

# **Comprehensive Research Report on Participants in Financial Markets**

## **Project 1: Foundation Project**

**Understanding the Financial Markets Ecosystem**



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# EXECUTIVE SUMMARY

Financial markets are the backbone of modern economies, serving as platforms where capital flows from savers to those who need it for productive investments. This report provides a comprehensive analysis of the financial market's ecosystem, examining all key participants, their roles, incentives, regulatory frameworks, and interconnections.

The financial markets ecosystem comprises multiple interdependent participants: **retail investors seeking wealth creation**, **institutional investors managing collective capital**, **intermediaries facilitating transactions**, **corporate issuers raising capital**, **regulators ensuring market integrity**, and a support ecosystem of ancillary service providers. Understanding how money flows through this system — from *individual savers* through **brokers**, **exchanges**, **clearing corporations**, and **depositories** to companies and back — is fundamental to grasping how capital allocation works in a modern economy.

This report demonstrates that financial markets are not random or chaotic systems, but carefully orchestrated ecosystems with defined rules, incentive structures, and risk management mechanisms. Each participant has specific motivations and constraints that drive their behavior. Conflicts of interest and information asymmetries present ongoing challenges that require continuous regulatory vigilance.

**Key Takeaway:** Financial markets function as a complex web of incentives, regulations, and dependencies. Success in finance, accounting, and tax roles requires understanding not just individual components but how they interconnect and influence each other.

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# 1. INTRODUCTION TO FINANCIAL MARKETS

## 1.1 What Are Financial Markets?

Financial markets are organized systems where securities (stocks, bonds, derivatives) and other financial instruments are bought and sold. They are platforms that connect participants with different needs: those seeking to invest capital (savers) and those seeking to raise capital (borrowers/issuers).

Unlike informal lending between friends, financial markets operate with standardized processes, transparent pricing, regulatory oversight, and professional intermediaries. They enable the efficient allocation of capital across the economy—from grandmothers with savings to entrepreneurs building startups, from pension funds to multinational corporations.

**Definition:** A financial market is any marketplace where buying and selling of financial assets occur at prices determined by supply and demand.

## 1.2 Why Financial Markets Exist

Financial markets solve four fundamental problems in any economy:

**1. Capital Allocation:** Savers have capital; entrepreneurs have ideas. Markets connect them.

Without markets, capital stays idle or is allocated inefficiently (through personal networks or government direction).

**2. Risk Transfer:** Markets allow those who want to avoid risk to transfer it to those willing to bear it. Insurance works on this principle. Futures markets allow farmers to lock in prices.

**3. Price Discovery:** In markets, millions of transactions reveal the "true" price of an asset. This price contains all available information and becomes the signal for investment decisions.

**4. Liquidity:** Financial markets let you convert securities into cash quickly. Without liquidity, investors wouldn't buy illiquid securities, making capital raising expensive or impossible.

**Real Example:** When Reliance Industries wanted to expand its refineries in 2005, it could have asked a bank for a ₹10,000 crore loan. Instead, it issued bonds and equity through the financial market. Why? Because:

- It could raise more capital than any single bank could lend
- It could reach international investors, not just Indian banks
- The market price showed investors what rate of return they demanded, helping Reliance understand its cost of capital
- Multiple investors each took smaller chunks of risk rather than one bank taking all the risk

## 1.3 Primary vs. Secondary Markets

### Primary Market:

- Where NEW securities are issued
- Money flows from investor to company
- Examples: IPOs, FPOs, bonds issued for the first time
- The company receives the capital raised
- No secondary trading happens here—this is pure capital raising

### Secondary Market:

- Where EXISTING securities are traded
- Money flows from one investor to another, not to the company
- Examples: You buy TCS shares from someone else on the stock exchange
- The company doesn't receive this money
- This is where most daily trading happens

**Why Both Matter:** Without the secondary market (liquidity and exit), investors wouldn't participate in the primary market (buying new IPOs). The secondary market's existence makes the primary market work.

### Example Timeline:

**Jan 2024: TCS issues new IPO (Primary Market)**

**₹10,000 Cr goes to TCS**

**Feb 2024: You buy TCS shares from another investor (Secondary Market)**

**₹50,000 goes to that investor, not to TCS**

**Mar 2024: You sell those TCS shares (Secondary Market)**

**₹52,000 goes to your bank account**

## 1.4 Capital Markets vs. Money Markets

Aspect	Capital Markets	Money Markets
Time Horizon	Long-term (> 1 year)	Short-term (< 1 year)
Instruments	Stocks, bonds, mutual funds	Treasury bills, commercial paper, call money
Participants	Retail, institutional investors, companies	Mostly banks, financial institutions
Purpose	Wealth creation, capital raising	Liquidity management, short-term funding
Risk	Higher (equity risk, interest rate risk)	Lower (credit risk, liquidity risk)
Volatility	High	Low

**Capital Market Example:** You invest ₹1,00,000 in an equity mutual fund for 10 years expecting 12% annual returns.

**Money Market Example:** A bank needs ₹100 Cr for 30 days while waiting for deposits to arrive. It borrows in the call money market (overnight lending between banks) at 6%.

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## 2. RETAIL PARTICIPANTS

### 2.1 Who Are Retail Investors?

Retail investors are individuals who invest their own savings in financial markets, typically through demat (dematerialized) accounts opened at stockbrokers. They range from salaried professionals to small business owners, retirees, and students.

#### Market Data:

- India has approximately **1.5 crore (15 million) retail investors** as of 2024
- This is up from 4 crore in 2021, showing explosive growth
- Average retail portfolio size: ₹5–50 lakhs
- Majority participate through mutual funds rather than direct equity

### 2.2 Types of Retail Participants

#### A. Individual Investors

These are long-term wealth creators. They invest for retirement, children's education, or general wealth building.

### **Characteristics:**

- Time horizon: 5–20+ years
- Risk appetite: Low to Medium
- Typical instruments: Mutual funds, bonds, fixed deposits, some stocks
- Frequency of trading: Low (buy and hold)

### **Motivations:**

- Beat inflation (savings account gives 3%, inflation is 6%)
- Retire comfortably (need ₹1 Cr by age 60)
- Build emergency funds
- Achieve specific life goals

**Example:** A 35-year-old software engineer invests ₹50,000/month in equity mutual funds via SIP (Systematic Investment Plan) targeting 12% annual returns over 25 years to build ₹5 Cr by retirement.

## **B. Traders**

Traders are speculators who profit from short-term price movements. They buy and sell multiple times per week or even per day.

### **Characteristics:**

- Time horizon: Minutes to weeks
- Risk appetite: Very High
- Typical instruments: Stocks, derivatives, leveraged products
- Frequency of trading: Very High (multiple transactions daily)

### **Motivations:**

- Quick profits from price movements
- Leverage effects (control ₹10 Cr portfolio with ₹50 lakh margin)
- Excitement/gambling element (for some)

**Example:** A day trader buys 1,000 shares of Reliance at ₹2,800 in the morning, sells at ₹2,850 by afternoon, making ₹50,000 profit (minus ₹2,500 in brokerage = net ₹47,500).

**Risk Reality:** 90% of day traders lose money. The odds are heavily stacked against retail traders competing against algorithmic traders and institutions.

## C. High Net Worth Individuals (HNIs)

These are ultra-wealthy individuals with significant capital to invest (typically ₹1 Cr+).

### Characteristics:

- Time horizon: Medium to Long-term
- Risk appetite: Medium to High
- Typical instruments: Direct equity, real estate, PE/VC funds, bonds, alternative investments
- Frequency of trading: Low to Medium
- Relationship-based: Often have dedicated relationship managers at brokers

### Motivations:

- Diversification across asset classes
- Tax optimization (using investment losses, 80C deductions)
- Legacy creation (passing wealth to next generation)
- Access to exclusive investments (PE, startups, hedge funds)

**Example:** An HNI with ₹50 Cr wealth allocates: ₹15 Cr to stocks, ₹15 Cr to real estate, ₹10 Cr to PE/VC funds, ₹5 Cr to bonds, ₹5 Cr to gold/alternative. This diversification reduces overall portfolio risk.

## 2.3 How Retail Investors Interact with Intermediaries

Retail investors cannot directly access stock exchanges. They must go through licensed intermediaries:

**Individual → Stockbroker → Stock Exchange → Clearing Corp → Depository**

### Step-by-step:

1. **Open account:** Individual goes to a broker (Zerodha, ICICI Securities, etc.) and opens a demat account
2. **Place order:** Individual logs into broker's app/platform and places a buy/sell order
3. **Execution:** Broker's system connects to exchange and executes order
4. **Settlement:** Exchange clears the trade (guarantees it will happen), clearing corp ensures payment
5. **Delivery:** Depository holds the securities; individual's demat account is credited

### Fee Structure (Example):

- Brokerage: 0.01–0.1% of transaction value
- Exchange fees: ₹10–50 per transaction

- Depository charges: ₹10–20 per debit transaction
- Taxes: 18% GST on brokerage

#### For a ₹50,000 stock purchase:

- Brokerage (0.05%): ₹25
  - Exchange fee: ₹15
  - Depository fee: ₹10
  - GST: ₹9
  - **Total cost: ₹59 (0.12% of transaction value)**
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## 3. INSTITUTIONAL INVESTORS

### 3.1 Who Are Institutional Investors?

*Institutional investors* are organizations that manage money on behalf of others. They control trillions in assets and dominate financial markets—they account for 60–70% of stock market trading volumes.

**Why They Matter:** Their buying and selling moves entire markets. When FIIs (Foreign Institutional Investors) sell ₹1,000 Cr of Indian stocks in one week, the Sensex drops significantly.

### 3.2 Types of Institutional Investors

#### A. Mutual Funds

Mutual funds pool money from many investors and invest it in stocks, bonds, or other securities according to a stated investment strategy.

#### How They Work:



## **Key Data:**

- India has ~2,000 mutual funds with ₹45+ lakh Cr assets under management (AUM)
- Dominance: Top 5 fund houses manage 40%+ of total AUM
- Monthly flows: ₹15,000–20,000 Cr flows into equity funds monthly (as of 2024)

## **Investment Mandate Examples:**

- **Large Cap Fund:** Invests only in India's top 100 companies
- **Small Cap Fund:** Invests only in smaller, emerging companies
- **Balanced Fund:** 60% stocks, 40% bonds
- **Debt Fund:** 100% bonds and fixed-income securities

## **Fee Structure:**

- Management Fee: 0.5–1.5% of AUM annually
- Exit Load: 0–2% if you exit within 1–3 years
- Transaction costs: Embedded in fund (not separately charged)

**Example:** You invest ₹1,00,000 in an equity mutual fund with 1% annual fee:

- Fee charged: ₹1,000/year
- Expected return: 12%/year = ₹12,000
- Net return to you: ₹11,000 (12% – 1% fee)

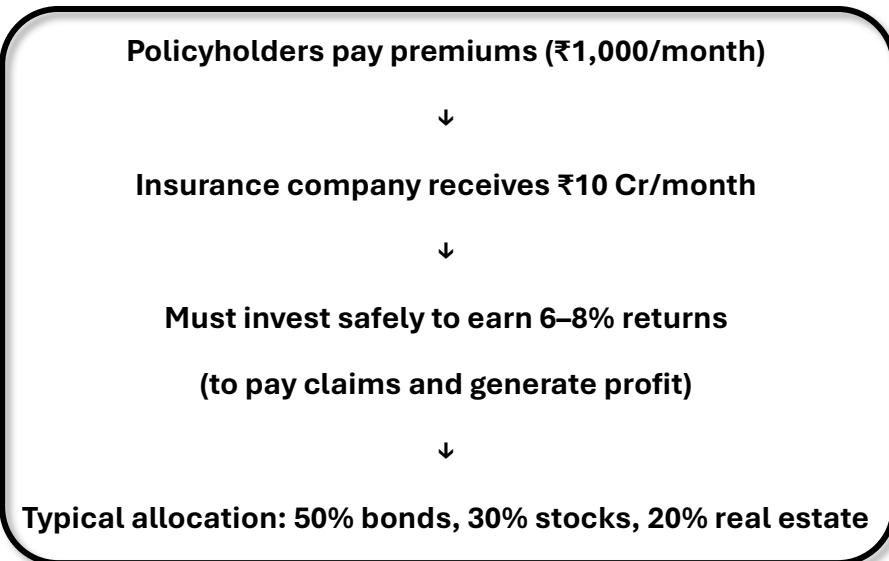
## **Regulatory Constraints:**

- Can hold maximum 10% of a company in one stock (limit on concentration)
- Cannot do leveraged buying (margin buying)
- Must follow specific asset allocation percentages defined in offering documents
- Must have independent auditors and custodians

## **B. Insurance Companies**

Insurance companies take premiums from policyholders and invest them to earn returns that help them pay future claims.

## How They Work:



## Key Data:

- India's insurance sector manages ~₹35 lakh Cr in invested assets
- Return requirements: Need to earn 6–8% annually to be profitable
- They are MAJOR buyers of government bonds (safe, government-backed)

## Investment Mandate:

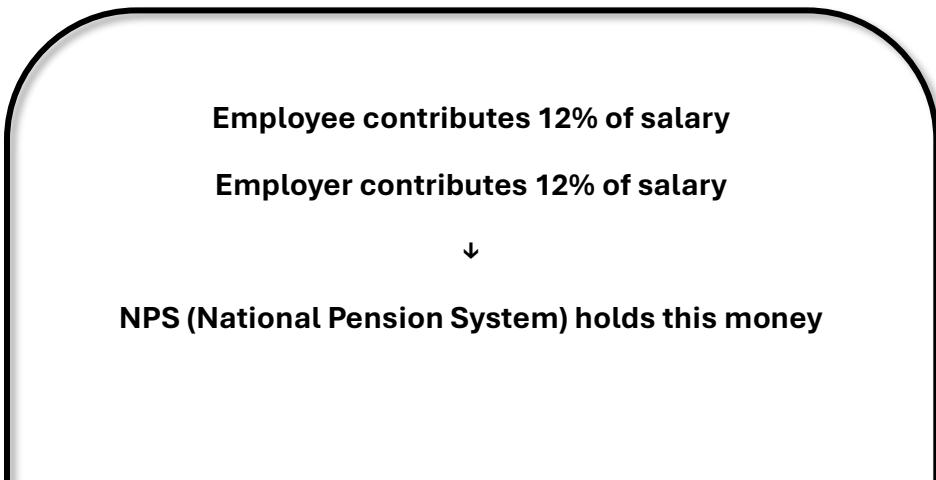
- Prioritize safety (can't take high risk—must pay claims)
- Need steady returns (not interested in gambling)
- Long-term horizon (claim liabilities stretch 20–30 years)

**Example:** Life Insurance Corporation (LIC) collects ₹50,000 Cr annually in premiums. If it earns 7% annually on invested assets of ₹40 lakh Cr, it generates ₹2.8 lakh Cr in returns—enough to pay claims and generate profit.

## C. Pension Funds

Pension funds manage retirement savings for employees and distribute them after retirement.

## How They Work:



Allocated to fund managers (equity 50%, debt 50% typically)



At retirement (60 years): Can withdraw or take annuity

### Key Data:

- NPS has ~2.5 crore subscribers
- AUM exceeds ₹8 lakh Cr
- Mandatory for all government employees (since 2004)
- Optional for private sector employees

### Investment Mandate:

- Maximize long-term returns (need 8–10% to provide adequate retirement)
- Reduce volatility as retirement approaches (auto-adjustment of equity/debt ratio)
- Cannot invest in speculative assets

**Example:** A 30-year-old employee contributes ₹1 lakh/year into NPS for 30 years:

- Total contribution: ₹30 lakh
- At 10% annual returns: ₹1.6+ crore by age 60
- Provides ₹12+ lakh annually as annuity starting at retirement

## D. Sovereign Wealth Funds

Sovereign funds are government-managed investment vehicles, usually funded by reserves or state-owned enterprise profits.

### Examples:

- Temasek (Singapore): ₹12+ lakh Cr in assets
- Norwegian Sovereign Wealth Fund: ₹13+ lakh Cr (world's largest)
- India: IIFC (India Infrastructure Finance Company)

**Mandate:** Invest state resources for long-term national benefit, generate returns for future generations.

## E. Hedge Funds (Overview)

Hedge funds are private investment funds for wealthy individuals and institutions, using sophisticated strategies and leverage.

**Characteristics:** High risk, high return, complex strategies, minimal regulation.

### 3.3 Why Institutional Investors Matter

Institutions move markets because they control massive capital and have sophisticated research. When an institutional investor makes an allocation decision ("we're increasing India exposure from 8% to 12% of our portfolio"), it means moving ₹50,000+ Crore into Indian stocks, which pushes prices up.

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## 4. MARKET INTERMEDIARIES

### 4.1 What Do Intermediaries Do?

Market intermediaries are the plumbing of financial markets. They execute trades, hold securities, clear transactions, and ensure everyone gets paid and receives what they bought.

**The Chain:**

**Broker → Exchange → Clearing Corporation → Depository → RTA**

### 4.2 Stockbrokers

**Function:** Brokers are agents who execute your buy/sell orders on the stock exchange and maintain your demat account.

**How They Work:**

1. You place order: "Buy 100 TCS shares at ₹3,500"
2. Broker forwards to Exchange's trading system
3. Exchange matches with a seller
4. Broker confirms: "100 TCS bought at ₹3,500"
5. Settlement happens (2 days later): You pay ₹3.5 Lakh, receive shares

**Revenue Model:**

- **Brokerage commission:** 0.01–0.5% per transaction
- **Margin interest:** If you buy on margin (loan from broker), pay ~12% annually
- **Interest on balances:** Your idle cash earns broker 4–6%, broker pays you 2%
- **Advisory fees:** Premium brokers charge ₹5,000+/month for research/advice

- **Data/tools:** Premium subscriptions for advanced trading tools

#### Types of Brokers:

- **Full-service brokers:** Zerodha, ICICI Securities (charge 0.05%)
- **Discount brokers:** Angel Broking, Shoonya (charge 0.01%)
- **Premium brokers:** Motilal Oswal, HDFC Securities (charge 0.5%, provide research)

#### Example Revenue (Broker with 10,000 customers):

- Average trading volume per customer: ₹5 Lakh/month
- Total trading volume: ₹50 Crore/month
- Brokerage (0.05%): ₹2.5 Lakh/month = ₹30 Cr annually
- Interest on idle balance (1% spread): ₹3 Lakh/month = ₹36 Lakh annually
- **Total revenue: ~₹35 Cr/year** (from 10,000 customers)

#### Regulatory Responsibility:

- **Know Your Customer (KYC):** Verify customer identity
- **Risk management:** Can't let customer leverage excessively
- **Compliance:** File regulatory reports with exchanges, depository
- **Grievance redressal:** Resolve customer complaints

### 4.3 Stock Exchanges

**Function:** Exchanges are platforms where orders are matched, prices are discovered, and trading happens.

#### How They Work:



**Examples:** NSE (National Stock Exchange), BSE (Bombay Stock Exchange)

## Market Data:

- NSE volumes: ~1.5 billion shares traded daily (₹70,000+ Cr daily)
- Listed companies: ~2,000 on NSE, ~6,000 on BSE (BSE includes smaller regional companies)

## Revenue Model:

- **Listing fees:** When a company IPOs, pays listing fees (~₹50–500 Lakh depending on company)
- **Trading fees:** Brokers pay ₹1–10 per trade
- **Data fees:** Real-time price data sold to market data providers
- **Technology licensing:** Other exchanges pay NSE for technology

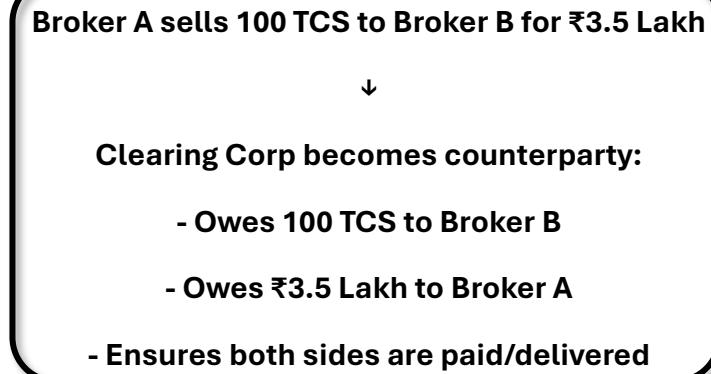
## Regulatory Responsibility (Self-Regulatory Organization):

- **Set listing standards:** Companies must meet net worth, profitability criteria
- **Surveillance:** Monitor for manipulation, insider trading
- **Enforce rules:** Punish brokers and traders who violate rules
- **Transparency:** Publish price data, trading volumes in real-time

## 4.4 Clearing Corporations

**Function:** Clearing corps guarantee every trade will settle. If one party can't pay or deliver, the clearing corp steps in.

### Example:



**Why This Matters:** Without a clearing corp, you'd need to know and trust the other party. With a clearing corp, you only need to trust the clearing corp (which is safer and well-capitalized).

**Examples:** NSCCL (NSE Clearing Corporation), ICCL (BSE Clearing Corporation)

## Risk Management:

- Collateral: Brokers post margin (security deposit) to cover potential losses
- Mark-to-market: Every evening, recalculate positions, adjust margins if needed

- Default fund: Clearing corp maintains a ₹5,000+ Cr reserve for emergencies

**Revenue:** Transaction fees (₹0.50–2 per trade)

## 4.5 Depositories

**Function:** Depositories hold securities in electronic form (dematerialized). You don't hold physical certificates; the depository holds them and updates your account electronically.

**How It Works:**

**Before 1996: You owned physical share certificates (could be lost/stolen)**

**After 1996: Depository holds all securities electronically**

**You own 100 TCS shares**



**Depository's system records: "Investor X owns 100 TCS"**



**When you sell: System updates "Investor X owns 0 TCS, Investor Y owns 100 TCS"**

**Examples:** NSDL (National Securities Depository Limited), CDSL (Central Depository Services Limited)

**Market Data:**

- **NSDL:** Holds ~₹80+ lakh Cr in securities (65% market share)
- **CDSL:** Holds ~₹45+ lakh Cr in securities (35% market share)
- Total demat accounts: ~5 crore in India

**Revenue Model:**

- **Debit transaction fee:** ₹10–20 per security debit (when you sell)
- **Credit transaction fee:** ₹5–10 per security credit (when you receive)
- **Quarterly/annual fees:** ₹100–500 per account per year
- **Corporate action processing:** Fees for dividend, split, bonus processing

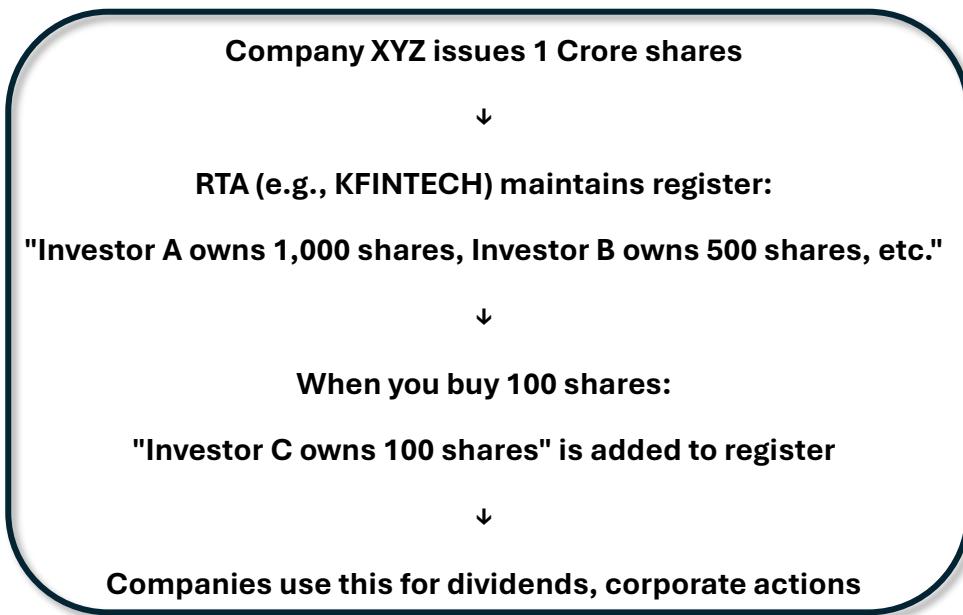
**Regulatory Responsibility:**

- **Account integrity:** Ensure no unauthorized trades in your account
- **Safekeeping:** Ensure securities are never lost or commingled with depository's property
- **Reconciliation:** Regular audits to verify securities are properly accounted for

## 4.6 Registrars & Transfer Agents (RTAs)

**Function:** RTAs maintain the register of shareholders for companies. When you buy shares, the RTA updates the company's shareholder list.

### How It Works:



**Examples:** KFINTECH, MMSL (MCS Registry), Indiabulls Ventures

### Functions:

- **IPO share allotment:** Process new investor applications, allot shares
- **Dividend processing:** Identify shareholders and disburse dividends
- **Corporate actions:** Process splits, bonus, mergers, conversions
- **Proxy voting:** Help facilitate shareholder voting

**Revenue:** Fees per transaction (IPO, dividend processing, etc.)

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## 5. CORPORATES & ISSUERS

### 5.1 Why Companies Access Financial Markets

Companies need capital to grow. They can get it from three sources: retained earnings, banks, or financial markets. Financial markets offer three advantages:

**1. Larger Capital:** Banks can lend ₹100 Cr; markets can raise ₹500 Cr **2. Diversified funding:** Instead of one bank, get capital from thousands of investors **3. Lower cost:** Banks charge 8–10%; equity investors might accept 12% (but it's your permanent capital, not debt)

## 5.2 How Companies Access Markets

### A. IPO (Initial Public Offering)

A company goes public for the first time, raising capital from public investors.

#### Process:

1. Company decides to go public (needs ₹500 Cr capital)
2. Hires investment bank (Goldman Sachs, JP Morgan) as advisor
3. Investment bank does roadshow: Meets 200+ institutional investors globally
4. Company sets price: "We'll offer shares at ₹500 per share"
5. Public subscription: Retail investors apply (₹10,000 minimum usually)
6. Shares allotted: 1 Crore shares issued, ₹500 Cr capital raised
7. Listing: Shares start trading on stock exchange

#### Example: Hyundai India IPO (2023)

- Price: ₹1,900 per share
- Shares issued: 1.75 Cr shares
- Capital raised: ₹3,300 Cr
- Oversubscription: 100+ times (₹330,000 Cr worth of applications)
- Listing: Listed on NSE at ₹2,000+ (investors made 5%+ in first day)

#### Costs of IPO:

- Investment bank fees: 1–2% = ₹5–10 Cr
- Legal/auditor fees: ₹1–2 Cr
- Marketing/printing: ₹0.5–1 Cr
- Total cost: ₹10–15 Cr (before even issuing shares)
- Break-even: Company needs share price to stay above listing to have been worthwhile

### B. FPO (Follow-on Public Offering)

An already-listed company issues more shares to raise additional capital.

#### Example: Reliance issues 2 Cr new shares at ₹2,200 per share, raising ₹44,000 Cr additional capital for refinery expansion.

## C. Bond Issuance

A company issues debt securities (bonds) with fixed interest rates instead of issuing equity.

### Structure:

₹100 Cr bond issue

- 5-year maturity
- 7% coupon (annual interest)
- Annual interest: ₹7 Cr/year
- After 5 years: Return ₹100 Cr principal

### Why Bond vs. Equity?

- Bond: Pay fixed 7%, investors accept lower return, company keeps ownership
- Equity: Investors demand 12%, company dilutes ownership by issuing shares

### Cost Analysis:

- Bond cost: 7% on ₹100 Cr = ₹7 Cr/year
- Equity cost: 12% expected return—if company makes ₹12 Cr profit, ₹12 Cr goes to shareholders instead of debt-holders

## 5.3 Cost of Capital Concept

Every company has a "cost of capital"—the minimum return it must earn to justify raising that capital.

### Formula:

$$\text{Cost of Capital} = (\% \text{ Debt} \times \text{Debt Rate}) + (\% \text{ Equity} \times \text{Equity Rate})$$

### Example:

₹100 Cr capital structure:

- ₹60 Cr debt at 8% = ₹4.8 Cr annual cost
- ₹40 Cr equity at 12% = ₹4.8 Cr annual cost
- Total annual cost: ₹9.6 Cr on ₹100 Cr = 9.6% cost of capital

### Why It Matters:

- Company must find projects earning > 9.6% returns
- If average project return is 10%, company makes 0.4% profit margin (risky)
- If average project return is 12%, company makes 2.4% profit margin (safer)

## 5.4 Impact on Companies

Going public creates major changes:

### Benefits:

- Access to large capital pools
- Valuation becomes public (for M&A, benchmarking)
- Currency for acquisitions (can use stock, not just cash)
- Employee incentives (ESOPs become valuable)

### Costs:

- Quarterly reporting requirements (must disclose financials every 3 months)
  - Shareholder scrutiny (activists, hedge funds can push for changes)
  - Compliance burden (Secretarial audits, corporate governance costs)
  - Stock price pressure (short-term focus instead of long-term strategy)
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## 6. REGULATORS & AUTHORITIES

### 6.1 Why Regulation Matters

Financial markets are prone to fraud, manipulation, and systemic failures. Regulators exist to:

- Protect retail investors from exploitation
- Maintain market integrity (prevent manipulation)
- Ensure systemic stability (prevent market crashes from destroying economy)
- Enforce transparency (require disclosure of financial information)

### 6.2 Key Regulators in India

#### A. SEBI (Securities and Exchange Board of India)

**Jurisdiction:** Equity markets, mutual funds, collective investment schemes

#### Key Regulations:

- **Listing Rules:** Requirements for companies to list (minimum net worth, profitability, etc.)
- **Insider Trading Rules:** Prohibit trading on non-public information
- **Takeover Code:** Rules for acquisitions and mergers

- **Broker regulations:** Rules for operation, capital requirements, compliance

#### **Enforcement:**

- Investigation: SEBI can subpoena documents, question individuals
- Penalties: Fines up to ₹1–25 Cr, imprisonment up to 5 years in severe cases
- Disgorgement: Forcing traders to return illegal profits

**Case Example (2023):** SEBI banned investor Sudhas for insider trading in Titan Company. He had access to unpublished quarterly earnings (material non-public information) before announcement and traded illegally.

## **B. RBI (Reserve Bank of India)**

**Jurisdiction:** Banking system, money markets, interest rates

#### **Key Functions:**

- Monetary policy: RBI sets repo rate (currently ~6.5%), which influences all interest rates
- Banking regulation: Rules for bank capital, loan defaults, etc.
- Payment systems: Manages RTGS, NEFT for fund transfers

## **C. Stock Exchanges (Self-Regulatory Organizations)**

**Jurisdiction:** Members (brokers), trading conduct, listing standards

#### **Key Functions:**

- Surveillance: Monitor for suspicious trading patterns
- Rule enforcement: Punish brokers who violate rules
- Market integrity: Ensure fair pricing, prevent manipulation

## **D. Reserve Bank (Monetary Authority)**

Controls base rates, inflation, and overall money supply.

## 6.3 What Happens When Regulation Fails?

### Historical Example: 1992 Indian Securities Scam

Context: 1990s India, stock market was exploding, regulations were loose

**Scam: Harshad Mehta (trader) and accomplices:**

- *Diverted ₹450 Cr of government securities illegally*

- *Used bank guarantees to "create" fake securities*

- *Manipulated stock prices by fake buying (pushing prices up)*

- *Sold shares to retail investors at inflated prices*

- *Made ₹500+ Cr illegal profit*

**Discovery: Reserve Bank noticed discrepancies in securities transfers**

**Impact:**

- *₹500 Cr loss to retail investors*

- *Banking system almost collapsed*

- *Stock market crashed 30% in 6 months*

- *23 people convicted (Mehta died in jail)*

**Regulatory Changes:**

- *Dematerialization mandatory (eliminated fake certificates)*

- *Electronic settlement (reduced fraud opportunity)*

- *Stricter broker capital requirements*

- *Market surveillance systems installed*

## Modern Example: Adani-Hindenburg Case (2023)

Hindenburg Research (short-seller) alleged:

- *Adani group inflated revenue, manipulated contracts*
- *Related-party transactions at inflated prices*
- *Use of shell companies in Mauritius, Singapore*

**Adani Response:**

- *Denied all allegations*
- *Called it "attack on India's reputation"*

**Regulatory Action:**

- *SEBI initiated investigation*
- *CBI started probe*
- *Stock market impact: Adani shares fell 40%+*
- *Ongoing regulatory scrutiny*

**Key Learning:** Regulation prevents cover-up, forces transparency, protects investors

## **6.4 Compliance Responsibility**

Every participant must comply:

- **Brokers:** Report suspicious trades, maintain client records, comply with net worth requirements
- **Companies:** Disclose material information, file quarterly results, conduct shareholder voting
- **Mutual Funds:** Follow investment mandate, maintain portfolio allocation limits
- **Custodians:** Safeguard securities, reconcile daily, segregate client assets

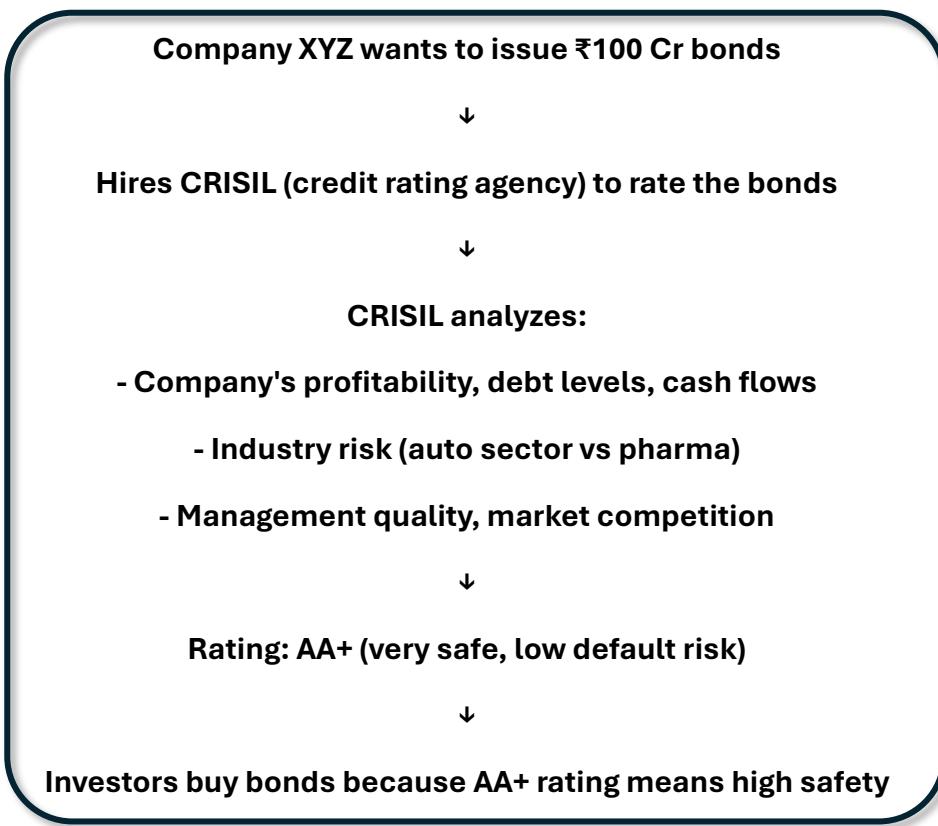
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## **7. ANCILLARY & SUPPORT ECOSYSTEM**

### **7.1 Rating Agencies**

**Function:** Rate the creditworthiness of bonds and issuers—essentially assessing default risk.

## How It Works:



## Rating Scale (CRISIL):

- **AAA:** Highest safety (default probability: 0.01%)
- **AA:** Very safe (default probability: 0.1%)
- **A:** Safe (default probability: 0.5%)
- **BBB:** Medium risk (default probability: 2%)
- **BB-C:** High risk to default (default probability: 10%+)

## Examples:

- Government bonds: AAA (India sovereign rating)
- Top 10 companies: AA-AA+ (Reliance, TCS, HDFC)
- Mid-size companies: A-BBB
- Startups/distressed: BB or below

**Major Rating Agencies:** CRISIL, ICRA, CARE

**Revenue Model:** Company paying for bond rating pays fees (₹10–50 Lakh typically)

**Conflict of Interest:** The issuer (company) pays the rating agency, creating incentive to rate favorably. This was a major issue in 2008 crisis when Lehman's bonds were rated AAA just before bankruptcy.

## 7.2 Research Houses

**Function:** Publish analysis of companies, stocks, and market trends.

**Who Uses Them:**

- Institutional investors (make allocation decisions based on research)
- Brokers (use to advise retail customers)
- Fund managers (use to pick stocks)

**Revenue Model:** Brokers and asset managers subscribe to research (₹50,000–5 Lakh/month per subscription)

**Types of Research:**

- Equity research: "Buy TCS at ₹3,200, target ₹3,800"
- Sector research: "Auto sector outlook for next 12 months"
- Market strategy: "FII flows, liquidity analysis, technical levels"

**Major Research Houses:** Goldman Sachs, JP Morgan, Citi, Nomura, Macquarie

## 7.3 Auditors

**Function:** Verify that company's financial statements are accurate and comply with accounting standards.

**How It Works:**



**Big 4 Audit Firms:** Deloitte, PWC, KPMG, EY (dominate India audit market)

**Revenue Model:** Companies pay audit fees (₹5–50 Lakh for large companies, more for Big 4)

#### **Regulatory Role:**

- NFRA (National Financial Reporting Authority) oversees auditors
- Companies must appoint independent auditors (rotate every 5 years for listed companies)
- Auditors have legal liability if they miss fraud

## **7.4 Legal & Compliance Firms**

#### **Functions:**

- **IPO lawyers:** Draft prospectus, ensure compliance with listing rules
- **Regulatory counsel:** Handle SEBI inquiries, defense in cases
- **M&A lawyers:** Structure acquisitions, due diligence
- **Compliance officers:** Ensure company meets all regulations

**Revenue Model:** Hourly fees (₹2,000–10,000/hour for good firms) or fixed retainers for ongoing compliance

## **7.5 Fintech Platforms (Modern Disruption)**

**Examples:** Groww, Moneyview, Paisa Bazaar, Shoonya, Upstox

#### **What They Do:**

- Offer zero-commission or low-commission trading
- Simplified investing (round-up savings, micro-investing)
- Aggregated advice (compare funds, products from multiple providers)
- Robo-advisory (algorithms suggest portfolio allocation)

#### **Impact on Traditional Ecosystem:**

- Disrupted broker commission model (Zerodha pioneered zero commission, forcing industry-wide change)
- Made investing accessible to ₹500 savings (micro-investing)
- Reduced need for relationship managers (algorithms replaced humans)
- Regulatory challenge: SEBI had to create regulations for robo-advisors

**Example:** Groww zero-commission trading model:

- Traditional: Brokerage 0.05% on ₹1 Cr trade = ₹50,000
- Groww: ₹0 brokerage

- Revenue: Interest on idle cash, premium features, data monetization
- 

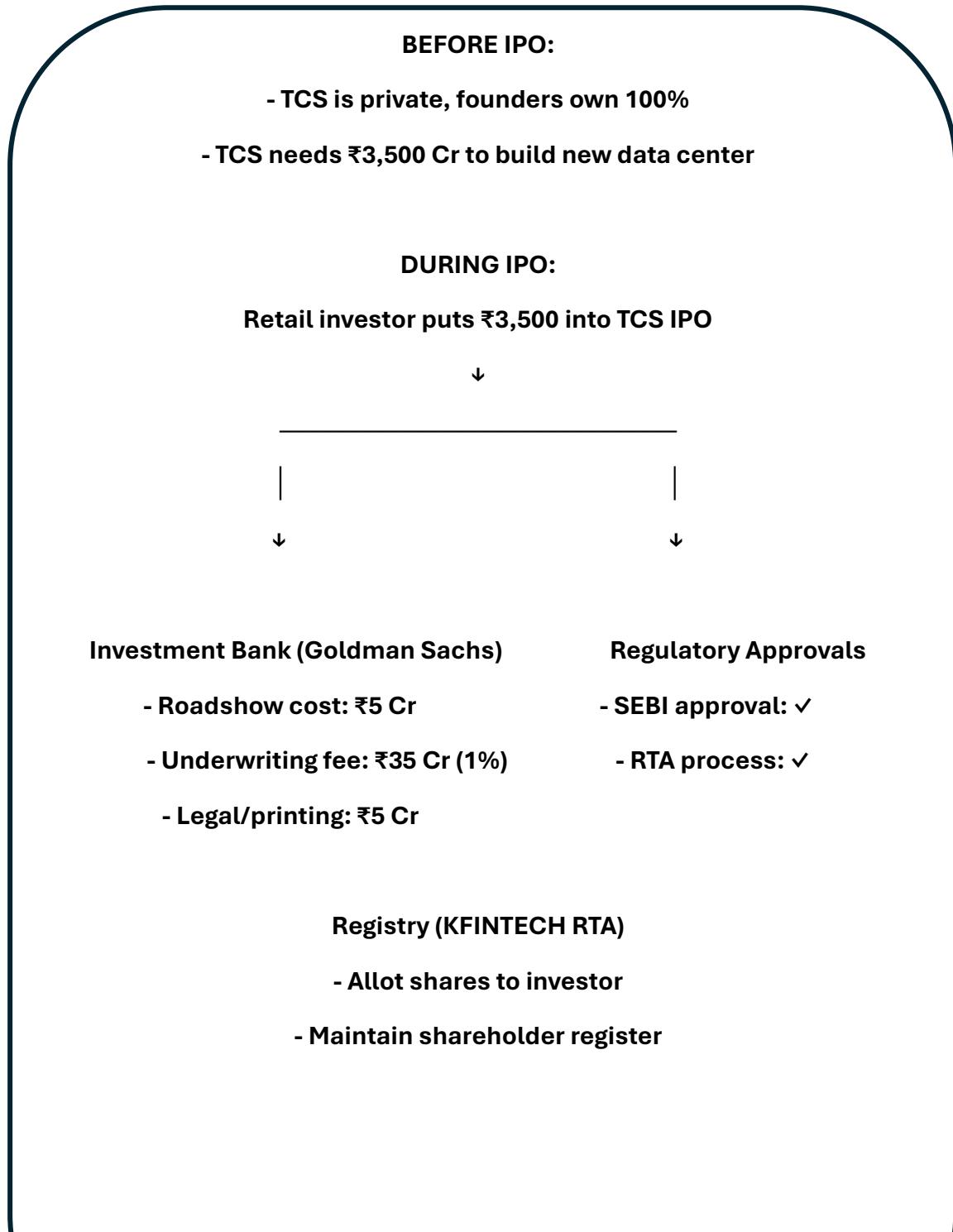
## 8. FLOW OF MONEY THROUGH THE SYSTEM

This is the heart of the financial ecosystem. Understanding money flow explains how all participants interconnect.

### 8.1 Flow 1: Retail Investor Buying a Stock (IPO)

**Scenario:** TCS issues 1 Cr new shares at ₹3,500 per share (₹3,500 Cr capital raised)

**Money Flow:**



### **Depository (NSDL)**

- Create electronic account

- Hold securities

### **Stock Exchange (NSE)**

- List company on exchange

- Collect listing fee: ₹50 Cr

### **Investor's Bank**

- Collect ₹3,500 from investor

**TCS Receives: ₹3,500 Cr - ₹45 Cr expenses = ₹3,455 Cr capital**



**Investor Receives: 1 share in demat account, plus right to future dividends**

#### **Key Points:**

- Money flows from retail investor → TCS (via intermediaries)
- Each intermediary takes a cut for services
- After IPO, investor owns stock, receives dividends, can sell in secondary market

## **8.2 Flow 2: Secondary Market Trading (Investor Selling Stock)**

**Scenario:** You bought 100 TCS shares in IPO at ₹3,500. Now (1 year later) TCS trades at ₹4,000. You sell.

#### **Money Flow:**

**You: "Sell 100 TCS @ ₹4,000"**

↓ (through your broker's app)

**Your Broker (Zerodha): Sends order to NSE**

↓ (charges ₹20 brokerage)

**NSE: Matches with buyer's broker**

↓ (charges ₹10 listing fee)

**Clearing Corporation (NSCCL): Guarantees settlement**

↓ (charges ₹5 fee)

**Buyer's Bank: Transfers ₹4,00,000 to your bank (T+1 day)**

**Your Bank: Credits your account: ₹4,00,000**

**Your Broker: Deducts ₹20 brokerage**

**You Receive Net: ₹3,99,980**

**Depository: Updates debit—your account ↓ 100 shares, Buyer's account ↑ 100 shares**

**TCS: Gets nothing (all money goes between investors)**

#### **Total Cost to You:**

- Brokerage: ₹20
- Tax: 18% GST on brokerage = ₹3.60
- Implicit cost (bid-ask spread): ₹50–100 (already factored in price)
- **Total cost: ₹75 (~0.02% of ₹4,00,000)**

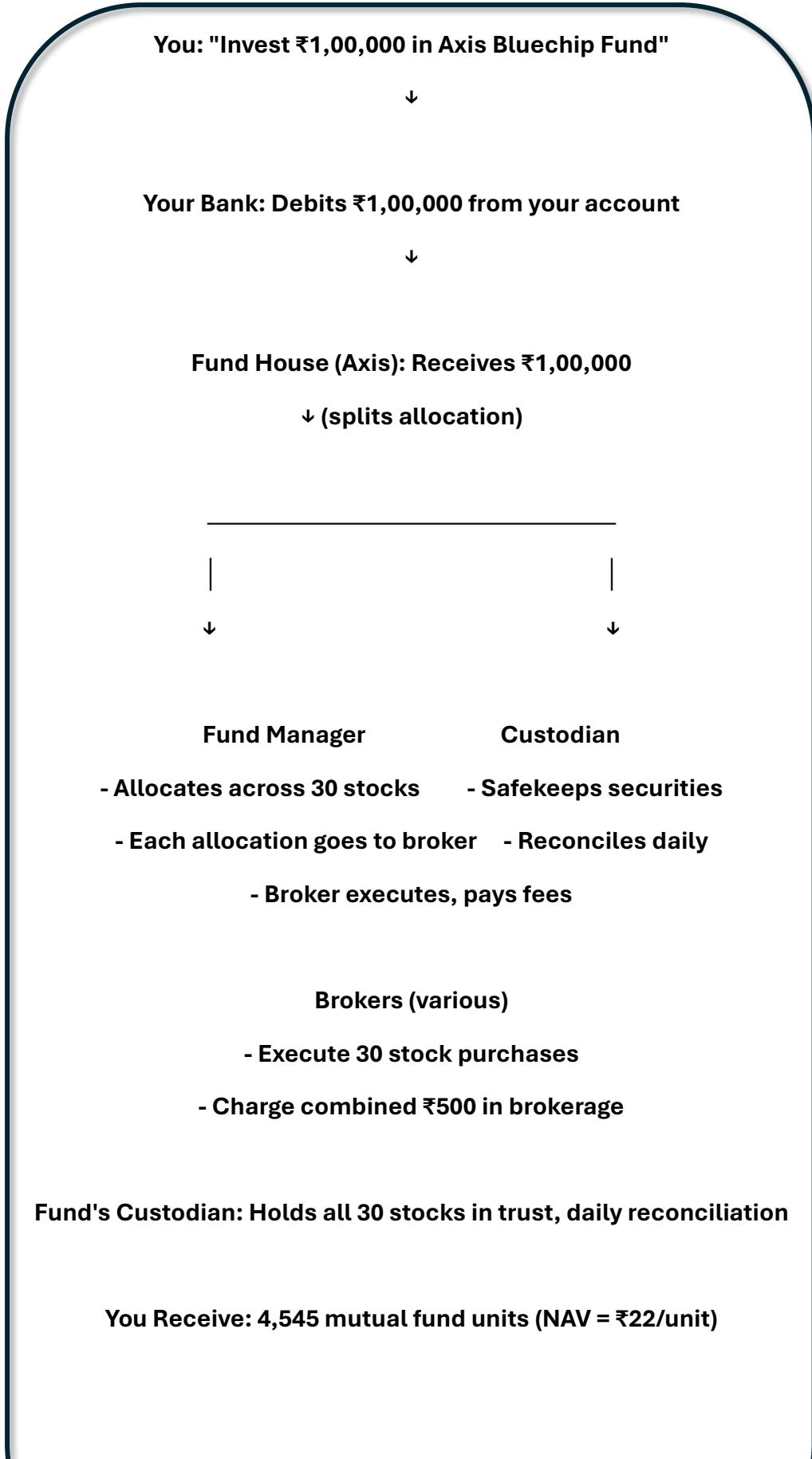
#### **Where the Money Goes:**

- ₹3,99,980 → You (your bank account)
- ₹20 → Broker (profit)
- ₹3.60 → Government (GST)
- ₹10 → Exchange (listing fee)
- ₹5 → Clearing corporation (clearing fee)

## 8.3 Flow 3: Mutual Fund Investment

**Scenario:** You invest ₹1,00,000 in Axis Bluechip Fund

**Money Flow:**



#### **Annual Returns Flow:**

**Stocks generate ₹12,000 dividends + ₹8,000 capital gains = ₹20,000**



**Fund deducts 1% management fee = ₹1,200**



**Net earnings: ₹18,800**



**Your 4,545 units now worth ₹1,18,800**



**Year 2 NAV = ₹26.10/unit (18.8% gain)**

#### **Key Points:**

- Your money → Fund house → Multiple brokers → Individual stocks
- Fund manager allocates based on research
- Custodian safeguards, you don't own individual stocks
- Fund fees reduce your returns (1% annually is significant over 20 years)

## **8.4 Flow 4: Bond Investment**

**Scenario:** You invest ₹10,00,000 in a Corporate Bond (5-year, 8% coupon)

#### **Money Flow:**

#### **PURCHASE FLOW:**

**You: "Buy ₹10,00,000 bond"**



**Primary Dealer (NSE or BSE) / Broker:**

- Facilitates transaction
- Charges ₹500 commission

**Company (Issuer):**

- Receives ₹10,00,000 (less commission = ₹9,99,500)

**- Issues bond certificate to you**

**Your Bank:**

**- Debits ₹10,00,000**

**Depository:**

**- Holds bond electronically in your account**

**ANNUAL INTEREST FLOW (Years 1–5):**

**Each year:**

**Company transfers ₹80,000 interest**



**Your Bank account: Credited ₹80,000**

**AT MATURITY (Year 5):**

**Company transfers: ₹10,00,000 principal + ₹80,000 final interest**



**Your Bank account: Credited ₹10,80,000**



**Your total received: ₹10,00,000 initial + (5 × ₹80,000) = ₹14,00,000**

**Your gain: ₹4,00,000 (400,000 ÷ 10,00,000 = 40% total, 8% annual)**

### **Key Points:**

- Bond is fixed income—get predictable interest regardless of company profit
- Lower risk than stocks (you get paid before shareholders in case of bankruptcy)
- Reinvestment risk: If rates drop to 6%, you can't reinvest at 8%

## **8.5 Settlement & Clearing Cycle**

**T = Trade day, T+1 = Next day**

**Monday (T):**

- You buy 100 shares at ₹500 = ₹50,000
- Exchange records trade
- Clearing corp guarantees it

**Tuesday (T+1):**

- You must have ₹50,000 in account (clearing corp checks)
- Seller must deliver 100 shares from demat (RTA checks)

**Wednesday (T+2):**

- Money transfers: ₹50,000 from your bank to seller's bank
- Securities transfer: 100 shares debit from seller, credit to you
- Settlement complete

**From Wednesday onwards:**

- Shares are yours (you can sell anytime)
- You can receive dividends on those shares

**Why T+2 (not T+0)?**

- Need time to verify buyer has money, seller has shares
  - Need to update depository records
  - Need to clear payments through banking system
-

## 9. RISKS & CONFLICTS OF INTEREST

### 9.1 Information Asymmetry

**Definition:** Some market participants have more/better information than others, creating unfair advantage.

#### Example:

**Scenario:** XYZ Pharma is about to release quarterly earnings

#### Information Holders:

1. **XYZ Board of Directors:** Know earnings are ₹500 Cr (beating expectations)
2. **Auditors (checking draft statements):** Know earnings are strong
3. **Brokers advising on capital raising:** Know company is doing well
4. **Public/Retail investors:** Assume company makes ₹400 Cr (last quarter)

#### Information Asymmetry:

- Insiders know earnings are 25% higher than expected
- Insiders can buy shares before announcement (knowing it will jump 25%)
- Public investors don't know, so they don't buy cheap shares
- When earnings released: Stock jumps 25%, insiders make huge gains, public loses opportunity

**Problem:** Unfair market—insiders systematically beat the market

**SEBI Response:** Insider Trading regulations

- Prohibit trading on material non-public information
- Define "insiders": Board members, employees, contractors, advisors
- Penalties: Up to 25 times profit or ₹5 Cr fine, whichever is greater
- Imprisonment: Up to 5 years

#### Detection Methods:

- Pattern analysis: If one person consistently buys before good news, investigate
- Whistleblowers: Anonymous tips to SEBI
- Data analytics: AI systems detect unusual trading before news breaks

## 9.2 Market Manipulation

**Definition:** Using false information or unusual trading to artificially move prices.

### Example 1: Pump & Dump

*Manipulator buys 10,000 shares of XYZ Micro-cap at ₹10 = ₹1 Lakh investment*

*Manipulator pays fake social media accounts to post:*

*"XYZ Micro-cap is undervalued, insider buying, will be ₹50 in 3 months!"*

*Retail investors see posts, believe it's real, buy XYZ*

*Price jumps from ₹10 to ₹30 (demand increases)*

*Manipulator sells all 10,000 shares at ₹30 = ₹30 Lakh proceeds*

*Profit: ₹29 Lakh in 1 month*

*Stock eventually crashes back to ₹5 (bad news, no business fundamentals)*

*Retail investors who bought at ₹20–30 lose 50%–75%*

### Example 2: Spoofing

*Manipulator places fake buy order: "Buy 50,000 shares of TCS @ ₹3,500"*

*Price jumps due to apparent demand*

*Manipulator cancels fake order 100 milliseconds later*

*But damage is done: algorithmic traders saw demand, rushed to buy*

*Price rises, manipulator's existing position gains value*

**SEBI Response:** Surveillance systems detect unusual patterns

- Volume spikes without news
- Orders placed and canceled rapidly (spoofing)
- Unusual trading patterns by one person/group
- Penalties: ₹10 Cr+ fines, trading bans, imprisonment

## 9.3 Insider Trading (Detailed)

**Definition:** Trading on material non-public information you have access to.

### Real Case: Amit Goyal (JP Morgan employee, 2013)

**Background:** Amit worked in JP Morgan's M&A team

#### Information Access:

- Knew Bharti Airtel was acquiring Zain Africa ( $\text{₹}450 \text{ Cr deal}$ )
  - Knew Bharti Airtel was buying Telenor's operations
    - This was unpublished, material information

#### Illegal Trading:

- Bought Bharti Airtel shares before announcement (betting on deal bump)
  - Bought Zain Africa related stocks
    - Made ₹70+ Lakh illegal profit

#### Detection:

- SEBI noticed abnormal trading pattern
  - Matched trades to his account
- Subpoenaed him, traced communication with information source

#### Punishment:

- ₹1.5 Cr fine
- 5-year ban from securities market
- Imprisonment risk (case ongoing)

#### Impact:

- JP Morgan fired him
- His career in finance ended
- Cost: ₹1.5 Cr fine + opportunity cost of lost income >> ₹70 Lakh gain

## 9.4 Conflicts of Interest in Ecosystem

### A. Broker as Advisor & Executor

**Conflict:** Broker earns brokerage from every trade (incentive: increase trading)

But advisor role requires recommending minimum trading (incentive: reduce trading)

#### Example:

Retail investor asks: "Should I rebalance my portfolio from 70% equity to 60%?"

**Honest advice:** "Your age and risk profile suggest 60% allocation. Sell ₹50 Lakh equity, buy bonds."

Expected profit: ₹500 brokerage

**Self-interested advice:** "Actually, market is rising. Stay 70% equity. This is great buying opportunity. Start buying more with ₹50 Lakh."

**Expected profit:** ₹1,000+ brokerage (buy + more market exposure)

**Problem:** How do you know if broker's advice is honest?

**SEBI Solution:** Fiduciary duty rules

- Brokers must prioritize client interest over their own profits
- Disclosure: Must disclose if they profit from recommendation

### B. Rating Agency Conflict

Company XYZ wants to issue ₹500 Cr bonds

Hires CRISIL to rate them

**CRISIL analyzes:** Company has shaky balance sheet, high leverage

**Rating:** BBB (risky)

**Company says:** "That's too harsh. We'll hire ICRA or CARE instead."

**Problem:** If CRISIL rates BBB and company hires ICRA for AA rating,

company will use ICRA's rating to sell bonds (shopping for ratings)

Investors confused: Which rating is real?

### 2008 Crisis Example:

- *Lehman Brothers' bonds rated AA just before collapse*
- *Rating agencies knew Lehman had leverage issues*
- *But Lehman was a big client (paying fees), so agencies gave good ratings*
- *Investors relied on AA ratings, lost everything when Lehman collapsed*

### Regulatory Response:

- Must disclose who paid for rating
- Cannot rate based on client relationship
- Conflict of interest disclosures mandatory
- Agencies liable for fraud if ratings are knowingly false

## C. Custodian Offering Advisory

Bank XYZ is both:

1. **Custodian:** Safekeeps your securities (duty: unbiased safekeeping)
2. **Advisor:** Recommends stock purchases (incentive: earn advisory fees)

**Conflict:** Custodian might recommend expensive/risky products to earn advisory fees instead of truly safekeeping your interests.

## 9.5 Systemic Risk

**Definition:** If one participant fails, entire system collapses.

### Example: Lehman Brothers Collapse (2008)

#### **Background:**

- *Lehman Brothers was major investment bank*
- *Provided liquidity to entire market (repo lending, stock lending)*
- *Held trillions in customer assets as custodian*

#### **Lehman Failure:**

- *Lehman went bankrupt Sept 15, 2008*
- *Thousands of customers couldn't access their assets*
- *Counterparties who lent to Lehman couldn't recover money*
- *Credit markets froze (no one trusted anyone)*

#### **Cascade Effect:**

- *AIG nearly collapsed (insured Lehman's risk)*
- *Investment banks couldn't get funding*
- *Stock markets crashed 50%+*
- *Global recession triggered*
- *Unemployment hit 10%+*
- *₹50+ lakh Cr in wealth destroyed*

**Lesson:** One firm's collapse → Systemic collapse

**India's Protection:** Circuit Breakers

- If Sensex drops 10%, trading halts for 15 minutes (cooling off period)
- If drops 20%, trading halts for 1 hour
- Prevents panic selling from cascading

# 10. LEARNINGS & IMPLICATIONS FOR PROFESSIONAL ROLES

## 10.1 For Finance Professionals

**Understanding this ecosystem helps you:**

1. **Make investment decisions:** Know that FIIs selling ₹5,000 Cr in a day doesn't mean economy collapsed—just reallocation. Don't panic-sell your portfolio.
2. **Value companies:** Understand cost of capital, capital structure, and why a company chooses debt vs. equity raises capital.
3. **Predict market movements:** When RBI cuts rates, understand how it flows through: RBI → Banks → Companies → Borrowing costs → Valuations → Stock prices.
4. **M&A strategy:** Understanding cost of capital helps you evaluate: Is ₹10,000 Cr acquisition price reasonable? What returns do we need?
5. **Capital allocation:** Knowing who controls capital (institutions, not retail) helps you understand whose liquidity matters.

## 10.2 For Accounting & Audit Professionals

**Understanding this ecosystem helps you:**

1. **Audit focus areas:** Know which financial statement items are most material. For financial companies, capital adequacy is critical. For banks, loan loss provisions are critical. For mutual funds, valuation of securities is critical.
2. **Conflict of interest:** Understand how financial ecosystem creates pressure for fraud. A fund manager under-reporting NAV losses or a bank hiding bad loans affects thousands of retail investors.
3. **Revenue recognition:** Understand complex revenue models. When does a broker recognize brokerage? When customer places order (accrual) or when settlement happens (cash basis)?
4. **Related-party transactions:** Understand where related parties hide. Fund manager invested in stocks where he also provides advisory—conflict.
5. **Disclosure adequacy:** Understand which disclosures matter. Institutional ownership concentration is critical (if top 10 institutions own 40%, they can force decisions).

## 10.3 For Tax & Compliance Professionals

**Understanding this ecosystem helps you:**

1. **Investment incentives:** Know that different investors have different tax positions. HNIs use capital loss harvesting (sell losing stocks before year-end to offset gains). Understand this creates sell pressure at year-end.
2. **Transaction costs:** Understand brokerage, clearing fees, exchange fees—these are tax-deductible for professional traders, not for regular investors.
3. **Dividend policy:** Companies optimize dividend timing for tax. If shareholders are mostly tax-exempt institutions (insurance, pension funds), pay dividend. If retail, avoid dividend (tax inefficient).
4. **Investor residence:** Foreign Institutional Investors (FIIs) get different tax treatment than domestic institutions. This affects capital flows.
5. **Transaction structuring:** Understand how corporate actions (splits, bonus, mergers) have tax implications that affect investor behavior.

## 10.4 Core Takeaways

1. **Financial markets are systems:** Not random. Every rule, fee, and regulation exists for a reason—usually to manage some risk or conflict.
  2. **Money flows, not stocks:** Focus on who makes money at each stage—that's who has incentives to behave a certain way. Brokers want trading volume. Exchanges want listings. Regulators want integrity. Insiders want to profit.
  3. **Interconnectedness:** Change one variable (RBI cuts rates), everything shifts (borrowing costs ↓, company valuations ↑, stock prices ↑, household savings change). Understanding linkages is key.
  4. **Conflicts are permanent:** You can't eliminate them. Auditors want long-term clients (bias toward leniency). Rating agencies want issuer business (bias toward generous ratings). Only transparency and regulation manage these conflicts.
  5. **Scale matters:** Retail investor buying ₹10,000 of stocks = noise. Pension fund buying ₹10,000 Cr = moves market. Understanding who controls capital is critical.
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# CONCLUSION

Financial markets are the heart of modern economies, facilitating **capital allocation, risk management, and wealth creation**. This report has examined all key participants—from individual retail investors to massive institutional funds, from stockbrokers to clearing corporations, from corporate issuers to regulators.

The ecosystem functions through a complex web of incentives and regulations. Each participant has specific motivations: **investors seek returns, intermediaries seek fees, regulators seek integrity, companies seek capital**. Understanding these incentives helps explain market behavior.

Money flows through the system in standardized ways: from savers through brokers to exchanges, via clearing corporations to depositories, eventually to companies that raise capital. Intermediaries take fees at each stage, but they also reduce friction, ensure fairness, and manage risk.

Conflicts of interest are permanent features, not bugs. Insider trading, market manipulation, rating agency conflicts, and custodian advisory conflicts all present ongoing challenges. Regulation helps manage these conflicts, but cannot eliminate them.

For professionals in finance, accounting, and tax roles, understanding this ecosystem is foundational. It explains:

- How capital allocation decisions are made
- Where audit risks and accounting issues hide
- How tax policy affects investor behavior
- Why certain regulations exist and what they achieve

This knowledge positions you to move from textbook learner to systems thinker—someone who understands not just how things work in isolation, but how they interconnect and influence each other.

## APPENDIX A: Key Definitions

**Demat Account:** Electronic account holding securities (stocks, bonds, mutual funds), instead of physical certificates.

**NAV (Net Asset Value):** Price of one mutual fund unit = (Total Assets – Total Liabilities) ÷ Number of Units.

**Leverage:** Using borrowed money to amplify returns. A trader with ₹1 Lakh can control ₹10 Lakh portfolio using ₹9 Lakh margin (9x leverage).

**Bid-Ask Spread:** Difference between price buyers willing to pay (bid) and price sellers willing to accept (ask). Smaller spread = more liquid security.

**Circuit Breaker:** Automatic trading halt triggered by large price movements, preventing panic selling.

**T+2 Settlement:** Trade date + 2 days is when money and securities actually exchange hands (delivery and payment).

**Material Non-Public Information:** Information that affects stock price but is not yet public (e.g., earnings results before announcement).

**Collateral:** Security deposit posted to guarantee you'll fulfill trade commitments.

**Coupon:** Annual interest payment on bonds (typically paid semi-annually or quarterly).

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## APPENDIX B: Important Regulatory Documents

- SEBI Act, 1992
  - Listing Regulations, 2015
  - Insider Trading Regulations, 2015
  - Takeover Code, 2011
  - Stock Exchange Bylaws & Rules
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**End of Report**