Commerce CLASSES

Business Studies Notes PDF

On

Financial Markets

(Class – 12 / Chapter- 10)

INTRODUCTION

Financial Intermediation = process of allocating funds from saving surplus units (E.g. households) to saving deficit units (e.g. industries, government etc).

• Alternatives = Banks or Financial markets

Financial Markets: These are the institutional arrangements by which savings generated in the economy are channelised into avenues of investment by industry, business and the government. It is a market for the creation and exchange of financial assets.

Functions of Financial Market:

- **Mobilisation of savings and channeling them into the most productive uses:** A financial market performs the allocative function by linking the savers and investors, thus mobilising savings and channelising them to make the most use of these idle savings.
- **Facilitating price discovery:** The interaction between the households (supplier of funds) and business firms helps to establish a price for the traded financial asset in the market.
- **Providing liquidity to financial assets:** Financial assets can be easily converted into cash as financial markets provide facility of purchase and sale of financial assets.
- **Reducing the cost of transactions:** Financial markets provide information about the traded securities and save time, effort and money of both the buyers and sellers of a financial asset.

There are two types of Financial Markets:

- Money Market
- Capital Market

A. MONEY MARKET:

It is a market which deals in short term securities and whose maturity period is less than one year.

Money Market Instruments:

Instruments	Issued By	Duration	Purpose
Treasury Bill	RBI on behalf of the central government.	14 to 365 days	To fulfill short term needs.
Commercial Paper	Large and creditworthy company	15 to 365 days	Seasonal and working capital needs.
Call money	Inter-bank transaction	1 to 15 days	To maintain CRR.
Certificate of deposits	Commercial bank and financial institution.	91 to 365 days	Helps tight liquidity period.
Commercial Bill	Seller to buyer	Up to 1 year	Meet working capital requirements.

B. Capital Market:

It is a market which deals in medium and long term securities with a maturity period of more than one year.

Distinction between Capital Market and Money Market:

Basis	Money Market	Capital Market
Participants	RBI, banks, financial institutions and finance companies.	Financial institutions, banks, corporate entities, foreign investors.
Instruments	Treasury bills, trade bills reports, commercial paper and certificates of deposit.	Equity shares, debentures, bonds and preference shares.
Investment outlet	Requires a huge investment outlet. e.g., treasury bills require a minimum amount of ₹25,000 and its multiples thereof.	Requires a small investment outlet as unit value of securities is very low i.e., ₹10 or ₹100.
Duration	Deals in short- term securities with maturity period of less than one year or even a single day.	Deals in medium and long-term securities with a maturity period of more than one year.
Liquidity	Instruments are highly liquid as there is a ready market for the sale, purchase or discounting of instruments.	Instruments are liquid as they can be easily traded in stock exchange but comparatively less liquid.
Safety	Instruments are safe because of shorter duration of investment.	Instruments are risky because of the longer duration of investment both in terms of returns and repayment.
Expected Return	Money market securities yield comparatively less return on investment due to shorter duration.	Capital market securities yield higher returns due to longer duration.

The capital market can be divided into two parts:
1. Primary Market
2. Secondary Market

1. Primary Market:
• New issues markets
• Transfers investible funds from savers to entrepreneurs.
• Funds used for setting up new projects, expansion, diversification, modernization of existing projects, mergers and takeovers etc.

Methods of Floatation of New Issues in Primary Market:

- **Offer through Prospectus:** It involves inviting subscriptions from the public through issue of prospectus. A prospectus makes a direct appeal to investors to raise capital through an advertisement in newspapers and magazines.
- **Offer for Sale:** Under this method, securities are offered for sale through intermediaries like issuing houses or stock brokers. The company sells securities to intermediary/broker at an agreed price and the broker resells them to investors at a higher price.

- **Private Placements:** It refers to the process in which securities are allotted to institutional investors and some selected individuals.
- **Rights Issue**: It refers to the issue in which new shares are offered to the existing shareholders in proportion to the number of shares they already possess.
- **e-IPOs**: It is a method of issuing securities through an on-line system of stock exchange. 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 e-initial public offer. SEBI's registered brokers have to be appointed for the purpose of accepting applications and placing orders with the company.

2. Secondary Market:

- Secondary market is a market which deals with the sale and purchase of existing securities. It is also called the stock market or stock exchange.
- SEBI prescribes the framework within which all the securities are traded, cleared and settled.
- It provides opportunities of disinvestment and reinvestment to investors by exchange of securities.

Difference between Primary and Secondary Market:

Basis	Primary Market	Secondary Market
Nature of Securities	Securities issued for the first time.	Sale and purchase of securities which already exist.
Process of Transactions	Issue directly to investors or through an intermediary.	Ownership changes between brokers.
Capital Formation	Promotes direct capital formation.	Promotes indirect capital formation.
Trading of securities	Only buying of securities.	Buying and selling of securities.
Price Determination	Decided by management of the issuing company.	Determined by market forces of demand and supply.
Location	No geographical boundaries.	Located at a specific place.

STOCK EXCHANGE

It defines as "an organisation or body of individuals, whether incorporated or not established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities."

Functions of Stock Exchange/Secondary Market:

- Economic barometer
- Pricing of securities
- Safety of transactions
- Contributes to economic growth
- Spreading of equity cult
- Providing scope for speculation
- Liquidity
- Better allocation of capital
- Promotes the habits of savings and investment

Trading and Settlement Procedure:

- **In traditional times:** Outcry or auction system.
- **In modern times:** Electronic trading system for screen based trading. In this system transactions are carried on the computer screen and both the parties are able to see the prices of all shares going up and down all the time during business hours of the stock exchange.

Advantages:

- Ensure transparency
- Increases efficiency of operation and information
- Large number of participants, which improves liquidity
- Single trading platform

Steps in trading and settlement procedure:

- **Selection of Broker:** in order to trade on a Stock Exchange first a broker is selected who should be a member of stock exchange as they can only trade on the stock exchange.
- **Placing the order:** After selecting a broker, the investors specify the type and number of securities they want to buy or sell.
- **Executing the order:** The broker will buy or sell the securities as per the instructions of the investor.
- **Opening Demat Account:** It involves opening a demat account with a depository participant and a bank account for cash transactions.
- **Settlement:** After receipt of contract note and a day before the final settlement, the investor delivers the securities sold or makes payment for securities purchased, which is called pay in day. On T+2 day the broker delivers payment or securities to the exchange.

DEMATERIALIZATION AND DEPOSITORIES

Dematerialization:

It refers to the process of canceling the physical form of securities and converting them into electronic form. It was introduced under the Depositories Act 1966.

Working of Demat System:

- Identify depository participants either bank, broker or financial institution.
- An account opening form and formalities related to other documentation like PAN card details, photograph, etc. is completed.
- The physical certificate related to existing securities is given to the depository along with a dematerialisation form.
- If investors plan to apply for shares in the IPO, then details of depository participant and demat account has to be provided in the application form. The allotted shares automatically get credited to the demat account.
- If shares are sold through to a broker then the depository participant is to be instructed to debit the account with the number of shares the broker then gives instruction to his depository to deliver the shares to the stock exchange the broker receives payment from the buyer and paste them to the seller of securities.
- The entire transaction is completed within a period of 2 days the delivery of shares and receipt of payment from the buyer is on T + 2 basis settlement period.

Depository Services: Just like a bank keeps money in safe custody for customers, a depository also is like a bank and keeps securities(e.g. shares, debentures, bonds, mutual funds etc.) in electronic form on behalf of the investor. In the depository a securities account can be opened, all shares can be deposited, they can be withdrawn/ sold at any time and instruction to deliver or receive shares on behalf of the investor can be given.

At present there are two depositories in India:

- NSDL (National Securities Depository Ltd.)
- CDSL (Central Depository Services Ltd.)

Depository Participants: Depository participants are intermediaries electronically connected with the depository. They act as a connect point between the depository and the investor.

National Stock Exchange of India (NSEI)

It was recognised in 1992 and started working in 1994. It launched the capital market segment in November 1994 and option segment in June 2000 for various derivative instruments.

Objectives and Nature of NSEI are as follows:

(i) Securities traded – Capital market + Money market
(ii) Payment and delivery in 15 days time period

Market segments of NSEI

Exchange provides trading in following segment:

- Wholesale debt market segment
- Capital market segment

Over the Counter Exchange of India (OTCEI)

The OTCEI was incorporated in 1990. The trading started in this exchange in 1992. This exchange is established on the lines of NASDAQ, the OTC exchange in the USA.

Objectives and Nature of OTCEI are as follows:

(i) Compulsory market makers to provide liquidity
(ii) Settlement period of OTCEI is one week

BSE (Bombay Stock Exchange Limited)

It was Asia's first stock exchange and was established in 1875. It provides a platform for raising capital which has contributed to the growth of the corporate sector. Permanent recognition to BSE was granted as per the Securities Contract (Regulation) Act, 1956.

Objectives of BSE:

(i) Efficient and transparent market for trade.
(ii) Trading platform for equities.
(iii) Ensure active trade.
(iv) Services to capital market participants.
(v) Conform to international standards.

Securities and Exchange Board of India (SEBI)

SEBI was established by the Government of India on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of the securities market and for investor protection. It was given a statutory status on 30

January1992 through an ordinance which was later replaced by an Act of Parliament known as the SEBI Act, 1992. It seeks to protect the interest of investors in new and second hand securities.

Objectives of SEBI

- To regulate the stock exchange and the securities market to promote their orderly functioning.
- To protect the rights and interests of investors and to guide & educate them.
- To prevent trade mal practices such as internal trading.
- To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc.

Functions of SEBI

1. Protective Functions:

(a) Prohibit fraudulent & unfair trade practices in the secondary market (e.g. Price rigging & misleading statement).
(b) Prohibit insider trading.
(c) Educate investors Promote fair practice & code of conduct in the securities market.

2. Development Functions:

(a) Promotes training of intermediaries of the securities market.
(b) Investor education.
(c) Promotion of fair practices code of conduct of all SRO‘s.
(d) Conducting research & publishing information useful to all market participants.

3. Regulation Functions:

(a) Registration of brokers and sub brokers & other players in the mkt.
(b) Registration of collective investment schemes & mutual funds.
(c) Regulation of stock bankers & portfolio exchanges & merchant bankers.

The Organisation Structure Of SEBI

SEBI has five operational departments headed by the Executive Director. It is advised or assisted in policy formation by two advisory committees –

- The primary market advisory committee
- The secondary market advisory committee

Objectives of Advisory Committees

- To advise SEBI on matters related to regulations.
- To advise SEBI on development and regulation of the primary market.
- It advises SEBI on disclosure requirements for the companies as per the provisions mentioned in the Act.
- To advise SEBI in the legal framework for making dealing in the primary market simple and transparent.