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INDIAN FINANCIAL SYSTEM

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6 CREDIT HOURS

CAPITAL MARKET
UNIT: 2
20 MARKS

CAPITAL MARKET

CHAPTER CONTENT

1. Functions and Instruments;
2. Primary and Secondary Markets- Functions and inter-relationship,
3. Methods of New Issues;
4. Indian debt market and equity market;
5. Market Intermediaries- Brokers, Sub-Brokers
6. Role of Stock Exchanges in India;
7. Recent trends in the Indian capital market.

MEANING

CAPITAL MARKET:

1. Medium and long term financial market
2. Period of 1 year or more
3. Index of economic and industrial development
4. Important constituent of financial market
5. Is concerned with supply of long term capital to the industries.
6. Capital market may be defined as a highly organized market which provides permanent capital to the industry , trade and commerce.
7. Corporate organization raise long term capital by issuing their shares and debentures from the capital market.

Capital market consists of a series of channels through which the savings of the community are made available for industrial and commercial enterprise and public authorities. -----S.C.Kuchhal

CHARACTERISTICS OF CAPITAL MARKET

1. Sources of fixed capital
2. Sources of finance for the corporate sector
3. Well spread
4. Sources of finance for the government
5. Existence of brokers and sub brokers
6. Regulated market
7. Provide investment opportunities
8. Liquidity
9. Channelization of funds
10. Large numbers of Participants

Capital Market creates a good invest opportunities for the high net worth investors (NWI) and retail investors.

DIFFERENCE BETWEEN CAPITAL MARKET AND MONEY MARKET

CAPITAL MARKET	MONEY MARKET
Capital market is a highly organized and well regulated market which supply long term capital to trade, industry and commerce	Money market is a highly organized market which provides short term credit to trade, industry and commerce
The main function of capital market is to provide medium term and long term capital to the business firms	The main function of money market is to accept deposits and to provide short term capital to trade, industry and commerce
Capital market cannot create credit in the financial system	Money market creates credit in the system, commercial bank by accepting and lending process, credit in the financial system
Capital provided by the capital market is used as fixed capital by the business organization	Funds provided by the money market are used as working capital by the business houses.
Capital market is mainly regulated by the SEBI	Money market is classified as RBI
Capital Market is classified as New issue market or primary market and secondary market or stock exchange	Money market is classified as Treseaury bill market, commercial paper, call money market, certificate of deposit

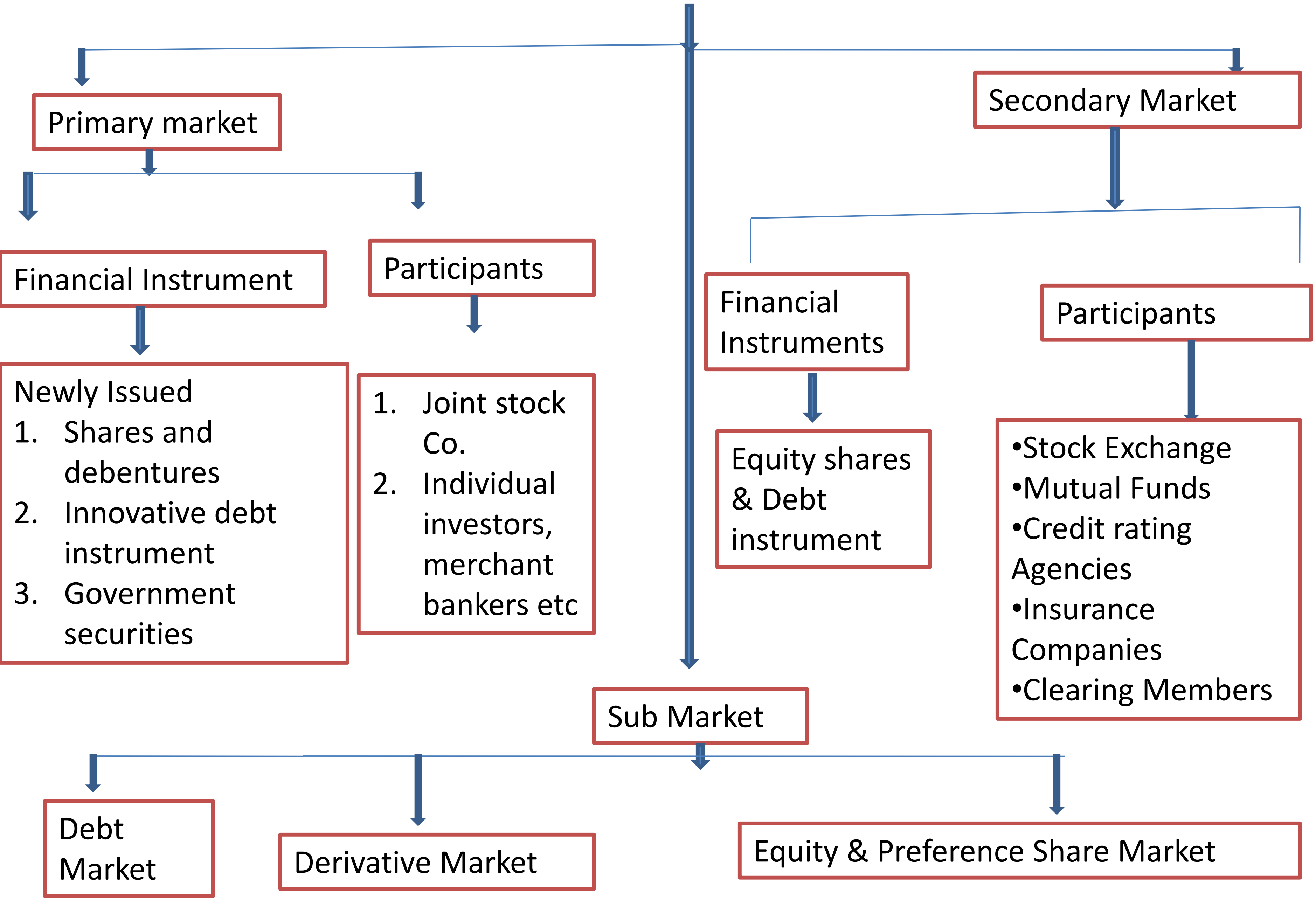
Functions of Capital Market

1. Supply of Long term capital
2. Establish a ready market
3. Capital Formation
4. Regulated Market
5. Provides Investment opportunities
6. Mobilizing the savings
7. Rendering advisory functions
8. Trading of Government securities
9. Underwriting functions
10. Provide capital to public sector undertaking
11. Fostering economic growth
12. Greater opportunity to savers and investors

Importance of Capital Market

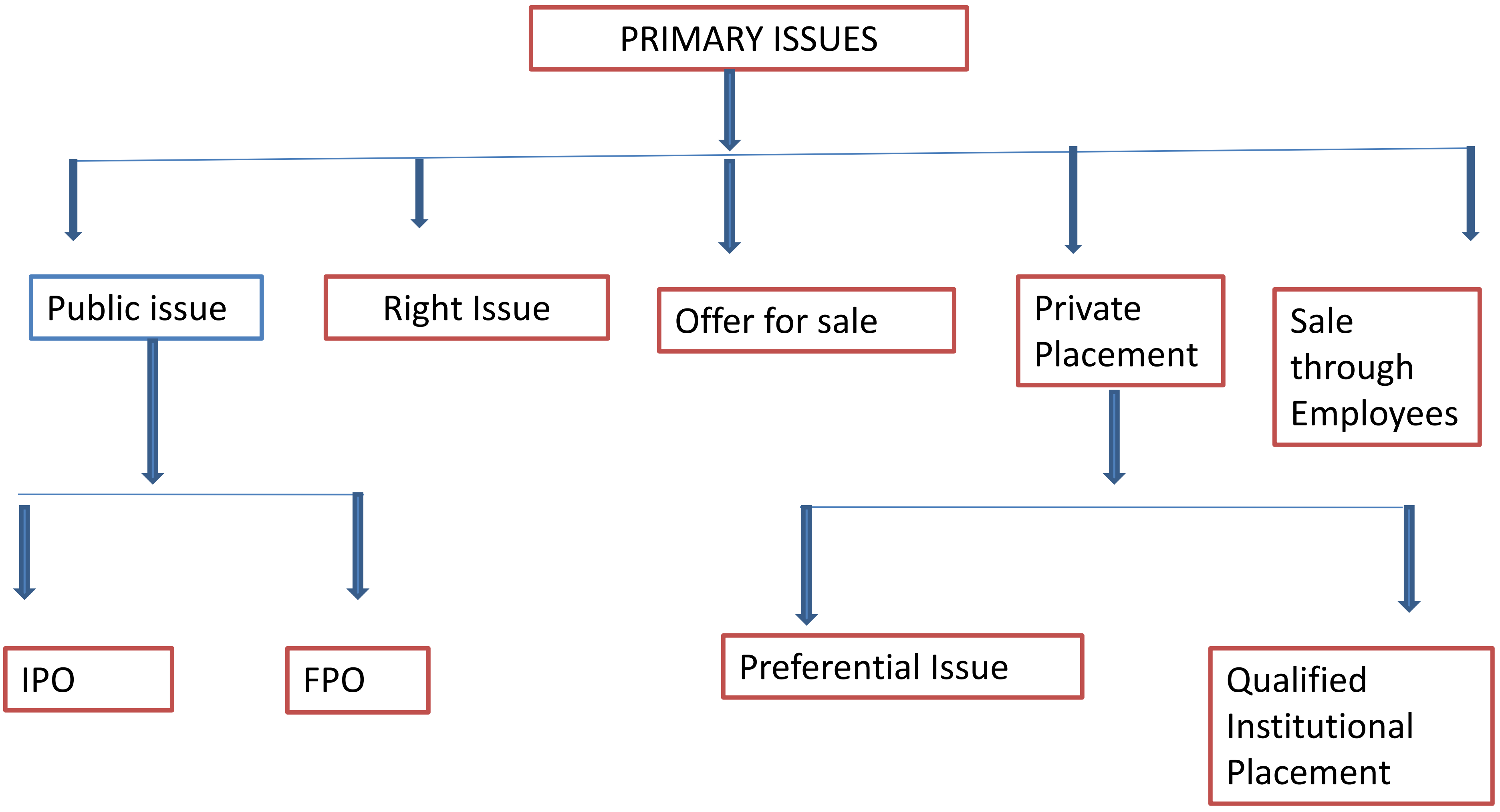
1. Establishment and expansion of industry
2. Encouragement of investment
3. Creation of fixed capital
4. Formation of capital
5. Economic growth
6. Continuous and ready market
7. Mobilization of savings
8. Raising international funds
9. Providing long term loans
10. Providing investment opportunities

DIFFERENT COMPONENTS OF CAPITAL MARKET



Role of Capital Market

1. Capital Formation
2. Providing Long term loans
3. Helps to Government
4. Economic development
5. Rendering advisory services to industry
6. Create continuous and ready market
7. Creation of fixed capital Constant flow of capital
8. Establishment and expansion of industry
9. Enhancement of goodwill of the firm


PRIMARY ISSUES
Public issue
Right Issue
Offer for sale
Private Placement
Sale through Employees
IPO
FPO
Preferential Issue
Qualified Institutional Placement

METHODS OF RAISING FUNDS FROM PRIMARY MARKET

1. **Public Issue:** Companies desirous of raising capital from the primary market through the issue of their securities from the public may resort to the prospectus method or book building method. When the company issues shares for the first time to the public, it is known as IPO and the second and subsequent issues are known as follow on public offering FPO.
2. **Right Share Issue**
3. **Private Placement**
4. **Bought out deal**: Bought out deal is a method of offering securities to the public through a sponsor or merchant bankers. The sponsor offloads the securities at the appropriate time by offering them to the public. In this method the merchant bank or sponsor becomes an intermediary investor who purchases stake in the company and then offloads it to the public.
5. **Issuing of shares in foreign Countries**: Indian companies can raise capital from international capital market through GDRs, ADRs and through issue of FCCBs. GDRs are the negotiable instruments that are traded in the international market. ADRs are negotiable instruments and are traded in the US Depository Bank. Indian companies may also raise funds from abroad by issuing convertible foreign currency bonds (FCCBs). Such bonds may be converted afterwards into equities.

Public issue through Prospectus Method

1. Prospectus is a statement issued by a public limited company inviting general public to subscribe shares or debentures of the company. It contains relevant information about the companies financial statement and other relevant information for the prospective investors.

Rules of Public Issue

1. Securities must be registered with a recognized stock exchange
2. A draft prospectus is to be prepared.
3. Price of the issue of the securities are fixed and when the shares are issued under book building method, a price band is fixed.
4. Underwriters, lead managers, advertising agencies are to be appointed.
5. A draft prospectus is to be submitted to the SEBI and Registered of Companies
6. Finally securities are offered for sale to the public.
7. Primary issue is governed by Disclosure of Investors protection by SEBI.
8. The merchant Bankers who are appointed by the issuing company as lead managers are required to undertake a due diligence exercise and ensure that all the formalities relating to DIP have been complied while submitted draft offer documents to the SEBI.
9. The merchant Bank can also submit Red Herring Prospectus to the SEBI.

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10. The draft offer document should be filed with SEBI at least 21 days prior to the filing of the offer document or the prospectus with the Register of Companies (ROC) Or stock Exchange.

Intermediaries to the Issue

1. Merchant Banker:

a. A merchant banker as per SEBI guidelines, has to act as a book running lead manager to an issue.

b. This lead manager has to perform most of the pre issue and post issue activities.

c. The pre issue activities due diligence of the operations or management of the issuing company, drafting of the offer document, finalizing the prospectus, ensuring the compliance with legal requirements, completion of formalities with the stock exchanges and Register of Companies.

d. The post issue activities include the management of **the escrow account**.

2. **Registrar to the issue:**

a. The registrar to the issue finalizes the list of eligible allottees, ensure crediting of shares to the demat accounts of the eligible allot tees and dispatch the refund orders.

3. **Banker to the issue**

These are banking institutions which are appointed by the merchant bankers to carry out activities relating to collection of application amounts, transfer of the amount to the escrow account, and dispatching the refund amount.

Advantages of the Public Issue Through Prospectus Method

1. Through this method a wide approach can be made to the prospective investors.
2. A certain quantity of shares must be allotted to the applicants compulsorily.
3. The issues are widely distributed.
4. In this method, owernership of shares are largely scattered, so it checks the concentration of wealth and economic power.

BOOK BUILDING METHOD

1. In the Book building method, the pricing of the securities is left to the investors. It provides an opportunity to the market to discover the price of the securities in a realistic way.
2. The issuing company using the bid prices fixes the issue prices.
3. In this method, the issuing company prior to filling the prospectus, builds up and assess the demand for the securities, the pricing of the issue and the number of securities to be issued.
4. Here, a red herring prospectus is filed with the Registrar of Companies which does not contain the number of securities to be issued and the issue price.
5. It contains either the floor price of the issuing securities or the price band with the range within which the bids can move
6. The gap between the floor price and the upper limit of the price band shall not be more than 20%.
7. The investors bid freely within the price band.
8. After completion of the bidding process, the cut off price is ascertained.
9. Finally the issuing company finalise the basis of allotment of securities.
10. The final prospectus with all the details including the final issue price and the issue size is submitted to the Registrar of Companies (ROC)

Process of Book Building

1. Selection of Book Runner
2. Drafting red herring prospectus
3. Circulating the red herring prospectus
4. Fixed the price band
5. Offer bid price for securities
6. Analysis of bid
7. Opening bank accounts
8. Receiving final applications
9. Filing final prospectus with ROCs
10. Listing of securities.

ADVANTAGES OF BOOK BUILDING METHOD

1. In this method, the price of securities issued is ascertained in a more pragmatic way.
2. Cost of issue of securities can be minimized through this method.
3. It helps in appraising the intrinsic worth of the securities issued by the companies.
4. The issue price is market determined. As a result, the market price of such securities does not fall abruptly after listing.
5. In this method, pricing of the issue is determined on the basis of optional demand for securities.
6. Method of allocation of securities to the applicants is transparent.
7. It is not a time consuming method.
8. Possibility of under subscription is less.
9. It enables issuers to reap benefits arising from price and demand discovery.
10. In this method, the investors' fund is not locked up for a long period.

OFFER FOR SALE METHOD

1. This is the method of issuing securities of companies through the intermediaries such as issue house, merchant banks, stock brokers, investment banks, etc.
2. Here the issuing company does not offer securities directly to public.
3. In this method, the issued company sells all the securities to the intermediaries at an agreed price.
4. Afterwards, these intermediaries dispose of these securities to the general public and institution.

Advantages of offer for Sale Method

1. This is economical method of issuing securities.
2. Issues are well distributed
3. This is a less complicated method
4. This is a transparent method

Qualified Institutional Placement (QIP)

1. This method has emerged as a new fund raising instrument for listed companies in India.
2. The QIP signifies an issue of equity shares or securities convertible into equity shares by a listed company to QIB
3. This process is followed on the basis of SEBI guidelines.
4. Unlike a private placement, there is no lock in clause in this route.
5. In this process the issuing company can raise the required funds from foreign as well as domestic institutional investors without getting listed on any foreign stock exchange.
6. This process is simple enough and completed quickly.
7. As per SEBI no single allot tee shall be allotted in excess of 50% of the issue size. The investors are not allowed to withdraw their bids/ applications after the closure of the issue.
8. The aggregate fund that can be raised through QIPs in a single financial year shall not exceed 5 times of the net worth of the issuer (as on the end of the previous financial year)
9. The floor price for the QIP is based on two week’s average preceding the date of the board meeting to take QIP decisions.

Distinction between New Issue Market and Stock Market

New Issue Market	Stock Market
This market is regulated for new issue of securities. Corporations issues equity shares, preference shares, and debentures for raising long term loans	This market is highly organized and listed securities are transacted
New issue provides fresh capital or additional capital to the corporate sector	Only there is rolling of existing capital in the stock market
Investors subscribes securities of companies directly from the issuing companies	It deals with trading of securities of companies which are listed on stock exchange
SEBI looks on the overall operations of this market	Trading of the securities is controlled by the SEBI and stock exchange
Market where stocks are issued for the first time	Market where stocks are issued other than the first time
Fixed price	Fluctuates with the demand and supply force

Difference Between Debt Market and Equity Market

Equity Market

- Investors are quite cautious in entering the equity market. This Market is associated with higher risk. Equity markets are vulnerable to political, economic, national, and global factors.
- One can be either an investor or a trader in the equity market. A company can issue shares to raise capital; when one buys these shares one becomes a shareholder in the company. If the company grows, the value of the shares rises. It is of utmost importance to understand when to hold the shares and when to let go.
- Many traders buy and sell shares within a very short period of time. One can choose to hold shares over a longer span of time too.
- In India, the buying and selling of shares is facilitated through a demat account . A trading and demat account can be opened with a few easy steps.

Types of Trades in the Equity Market

- Intraday Trades: Intratrade refers to the process of buying and selling off of shares on the same day.
- Buy Today Sell Tomorrow (BTST): This process enables to sell off the shares before it is credited to one’s demat account.
- Position Trades: Position trading disregards short-term price fluctuations in favour of long-term goals.

Debt Market

Debt Market:

- The debt market is associated with low risk. Another standout feature of the debt market is that it can act as a regular source of income and capital preservation. Not only is the debt market less risky, it's also less volatile in nature than the equity market. For this reason, the returns from the debt market are generally lower than those from the equity market.
- In the equity market, one buys and sells shares/stocks. In the debt market, on the other hand, bonds, certificates of deposits, debentures, government securities are bought and sold.

Types of Debt Instruments

Bonds: Both the government, as well as a company, can issue bonds. By investing in the bonds, one can effectively loaning money to the issuer of those bonds. The issuer then repays this loan, along with interest, over the course of a predetermined period of time.

Government securities or G-secs: These are issued by the RBI on behalf of the Government of India. These securities are offered for both the short and long terms. Short term bills with a maturity of less than one year are called Treasury Bills (T-bills) while long term instruments are called Government Bonds or Dated Securities.

Debentures: These are issued solely by the companies and come with a fixed interest rate. One can invest in either convertible or non-convertible debentures.

Participants in the debt market

1. **Central and state government instruments**: Government dated instruments and Treasury Bills
2. **Primary Dealers: they are the market makers** i,e by quoting both buying and selling price of these securities, they try to estimate the market demand and demand price for such securities.
3. **Public sector undertakings**: PSUs issue both tax free and taxable bonds to meet their long term and working capital nedds. They also invest in debt securities.
4. **Corporate houses**: they are both issuers of debt instruments and investors in the debt market.
5. **Commercial banks**: They also issue certificate of deposits to finance their short term credit needs as well as bonds to finance ther long term credit needs.
6. **Insurance companies**: the insurance companies both public and private also invest in the debt market. However, the limits to such investment are controlled by the IRDA
7. **Mutual Funds:** several mutual funds having debt funds are the predominant investors in the Indian Debt Market.
8. **Foreign Institutional Investors**: the FIIs are also permitted to invest in government securities and corporate bonds

Market Intermediaries: Brokers and Sub Brokers

Stock Brokers	Sub Broker
A stock broker is a registered member of a stock exchange and performs as a functionary of the stock market to buy , sell and deal in securities.	A sub- broker is a non member of a stock exchange performs as an agent of a broker, and assit the investment in buying, selling or dealing in securities through such stock broker
The periphery of activitiesof a broker is wide	The periphery of activities of a sub broker is restricted
Brokers are the SEBI registered functionaries in the stock market	Sub brokers are not SEBI registered functionaries in the stock market
Initial investment made by a broker is high	Initial investment made by the sub broker is comparatively low
They posses sufficient amount of market information	They may not have sufficient amount of information about the market
Brokers have the right to lien on the clients' securities if dues are not settled by the clients	Sub brokers do not have such right
A broker is required to pay a higher amount to SEBI for registration and annual fees	A sub broker is required to pay comparatively small amount of license fees and annual fees

Role of stock exchange in India

1. **. Mobilization of Savings**

To ensure investor's protection, all the trading transactions in the capital markets are regulated with proper regulations and rules. This also helps in consolidating the confidence of small savers and individual investors.

Promoting Capital Formation

The mobilization of funds from the savers by the capital markets is channelized to various industries which are involved in production and manufacturing of various goods and services which is beneficial for the economy. This enhances the capital formation and development of the national assets.

3. **Liquidity of Investment**:

Investors can liquidate their securities and other capital market assets anytime during the trade hours and days. Therefore, stock exchanges help in ensuring liquidity of investment. The online trading carried out on the stock exchanges after dematerialization of securities has transformed the trading experience.

4. **Investment Safety**:

One of the most important role of stock exchange in ensuring investment safety to the investors. After the dematerialization act, trading on stock exchanges has been completely online. The Securities and Exchange Board of India (SEBI) keeps an eye on the functioning of exchanges and keeps on identifying new loopholes in the system. Several measures are enforced at times to overcome the same and ensure investment safety.

5. **Wide Markebility to securities:** After the establishment of online trading system, investors can keep an eye on the price movements and make the most out of all the price movements in the capital markets. The modern stock exchanges backed by information technology have provided wide marketability to the securities.

6. **Funds for development purpose**: The industries are the one which are involved in government development projects including infra companies, railways, telecommunications etc. Stock exchanges help in constant evaluation of government securities.

7. **Barometer of the National Economy:** The stock exchanges are considered to be the barometer of a nation's economy. The economy of a country is economically symbolized by the most significant stock exchange of that particular country. These stock exchanges help in representing the progress and situation of a nation's economy at national and international levels. For instance, Bombay Stock Exchange or BSE is often considered by overseas investors to have an idea about the economic condition of our country.

Recent changes in Indian Capital Market

1. **Economic Liberalization through Indian Capital Market:**

The economic liberalization has gone more deregulation, Liberalization and privatization of some of the public sector undertakings in India. This has resulted within the shares of the general public sector undertakings being made available to the general public.

2. **Promotion of maximum private sector banks:-**

Opening of more private sector banks has consequences in the public contributing to the shares of these banks in Indian capital market.

3***. Promotion of Mutual Funds:-***

The promotion of mutual funds by nationalized also as non-nationalized banks has also improved the New Delhi market. They were helpful to the general public by way of tax saving schemes. Example: UTI’S monthly income scheme. Mutual Funds promoted by nationalized banks increased investments.

4. **Regulation of NRI Investments:-**

The conversion of Foreign Exchange Regulation Act (FERA) as Foreign Exchange Management Act (FEMA) has permitted better encouragement to non resident investors.

5. **Online Trading in Indian Capital Market:** Some of the stock markets in India have introduced computer system for their trading regarding activities. The brokers can get hooked-up and do their trading on online basis.

6. ***Transparency through online trading:-***

The online trading by using computer has brought transparency to the transactions in the financial market. People are able to know prices prevailing in the market at any time as such the brokers cannot use their clients of their profits.

7. ***National Stock Exchange:***

A new stock market called National Stock Exchange has been created where a large number of companies have listed. It is a strong competitor to the Bombay Stock Exchange and it is able to influence the Bombay Stock Exchange. The National stock market deals in shares of companies throughout India and therefore the prices prevailing within the market may be a benchmark for stock prices

8. **Sensitivity Index:**

The calculation of index has also undergone a change. Sensitivity index has been introduced which represents. Important 30 companies whose volume and value of shares determines the market condition. The sensitivity index is an indication of the condition prevailing in the market and the condition that are likely to be encountered by the market.

9. ***Circuit-Breaker:***

The Bombay stock market has introduced a cut-off switch which is called circuit breaker.

10**. Demating of shares:-**

Demating may be a system under which physical delivery of shares is not any more adopted. It is called “scrip less trade”. The shares of individual’s investors are held by stock holding company and a pass book is given to individual investors .

11**. Market Makers**

The share price of companies will be decided by the market forces of supply and demand. There are market makers who will ensure the supply and reasonable price for the stock of companies.

12. ***Securities and Exchange Board of India***

SEBI was the one among the most important milestone in era of 90’s. SEBI provided security to all or any sort of investors who are involve in investment activities.

13**. Over the Counter Exchange of India (OTCEI) :-**

For the aim of newly promoted companies, another stock market with lowest degree of condition has been promoted and it's called Over The Counter Exchange of India(OTCEI).It may not be possible for all the new companies to list their shares with the prevailing stock exchanges.

14. **Renewal of Registration:-**

All the brokers and sub brokers have to register afresh with SEBI and SEBI will keep its eyes on each and every activity and inquire about all the complaints.

15. **<u>Non-Banking Financial Companies:-</u>**

The role of non-financial companies has also been reviewed. RBI has introduced new condition, restricting their activities. New norms with reference to capital of non banking financial companies are introduced.

16. **<u>Merchant Banker:-</u>**

Merchant bankers have been allowed to take part in the stock market operation and their functions are also regulated by SEBI. They not only help companies in capital budgeting but also guide the foreign investors in the purchase of securities.

17**<u>. Forward trading:-</u>**

Forward trading has been introduced since 9th June 2000 in Bombay Stock Exchange on a trial basis and it found successful, it will be extended. It will be helpful to the investors in ascertaining truth colors of existing companies.

18. **<u>Educating Public</u>**

Press and media have contributed tons in popularity the New Delhi market and that they are highlighting the costs of securities a day. The mutual funds and merchant banks are asked to line apart some of their funds towards educating the general public on the developments within the New Delhi Market.

19. ***<u>Government Securities Market</u>***

The central government has de-linked Government securities from trading along with company securities. In other words, there'll be separate marketplace for Government securities and that they won't be dealt along side company securities within the stock exchange.

20. **<u>Future trading:-</u>**

Future trading may be a contract to shop for or sell a selected financial instrument on a future date at a specific price. The contract enables the parties to transfer risk is minimized. In every future contract, we've a buyer and a seller. And if one makes a profit during a particular contract,

THANK YOU