Financial Market

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Financial market performs allocative function as it allocates or move funds available for investment into their most productive investment opportunities.

Functions of Financial Markets

1. Mobilisation of savings and channelising them into the most productive uses: Financial markets act as a link between savers and investors. Financial markets transfer savings of savers to most appropriate investment opportunities. It gives savers the choice of different savers.

2. Facilitate price discovery: Price of anything depends upon the demand and supply factors. Demand and supply of financial assets and securities in financial markets help in deciding the prices of various financial securities.

3. Provide liquidity to financial assets: In financial markets, financial securities can be bought and sold easily. So financial market provides a platform to convert securities in cash.

4. Reduce the cost of transaction: Financial market provides complete information regarding price, availability and cost of various financial securities. So investors and companies do not have to spend much on getting this information as it is readily available in financial markets.

Classification of Financial Markets

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Classification of Financial Markets

Money Markets

Money market is a market for short-term funds meant for use for a period of upto one year. Generally, money market is the source of finance for working capital. Transactions of money market include lending and borrowing of cash for a short period of time and also sale and purchase of securities having one year term or which gets redeemed (paid back) within one year period.

Features of Money Market/Money Market Instruments.

1. Market for short-term.

2. No fixed geographical location.

3. Money market instruments are less risky and highly liquid.

4. Major institutions involved in money market are R.B.I., Commercial Banks, LIC, GIC, etc.

5. Money market enables companies to meet the requirement of short term funds and temporary deployment of excess funds for earning returns.

6. Common instruments of money market are Call money, Treasury bill, CP, CD, Commercial bill, etc.

7. Discount finance house of India is established to provide a ready market for instruments of money market.

Capital Market

Capital market is a market for medium and long term funds. It includes all the organisations, institutions and instruments that provide long term and medium term funds. It does not include the instruments or institutions which provide finance for short period (upto one year). The common instruments used in capital market are shares, debentures, bonds, mutual funds, public deposits, etc.

Nature or Features of Capital Market

1. Link between savers and investment opportunities: Capital market is a crucial link between saving and investment process. The capital market transfers money from savers to entrepreneurial borrowers.

2. Deals in long-term investment: Capital market provides funds for long and medium term. It does not deal with channelising saving for less than one year.

3. Utilises intermediaries: Capital market makes use of different intermediaries such as brokers, underwriters, depositories, etc. These intermediaries act as working organs of capital market and are very important elements of capital market.

4. Determinant of capital formation: The activities of capital market determine the rate of capital formation in an economy. Capital market offers attractive opportunities to those who have surplus funds so that they invest more and more in capital market and are encouraged to save more for profitable opportunities.

5. Government rules and regulations: The capital market operates freely but under the guidance of government policies. These markets function within the framework of government rules and regulations, e.g., stock exchange works under the regulations of SEBI which is a government body.

An ideal capital market is one:

1. Where finance is available at reasonable cost.

2. Which facilitates economic growth.

3. Where market operations are free, fair, competitive and transparent.

4. Must provide sufficient information to investors.

5. Must allocate capital productively.

Types of Capital Market

Primary Market

Primary market is also known as new issue market. As in this market securities are sold for the first time, ie, new securities are issued from the company. Primary capital market directly contributes in capital formation because in primary market company goes directly to investors and utilises these funds for investment in buildings, plants, machinery, etc.

Method of Floatation of Securities in Primary Market

1. Public Issue through Prospectus: Under this method company issues a prospectus to inform and attract general public. In prospectus company provides details about the purpose for which funds are being raised, past financial performance of the company. background and future prospects of company.

2. Offer for Sale: Under this method new securities are offered to general public but not directly by the company but by an intermediary who buys whole lot of securities from the company. Generally the intermediaries are the firms of brokers. So sale of securities takes place in two steps: first when the company issues securities to the intermediary at face value and second when intermediaries issue securities to general public at higher price to earn profit.

3. Private Placements: It refers to the process in which securities are allotted to institutional investor and some selected individuals.

4. 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.

5. e-IPOs. (Electronic Initial Public Offer): It is the new method of issuing securities through on line system of stock exchange. In this company has to appoint registered brokers for the purpose of accepting applications and placing orders. The company issuing security has to apply for listing of its securities on any exchange.

Secondary Market

The secondary market is the market for the sale and purchase of previously issued or second hand securities.

In secondary market securities are not directly issued by the company to investors. The securities are sold by existing investors to other investors. Sometimes the investor is in need of cash and another investor wants to buy the shares of the company as he could not get directly from company. Then both the investors can meet in secondary market and exchange securities for cash through intermediary called broker.

Difference between Primary Market and Secondary Market

S.No.	Basis	Primary Market	Secondary Market
1.	Types of Securities	There is sale of new securities.	It is the market for existing or second hand securities.
2.	Issued by	In primary market securities are directly issued by companies.	Securities are transferred between investors only.
3.	Capital Formation	Primary market contributes directly for capital formation as funds are transferred from surplus units to deficit units.	Secondary market contributes indirectly for capital formation as funds are exchanged between surplus units only.
4.	Entry	All companies enter the primary market to raise capital for their operations.	Only listed companies' securities are bought and sold in secondary market.
5.	Geographical Location	There is no fixed geographical area for primary market. All the institutions, banks, foreign investors, etc. constitute primary market.	There is a fixed geographical area and working hours.
6.	Price	Prices of securities are fixed by the management of the company.	Prices of securities are fixed by the demand and supply factors of stock exchange market.

Difference between Capital Market and Money Market

S.No.	Basis	Capital Market	Money Market
1.	Participants	The participants in capital market are financial institutions, banks, public and private companies, foreign investors and ordinary retail investors from public.	The participants of money market are financial institutions, banks, public and private companies but foreign and ordinary retail investors do not participate in money market.

2.	Duration	The capital market deals in medium and long term securities.	Money market deals with short term securities having maximum tenure of 1 year.
3.	Instruments	The common instruments of capital market are equity shares, debentures, preference shares, bonds and other innovative securities.	The common instruments of money market are treasury bills, trade bills, CD, CP, etc.
4.	Investment outlay	The investment in capital market does not require huge financial investment as the value of securities is generally low, i.e., ₹10 to ₹100.	The instruments of money market are quite expensive so huge financial investment is required.

5.	Liquidity	Capital market securities are considered liquid because of stock exchange but compared to money market instruments these are less liquid.	Money market securities enjoy higher degree of liquidity.
6.	Safety	The instruments of capital market are riskier in respect to returns as well as respect to principal repayment as issuing company may fail.	The instruments of money market are safe or less risky due to short duration and soundness of issuers.
7.	Expected return	The expected return is higher in capital market as along with regular dividend or interest there are chances of capital gain.	The expected return of money market is less due to short duration.
8.	Type of capital	Companies approach capital market for fixed capital requirement.	Companies approach money market for working capital requirement.

Stock Exchange

A stock exchange is an institution which provides a platform for buying and selling of existing securities.

Functions of Stock Exchange/Secondary Market

1. Providing liquidity and marketability to existing securities: The main function of stock market is to provide ready market for sale and purchase of securities. The presence of stock exchange market gives assurance to investors that their investment can be converted into cash whenever they want. The investors can invest in long-term investment projects without any hesitation, as because of stock exchange they can convert long-term investment into short-term and medium-term.

2. Pricing of securities: The stock market helps to value the securities on the basis of demand and supply factors. The securities of profitable and growth oriented companies are valued higher as there is more demand for such securities. The valuation of securities is useful for investors, government and creditors. The investors can know the value of their investment, the creditors can value the creditworthiness and government can impose taxes on value of securities.

3. Safety of transactions: In the stock market, only the listed securities are traded and stock exchange authorities include the companies names in the trade list only after verifying the soundness of the company. The listed companies must also operate within the strict rules and regulations. This ensures safety of dealing through the stock exchange.

4. Contributes to economic growth: In stock exchange, securities of various companies are bought and sold. This process of disinvestment and reinvestment helps to invest in most productive investment proposal and this leads to capital formation and economic growth.

5. Spreading of equity cult: Stock exchange encourages people to invest in ownership securities by regulating new issues, better trading practices and by educating public about investment. Stock exchange guide investor in selecting securities.

6. Providing scope for speculation: To ensure liquidity and demand of supply of securities, the stock exchange permits healthy speculation of securities.

Trading Procedure on Stock Exchange

(a) Selection of broker: The buying and selling of securities can only be done through SEBI registered brokers who are members of the stock exchange. The broker can be an individual, partnership firms or corporate bodies. So the first step is to register. Before placing order to registered broker-investor has to provide other details and information. These include

- PAN number
- Date of birth and address
- Educational qualification and occupation
- Residential Status (Indian/NRI)
- Bank Account details
- Depository A/c details
- Name of any other brokers with whom registered
- Client code number in client registration form

After taking these information, broker opens a trading account in the name of investor.

(b) Opening demat account with depository: Demat (dematerialised) account or beneficial owner (BO) account refer to an account which an Indian citizen must open with the depository participant (banks or stock brokers) to trade in listed securities in electronic form.

At present in India there are two depositories: NSDL (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.) There is no direct contact between depository and investor. Depository interacts with investors through depository participants only.

The securities are held in the electronic form by a depository. Depository is an institution or an organisation which holds securities (e.g. shares, debentures, bonds, mutual funds, etc.).

(c) Placing the order: After opening the demat account, the investor can place the order. The order can be placed to the broker either (DP) personally or through phone, email, through app, etc.

Investor must place the order very clearly specifying the price at which securities to be bought or sold. e.g., "Buy 100 equity shares of Reliance 500 per share."

(d) Match the share and Best Price: The broker will then go online and connect to the main stock exchange and match the share and best price available.

(e) Executing order: When the shares can be bought or sold at the price mentioned, it will be communicated to the broker terminal and the order will be executed electronically. The broker will issue a trade confirmation slip to the investors.

(f) Issue of Contract Note: After the trade has been executed within 24 hours, the broker issues a contract note. This note contains the details of number of shares bought or sold, the price, the date, time of deal and brokerage charges.

This is an important legal document as it helps to settle disputes claims between investors and the brokers.

A unique order code number is assigned to each transaction by the Stock Exchange and is printed on the contract note.

(g) Delivery of share and making payment: Now the investor has to deliver the shares sold or pay cash for the shares bought. This should be done immediately after receiving the contract note or before the day when the broker shall make payment or delivery of shares to the exchange. This is called Pay in day.

(h) Settlement cycle:

(i) Cash is paid or securities are delivered on pay in day, which is before T +2 day as the settlement cycle is T +2 days. With effect from April 2003, the settlement cycle is T + 2 days on a rolling settlement basis. For example, if transaction has taken place on Monday, then payment must be given before Wednesday, i.e., T +2 (Transaction day and two more days).

(ii) On the T+2 day, the Stock Exchange will deliver the share or make payment to the other broker. This is called Pay out day. The broker then has to make payment to investor within 24 hours of the pay out day since he has already received payment from the exchange.

(iii) The broker can make delivery of shares in demat form directly to the investor's demat account. The investor has to give details of his demat account and instruct his Depository participant (DP) to take delivery of securities directly in his beneficial owner account,

Dematerialisation

Dematerialisation is a process where securities held by investor in physical form are cancelled and the investor is given an electronic entry or number so that he/she can hold it as an electronic balance in account. So in short, dematerialisation refers to holding securities in electronic form.

For this, investor has to open a demat Account. With an organisation called depository. Now even all Initial Public Offers (IPO) are issued in dematerialisation form and more than 99% of the turnover is settled by delivery in Demat form.

Benefits of Dematerialisation

1. Holding shares in demat form is very convenient as it is just like a bank account. Physical shares can be converted into electronic form or even electronic form can be converted back to physical certificate, i.e., Dematerialisation.

2. These demat securities can even be pledged or mortgaged to get loans.

3. There is no danger of loss, theft or forgery of share certificates.

4. Reduces paperwork.

5. It is broker's responsibility to credit the correct number of shares in the investor's account.

6. Securities of different companies can be held in a single demat account.

Working of Demat System

1. Before opening a demat account with depositories, the investor has to select a DP, i.e., depository participant. DP is the agent of depository. DP may be a bank, broker or a financial service company.

2. Filling of an account opening form, along with PAN card details, photograph, etc.

3. The physical share certificates to be given to DP along with a request form for dematerialisation.

4. If shares are applied in IPO, then simple details of demat account and DP to be given, allotment would automatically be credited to demat account.

5. If shares are to be sold through broker, the DP must be instructed to debit the account with the number of shares sold.

6. The broker then gives instructions to his DP for delivery of the shares to the stock exchange.

7. The broker than receives the payment and pays the person for the shares sold.

8. All these transactions are to be completed, within 2 days, i.e., delivery of shares. Payment received from buyers as settlement period is T+2 days since April 2003.

Constituents of Depository System

Depository system consists of:

(i) The depository

(ii) The depository participants

i) The Depository: Depository is the apex organisation or unit in the depository system. Depository is just like a bank where Depositor/Investor can deposit and withdraw the money or securities. In a depository, an investor can deposit and withdraw his shares. In India, there are 2 depositories i.e., NSDL and CDSL.

Features of depository are:

1. Depository is an institution which holds securities such as Shares, Debentures, etc.

2. Depository interacts with the investors through agents called Depository Participants (DPs).

3. DPs can offer services only after obtaining a certificate from SEBI.

4. Investors have to open depository account with any DP called demat account.

5. Depository with the help of DPs controls electronic transfer of securities and settlement of transactions.

6. Depository can hypothecate dematerialised securities against bank loan.

7. Depository issues receipt of bonus shares in electronic form. 8. Depository offers nomination facility of demat account.

(ii) The Depository Participants (DP): Depository participant is an agent of the depository. An investor has to interact only with a DP and not with the depository for all his dealings in shares in electronic form. As per SEBI guidelines, any financial institution, the share brokers, banks, etc. can become DP after registration with SEBI. DP is the vital intermediary in depository system and all buying and selling of shares under depository system take place through DP only.

Stock Exchange Indices

(i) Sensex: This is Bombay Stock Exchange Index. It is calculated by taking prices of 30 stocks across key sector of BSE.

(ii) Nifty: This is a National Stock Exchange Index. It is calculated by taking prices of 50 key stocks listed in NSEI.

SEBI

Securities and Exchange Board of India (SEBI) was set up in 1988 to regulate the functions of securities market. SEBI promotes orderly and healthy development in the stock market but initially SEBI was not able to exercise complete control over the stock market transactions. It was left as a watch dog to observe the activities but was found ineffective in regulating and controlling them. As a result in May 1992, SEBI was granted legal status. SEBI is a body corporate having a separate legal existence and perpetual succession.

Reasons for establishment of SEBI

With the growth in the dealings of stock markets, lot of malpractices also started in stock markets such as price rigging, unofficial premium on new issue, delay in delivery of shares, violation of rules and regulations of stock exchange and listing requirements. Due to these malpractices the customers started losing confidence and faith in the stock exchange. So government of India decided to set up an agency or regulatory body known as Securities and Exchange Board of India (SEBI).

Purpose and Role of SEBI

The basic purpose of SEBI is to create a transparent environment for effective mobilisation and allocation of securities in securities market. It also try to develop market through innovations and competitions. SEBI makes rules and regulations for all the intermediaries and institutions associated with security market.

SEBI performs a major role in fulfilling the needs of three groups i.e. investors, Intermediaries and Issuing companies.

(a) For Issuing Companies it performs a platform or market for raising finance by issuing of securities in an efficient manners.

(b) For Investors it provides a safe and secure place for allocating their savings is securities of different companies.

(c) For Intermediaries they provide a competitive, professional market with proper infrastructure so that they can render better services to investors and issuers.

Objectives of SEBI

The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market. The objectives of SEBI are:

1. To regulate the activities of stock exchange.

2. To protect the rights of investors and ensuring safety to their investment.

3. To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.

4. To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

Functions of SEBI

The SEBI performs functions to meet its objectives. To meet three objectives SEBI has three important functions. These are:

1. Protective functions

2. Developmental functions

3. Regulatory functions

1. Protective Functions: These functions are performed by SEBI to protect the interest of investor and provide safety of investment. As protective functions SEBI performs following functions:

(i) Check a price rigging: Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities SEBI prohibits such practice because this can defraud and cheat the investors.

(ii) It prohibits insider trading: Insider is any person connected with the company such as directors, promoters, etc. These insiders have sensitive information which affects the prices of the securities. This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.

(iii) SEBI prohibits fraudulent and unfair trade practices: SEBI does not allow the companies to make misleading statements which are likely to induce the sale or purchase of securities by any other person.

(iv) SEBI undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.

(v) SEBI promotes fair practices and code of conduct in security market by taking following steps:

- SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in mid term.
- SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.
- SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.

2. Developmental Functions: These functions are performed by the SEBI to promote and develop activities in stock exchange and increase the business in stock exchange Under developmental categories following functions are performed by SEBI:

- (i) SEBI promotes training of intermediaries of the securities market.
- (ii) SEBI tries to promote activities of stock exchange by adopting flexible and adaptable approach in following way:
- (a) SEBI has permitted internet trading through registered stock brokers.
- (b) SEBI has made underwriting optional to reduce the cost of issue.
- (c) Even initial public offer of primary market is permitted through stock exchange. (iii) SEBI conducts research and publish information useful to all market participants.

3. Regulatory Functions: These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

- (i) SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.
- (ii) SEBI registers and regulates the working of mutual funds, etc.
- (iii) SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.
- (iv) SEBI regulates takeover of the companies.
- (v) SEBI conducts inquiries and audit of stock exchanges.
- (vi) These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.
- (vii) Levying fee or other charges for carrying out purpose of the Act.