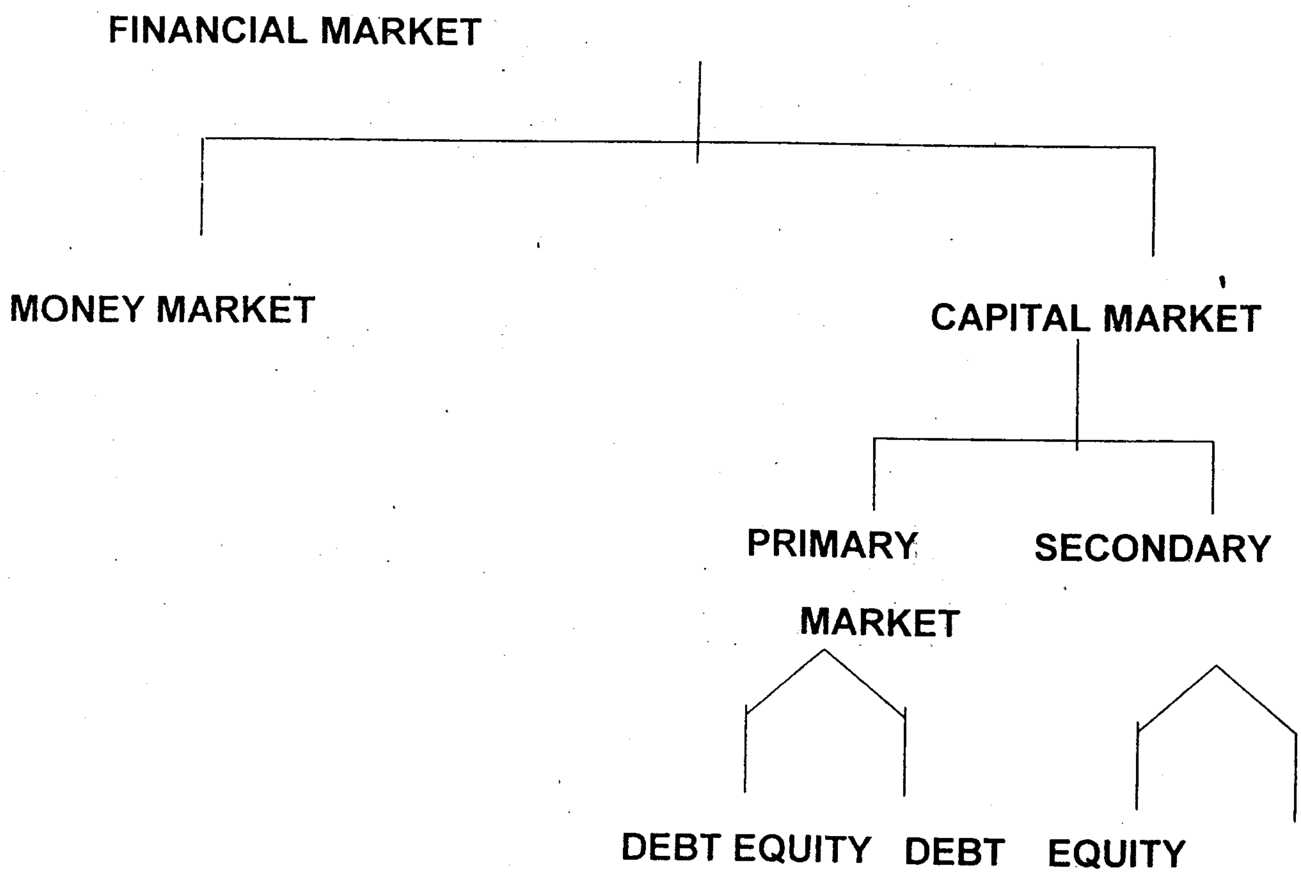
CONCEPT OF FINANCIAL MARKET:

If refers to the market which creates and exchanges financial assets.

FUNCTIONS OF FINANCIAL MARKET

1. **Mobilization of saving and channeling them Into the most productive uses:** A financial market facilitates the transfer of savings from savers to investors (industries)
2. **Facilitates price discovery:** In the 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. In doing so they provide liquidity to financial assets, so that they can be easily converted into cash whenever required.
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.

CLASSIFICATION OF FINANCIAL MARKETS



INSTRUMENTS:OF MONEY MARKET

1.Treasury Bill (T-bills): It is basically an instrument of short- term borrowing by the Government of India maturing in less than one year. They are also known as Zero coupon bonds.

2.Commercial Paper: It is a short- term unsecured promissory notes, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is issued by large and creditworthy companies to raise short-term funds at lower rates of interest than market rates. It usually has a maturity period of 15 days to one year.

3. Call Money: It is a short-term finance repayable on demand, with a maturity period of one day to fifteen days, used for inter-bank transactions. It is a method by which banks borrow from each other to e able to maintain the cash reserve ratio.

4. Certificate of Deposit (CD): It is a unsecured, negotiable short-term instruments in bearer form, issued by commercial banks and development financial institutions. It can be issued to individuals, corporations and companies.

5. Commercial Bill (Trade Bill): It is a short-term, negotiable, self-liquidating instrument which is used to finance the credit sales of firms. The bill can be discounted with a bank it the seller (drawer) needs funds before the bill maturity.

TYPE OF CAPITAL MARKET:

Primary Market: It is also known as the new issues market. It deals with new securities being issued for the first time. A company can raise capital through the primary market in the form of equity shares, preference shares, debentures, loans and deposits.

Secondary Market: It is also known as stock market or stock exchange or second- hand market. It is a market for the purchase and sale of existing securities.

Differences between Primary Market and Secondary Market

Primary Market	Secondary Market
It is the market for new securities. Securities are exchange between company and the investors. It promotes capital formation directly. Only buying of securities takes place. Securities cannot be sold here. There is no fixed geographical location. Prices are determined and decided by the management of the company. Securities are issued to investors for the first time.	It is the market for existing securities. Securities are exchanged between investors. It promotes capital formation indirectly. Bothe buying and selling of securities can take place in the stock exchange/stock market. There is a specified location. Prices are determined by demand and supply for the security in the stock exchange. Securities may be bought and sold many times but not the first time.

Methods of Floatation

Following are the method of raising capital from the primary market:

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.

Offer for sale: Under this method the sale of securities takes place in two steps. In the first step the company sells the entire lot of shares to the intermediary firms of stock brokers at an agreed price. In the second step, the intermediary resells these shares to investors at a higher price.

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.

- **Rights issue (for existing companies):** This is the offer of new shares (additional shares) by an existing company to the existing shareholders. The shareholder may either accept the offer for himself or assign to another. A rights issue to the existing shareholders is a mandatory requirement.
- **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).The issuer company should also appoint a registrar to the issue having electronic connectivity with the exchange.

STOCK EXCHANGE

- Meaning and definition of 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, organization, body of individuals, whether incorporated or not, established for the purpose of assisting, regulation and controlling of business in buying, selling and dealing in securities."

FUNCTION OF STOCK EXCHANGE

1. **Providing liquidity and Marketability to Existing Securities:** It gives investors the chance to disinvest and re-invest. 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. A stock exchange is a mechanism of constant valuation through which the prices of securities are determined.

3. **Safety of transactions:** The membership of a stock exchange is well regulated and its dealings are well defined according to the existing legal frame work. This ensures that the investing public gets a safe and fair deal on the market.
4. **Contributes to Economic Growth:** A stock exchange is a market in which existing securities are re-sold or traded. Through this process of disinvestment and re –investment savings get channelized into their most productive investment avenues. This leads to capital formation and economic growth.
5. **Spreading of Equity Cult:** The 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.
6. **Providing scope for speculation:** The stock exchange provides sufficient scope within in the provisions of law for speculative activity in a restricted ad controlled manner.

TRADING PROCEDURE:

The procedure for purchase and sale of securities in a stock exchange involves the following steps:

4. Selection of broker

The first step is to select a broker who will buy/sell securities on behalf of the investor. This is necessary because trading of securities can only be done through SEBI registered brokers who are charges brokerage/commission for his services.

5. Opening demat account

The next step is to open a demat account. Demat (Dematerialized)

Account which an Indian citizen must open with the depository participant (banks, stock, and brokers) to trade in listed in electronic form.

The securities are held in the electronic form by a depository. At present, there are two depositories in India NSDL (National securities Depository Ltd.) and CSDL (Central Depository Services Ltd.)

Depository interacts with the investors through depository participants. Your Depository Participant will maintain your securities account balances and intimate to you the status of your holding form time to time.

6.Placing the order

The next step is to place the order with the broker. The order can be communicated to the broker either personally or through telephone, cell phone, e-mail etc.

The instructions should specify the securities to be bought or sold and the price range within which the order is to be executed. Only the securities of listed companies can be traded on the stock exchange.

7.Executing the order

According to the instructions of the investor, the broker buys or sells securities. The broker then issues a contract note. A copy of the contract note is sent to the client. The contract note contains the name and the price of the securities, names of the parties, brokerage charged. It is signed by the broker.

8.Settlement

This is the last stage in the trading of securities done by the brokers on behalf of their clients. The mode of settlement depends upon the nature of the contract.

Equity spot market follows a T+2 rolling settlement. This means that any trade taking place on Monday gets settled by Wednesday. All trading on stock exchanges takes place between 9:55 am and 3:30 pm. Indian standard Time, Monday to Friday. Delivery of shares must be made in dematerialized form, and each exchange has its own clearing house, which assumes all settlement risk.

DEPOSITORY SERVICES:-

It refers to that service through which the transfer of ownership in shares takes place by means of book entry without the physical movement of shares.

PARTICIPANTS OF DEPOSITORY SERVICES:

I. **DEPOSITORY:-**A Depository is an institution which holds the shares of an investor in electronic form. At present, there are two depository institutions in India:
   - NSDL- National Securities Depository Limited.
   - CDSL- Central Depository Services Limited.

II. **DEPOSITORY PARTICIPANT: A** Depository participant (DP) is an agent of the depository. He functions as a mediator between the issuing company and the investors through the depository. He opens the accounts and maintains the securities account balance of the investors and conveys them status of their holding from time to time. As per SEBI guidelines, banks, stock brokers etc can become depository participants.

III. **INVESTOR:** He is a person who wants to deal in shares and whose name is recorded with a Depository.

IV. **ISSUING COMPANY:** It is that organization which issues the securities. The issuing company sends a list of the shareholders to the depositories.

D'MAT/Demat ACCOUNT:

Dematerialization(popularly known as D'Mat) is the process of converting a share certificate form its physical form to electronic form and credit the same number of holdings to the D'Mat A/C which the investor with a depository participant.

D'Mat Account refers to that account which is opened by the investors with depository participant to facilitate trading in shares.

BENEFITS OF DEPOSITORY SERVICES and D'MAT ACCOUNT:

i. Exemption of stamp duty for dealing in shares in the electronic form.
ii. Elimination of problem associated with transfer of shares in physical form.
iii. Increased liquidity through speedy settlement.
iv. Reduction in paper work.
v. Attracts foreign investors and promoting foreign investments

OBJECTIVES OF SEBI

1. To regulate stock exchanges and the securities industry to promote their orderly functioning.
2. To protect the rights and interest 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

Protective Functions:

i. SEBI prohibits fraudulent and unfair trade practices in the securities market such as

(a) Price Rigging – Marking manipulations with the sole objective of inflating or depressing the market price of securities.

(b)Misleading statement: SEBI prohibits misleading statements which are likely to induce the sale or purchase of securities.

ii. SEBI prohibits insider trading. An insider is a person connected with the company who is reasonably expected to have access to price sensitive information in respect of securities to the company is called insider trading.

iii. SEBI undertake steps to educate investors through investors, camps , T.V, Newspapers etc.,

iv. SEBI promotes fair practice and code of conduct in securities market such as

(a) Companies cannot roll over the debenture holders, funds unilaterally and cannot change terms – term.

(b) SEBI is empowered to investigate cases of insider trading and has provisions for still fine and imprisonment.

(c) SEBI has stopped the practice of making preferential allotment of shares at lower prices than market price.

v. SEBI issues timely guidelines clarifications to investors during stock market up's and downs.

DEVELOPMENT FUNCTIONS:

i. SEBI promotes training of intermediaries of the securities market such as brokers, sub- brokers etc.,

ii. SEBI has permitted internet trading in a limited way through registered stock brokers.

iii., In order to reduce the cost of issue, SEBI has made under- writing optional.

Iv.SEBI has accepted the system of using the stock exchanges to market IPO's

v.All intermediaries including collection banks here to register with SEBI

vi. Registration of foreign Institutional investors (FIIs) allowed for the development and growth of Indian markets.

Vii PSU bonds brought under SEBI's purview

Viii private mutual funds are allowed for the benefit of small investors.

Ix.Debenture trustees to be registered by SEBI etc.

Regulatory Functions:

1. SEBI registers and registers and regulates the working of mutual funds.

2. SEBI regulates takeover of companies

3. SEBI conducts inquires and audit of the stock exchange.

4. SEBI registers and regulates the working of stock – brokers, sub – Brokers, Brokers to an issue, share transfer agent and such other intermediaries in the stock market.

5. SEBI regulates the business in stock exchanges and securities market.

6. SEBI has notifies rules and regulations and a code of conduct to regulate the intermediaries in the securities market such as underwriters, merchants, brokers etc.

7. Levying fee or other charges for carrying out the purposes of the Act.

VERY SHORT ANSWERS.

Q1Give the meaning of 'Financial market'?

Ans. Financial market is the market for the creation and exchange of financial assets, example

shares, debentures, etc.

Q2Mention main purpose of financial markets.

Ans. Linking savers and investors.

Q3Who are the two competing intermediaries in banks andFinancial system ?

Ans. Banks and financial market.

Q4Give the meaning of 'money market'.

Ans. Money Market is a market for short term fund which deals in monetary assets whose period of maturity of 'capital market'.

Q5What are the instruments of capital market?

Ans. Equity shares or Debentures.

Q6What is other name of primary market?

Ans. New Issues Market.

Q7Give the meaning of 'secondary Market.

Ans. Secondary Market is market for purchase and sale of existing securities.

Q8What is 'demutualization' of stock exchange?

Ans. It separates the ownership and control of changes from trading rights of members.

Q9Name the barometer that reflects market direction, indicates dayto day fluctuation in stock price and measures overall market sentiment.

Ans. Stock Market Index.

Q10Name the benchmark index of NSE>

Ans. NIFTY

Q11Name the benchmark index of BSE.

Ans. SENSEX

Q13Who is a Broker?

Ans. A member of stock exchange through whom trading of securities is done is known as broker.

Q14 What is the system of electronic book entry form, of holding and transferring securities, called?

Ans. Dematerializations of securities.

Q15What do you mean by T+2?

Ans. T+2 refer to trading days. It is the settlement cycle in NSE.

Q16When was SEBI established?

Ans. 12 April 1988

Q17What is price rigging?

Ans. Price rigging refers to manipulation of prices of securities by companies for their own profits.

Q18What do you mean by depository institution?
Ans. A 'Depository' is an institution which holds securities like shares, debentures etc. in electronic from in which trading is done.

<u>Short question/answers</u>

Q1. What is meant by 'Primary Market'?

Ans. Primary market is a market in which new securities are issued for the first time to the investors.

Q2 Explain any three functions of financial market.
Ans. **Functions of a financial market:**

1. Mobilization of saving and canalizing them into most productive use.
2. Facilitating price discovery.
3. Providing liquidity to financial assets.
4. Reducing the cost of transactions.

Q3 Nature of money market can be well explained with the help of its features. State any three such features of money market.

Ans. Features of money market:

1. The money market is a market for short term securities with a maturity period up to one year.
2. It is a market where **low risk**, unsecured and short term debt instruments are traded.
3. It has **no physical location,** but is an activity conducted over the telephone and through the internet.

Q4. Write a note on 'Trade Bill'?

Ans. **Trade bill**

- Trade bills short-term bill drawn by one business firm on another to pay a specified sum of money.
- These are **freely marketable bills.** Drawer honors this bill on date of maturity.
- It is generally **used for credit purchase** of goods and can also be discounted with bank in case of emergency.

Q5 Explain the following money market instruments:
(a) Commercial paper (b) Commercial bill

Ans. **(a) Commercial paper:**

- It is an instrument by large and creditworthy companies to raise **short term** funds at **lower rates of interest** than the market rates.
- It is an **unsecured, negotiable** promissory note with a fixed maturity period.

(b) Commercial Bill:

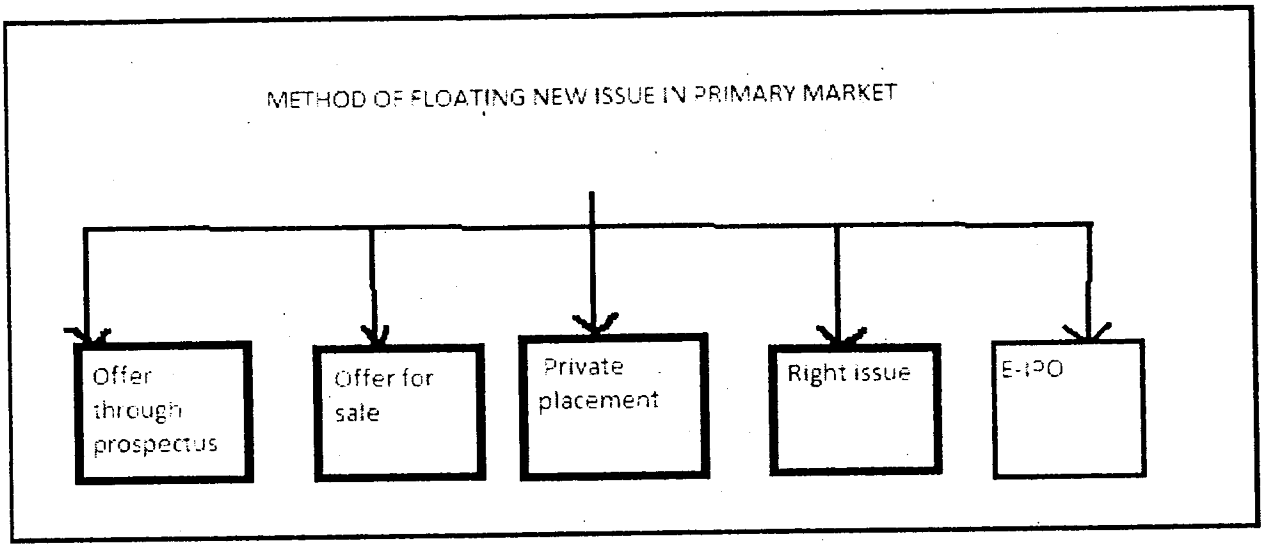
- The holder of trade bill has the liberty to retain these bill till their maturity or he can discount these bills with a bank, if is in need of funds, before the maturity date of these bills.
- When **trade bills** are **accepted by the commercial banks,** they are known as commercial bills.

- It is a **bill of exchange** used to finance working capital requirement of business firms. It is short-term, negotiable and self-liquidating instrument.

Long answer type question

1. State any five methods of floating new issues in the primary market.

Ans. The methods of floating new issues in primary market are :]



(a) **Offer through prospectus-** It is the method of floating new issues by inviting subscriptions from the public through issue of prospectus.

(b) **Offer for sale-** It is the method in which the securities are not issued directly to the public but through intermediaries like issuing houses or stock brokers.

(c) **Private placement-** It refers to allotment of securities by a company to institutional investors and some selected individuals.

(d) **Right issue-**It is privilege given to existing share in proportion to the number of shares they already hold.

(e) **E-IPO-**It refers to issuing securities through the online system of stock exchange.

2. Difference between capital market and money market:

Ans.

Basis	**Capital market**	**Money market**
1. Participant	The participants are financial institutions,	The participants are RBI, financial institution,

	banks, corporates, foreign investors and retail investors.	banks, and corporates.
2. Instruments	Instruments traded are shares, debentures and bond	Instruments traded are treasury bill, commercial paper, certificates of deposit, call money and commercial bill,
3. Investment outlay	Investment outlay is small.	Investment outlay is large.
4. Duration	It deals in medium terms securities.	It deals in short term securities
5. Liquidity	Capital market securities are comparatively less liquid.	Money market securities are comparatively more liquid.
6. Safety	Capital market securities are riskier than money market instruments.	Money market securities are comparatively safer.
7. Return	Generally yield a higher return than money market instruments.	Money market securities yield comparatively less return.

3. Explain the procedure of trading in the stock Exchange.

Ans. Few years back trading on a stock exchange took place through a system of auction or public outcry. But at present the trading is conducted through a computer at the broker's office.

Trading in stock exchange involves the following steps:

(i) **Selection of brokers:** the first step is to select the broker who will buy and sell the securities on behalf of the investor. A broker can be an **individual, corporate body** or **partnership firm.**

(ii) **Openings demat account:** A demand account through which share certificates and money are transferred in case of sale or purchase of securities.

(iii) **Placing order:** After openings demat account the investor **specifies the number** and type of securities that he want to purchase or sell.

(iv) **Execution of order:** According to the instruction of investor the broker **buys or sells the securities.**

(v) **Settlement:** the transaction on a stock exchange is carried out either on cash basis or on a carryover basis. The carry over basis is known as 'badla'.

Hots

Q1 The directors of a company want to modernize its plant and machinery by making a public issue of shares. They wish to approach the stock exchange, while the finance manager prefers to approach a consultant for the new public issue of shares. Advise the director whether to approach the stock exchange or a consultant for new public issue of shares and why. Also advise them about different methods which the company may adopt for the new public issue of shares.

Ans. The director should approach a consultant for new public issue of shares. The stock exchange deals with sale and purchase of existing securities only, not in new issue of securities.

Different methods which the company may adopt for the new public issue of shares:

Offer through prospectus.

I. Offer for sale
II. Private placement
III. Rights issue
IV. e-Ipos

Value Based Question

1. A public Ltd. CO. Achieve the minimum subscriptions by private placement. Whose interest has been ignored here.

Ans. Ignoring the interest of small investors.