Capital Market - Unit 9

Markets that facilitate the flow of long-term funds, are called capital markets. The main participants in these markets are households, businesses including those that are in finance, and governments. There are regulatory bodies that also play a major role in shaping these markets. Capital market securities, are expected to generate a higher annualised return to investors as against money market securities that have a higher degree of liquidity (i.e. can be liquidated easily without loss of value).

Capital markets, are a part of the larger financial market wherein, financial assets may be purchased or sold. One party transfers funds by purchasing financial assets previously held by another. Participants that provide funds are called surplus units while participants that obtain funds are called deficit units. The main providers of funds are households.

The capital market serves as an important source for productive use of an economy's savings. It provides incentive to savings and facilitates capital formation by offering suitable rates of interest as the price of capital. It provides an avenue for investors, particularly the household sector, to invest in financial assets that are more productive rather than in physical assets. It facilitates increase in production and particularly in the economy, and thus enhances the economic welfare of society. It is an important link between, those who save, and those who aspire to invest.

Financial markets facilitate the flow of funds from surplus units to deficit units. The markets that facilitate the flow of short-term funds (maturities of less than one year), are known as money markets while those that facilitate the flow of long-term funds are known as capital markets. Securities with maturities of one year or lesser, are called money market securities whereas securities with maturities of more than one year are called capital market securities. Money market securities have a higher degree of liquidity (i.e. can be liquidated easily without loss of value). But, capital market securities are expected to generate higher annualised returns to investors.

Capital Market securities include government bonds issued by the union and state governments, corporate bonds issued by corporations and companies, mortgages issued by households, corporate bodies or individuals, and equity shares issued by companies. Bonds are long-term debt obligations issued by governments and corporate bodies to support their operations. Mortgages are long-term debt obligations created to finance the purchase of real estate. Stocks (also called equity securities) are certificates representing partial ownership in the companies that issue them. The latter are included in capital markets because they have no maturities and are therefore, considered as long-term sources of funds. Bonds and mortgages represent debt, whereas equities represent ownership. Debt instruments bear amount and timings of interest and principal payments to investors who purchase them.

Securities have specific return and risk characteristics. The return is generally higher, when risk is perceived to be higher. Long-term securities of the capital markets, are expected to fetch higher returns, as the risk or uncertainty, of the expected return, is higher. Equity securities have higher expected return than most long-term debt securities, but they also exhibit a higher degree of risk.

Growth in GDP and investment, should be closely related. As growth occurs, demand for goods increases and capacity constraints become binding. Investment, financed by issuance of debt or equity is likely to follow. Exactly when, investment and issuance will be expected to occur, is unclear. In some cases issuance could lag well behind growth, in others, companies might issue and invest in anticipation of growth.

Information is a key determinant of asset prices, and should play an important role in primary market development. Investors should be more willing to invest, as better information about investment, is made available. Conversely, companies may be opposed to information disclosure as it can have a variety of economic costs.

Capital markets allow agents to insure themselves against unfavourable events, that are correlated with security prices. Together with financial futures markets and the insurance industry, they help to diversify risks across the community. Capital asset prices also reflect prospective economic developments, and thus help to collect information and share it across the community. This information helps to inform investors, of investment and other key decisions taken by company directors, public officials and other agents. Flow of information and securities through capital markets is imperfect and financial intermediaries can help to remedy these imperfections.

Good accounting standards are those judged to be of internationally acceptable quality if key elements required in guidelines produced by International Accounting Standards Committee(IASC) are adhered to. In practice, accounting authorities in a particular country may not legally oblige companies to comply with international standards. Poor accounting standards are those that are judged to be in need of significant reform.

The cost of capital should play an important role in primary market activity. As the cost of capital increases, issuers should be willing to issue less capital.

Capital markets are often heavily regulated but not all regulation need be positive. In many markets, entry by foreign investors is restricted. To the extent such restrictions increase the required return on capital, issuers will be more reluctant to issue equity. Market equity restrictions may be of several types e.g. investor types (individuals, corporations or funds), country of investor origin as class of shares available to foreigners. There may be outright prohibitions on investment in equity, or foreign investment may be subject to discriminatory regulations concerning minimum holding periods or repatriation rights over capital and income.

Investor protection refers to provision in company law and regulations that protect shareholders, including registration rights, voting rights, anti-director rights, minority shareholder rights and mandatory dividend payments. Good investor protection conforms to international standards; average quality is somewhat below international standards but adequate to support investment, while countries judged to have poor investor protection are those where there is significant risk of value loss on this count.

Primary and Secondary Capital Market

The primary market facilitates the issuance of new securities while secondary market facilitates the trading of existing securities. Primary markets provide funds to the initial issuer of securities. The secondary market creates liquidity for investors. Some securities are more active and can therefore be traded or marketed more readily. This is an important feature of the secondary market. The NYSE in the US of A is the largest secondary market in the world.

Primary market operations include new issues by new and existing companies, and governments. The issues may be of shares, rights issue, public offers or debenture bonds. There is no element of trading and an investor can apply directly to the issuer. This means of finance is sought, when debt is costly and raising money from the capital market is relatively cheap. Investors subscribe to benefit from dividend and, or capital appreciation.

Intermediaries associated with the primary capital markets are merchant bankers, registrars, underwriters, brokers, advisors, bankers, advertising agencies and printers. Primary markets are guided by regulators. Regulators generally prescribe guidelines and mandatory requirements for disclosure, investor protection and education.

Secondary market activities take place at stock exchanges and over the counter (OTC) exchanges, through their members. The intermediaries to the activities are members/brokers at the exchanges, portfolio managers, investment advisers and transfer agents. World over, the outcry system of the trading ring is being replaced by the screen based trading system. The latter system provides increased transparency, improved liquidity and lower settlement risk and greater information.

The cost of capital plays an important role in primary market activity. As the cost of capital increases, issuers should be inclined to issue less capital. Intuitively, equity issuance activity should be closely related to the market price of equity, which is one measure of cost. Higher prices should promote more issuances; lower prices would hinder issuance.

Managing new issues

Governments and companies can raise cash by placing their securities with a limited number of investors, offering them to a broad class of investor such as a company's existing shareholders, or by offering them to the public at large. Since there are relatively high costs to a public issue, private placements tend to be more common for small issues. Moreover, the terms and conditions of public issues are generally standardised and therefore companies needing to incorporate unusual features in their securities are more likely to make a private placement.

An initial public offering (IPO) is a first time offering of shares by a specific company to the public. As a privately held company expands, it may need more funds than it can obtain through borrowing and therefore could consider on IPO. Since, the firms that issue IPOs are not normally well-known to investors, they must provide detailed information about their operations and financial condition. A prospectus is provided to potential investors, who may wish to invest. It contains detailed financial statements and an explanation of the risk involved.

Companies can direct their sale of stock towards a particular group, such as existing shareholders, giving them pre-emptive rights (first priority) to purchase the new stock. By placing newly issued stock with existing shareholders, a company avoids diluting ownership. Pre-emptive rights are allowed to be exercised, by offering new shares during the subscription period at the price specified by the rights. Alternatively, the rights may be sold to someone else.

Rights issues, are sold when the company restricts the offer to its existing shareholders, who are then free to sell to other investors. Since the existing shareholder is conferred the right of first refusal to new issues of equity, it is referred to as the 'rights issue'.

Normally a company planning to issue an IPO, will hire a securities firm to recommend the amount of stock to issue and the asking price for the stock. It will also attempt to place the shares with investors and typically sells many of the shares to institutional investors.

Equity capital, is often arranged through merchant bankers or managers to an issue, who play the role of advisory and certification intermediaries. As per regulations, they may be required to fulfill certain criteria such as registration and capital adequacy requirements. They, as also stockbrokers, may also assume the role of underwriters. Underwriters help the company to issue new shares by extending their certification, which is more acceptable to the public and regulatory authorities. Since they go to the market frequently, they require to protect their reputations. They may also buy the shares at discounted issue prices and assume the risk of selling them later to investors at the higher issue price.

Underwriters guarantee success of an issue by pricing the new issue using their pricing skills, by their access to a network of investors to whom they can distribute the issue, and their skills for managing and laying off risk by providing guarantee.

The risk to underwriters is greatest in the fixed price offer for sale. The more the underwriters can pre-sell an issue, the less they are at risk. In the auction offer the risk is less, though here too the underwriter may have to buy unsold stock at the reservation price, which is the minimum bid price they may have committed to. For providing the guarantee, the underwriters are effectively providing a put option to the company, which comes at the price of a spread or commission. The company may exercise its option to sell.

The underwriter to an initial public offering typically undertakes an analysis of the company and then estimates the price range for the stock. The underwriter approaches clients and accepts indications of interest, which are non-binding orders for stock at different prices. These indications of interest, are used to set the final offer price at which the underwriter allocates shares. While investors are not bound by their indications, and have the opportunity to revise requirements, the continuing relationship between investors and underwriters ensures that investors cannot go back on their expression of interest with impunity.

This process of solicitation is often formalised into a book-building procedure, so that by the sale date, the underwriter has a more or less precise set of orders at different prices and is able to determine the (uniform) price at which the issue may be sold.

The interaction that takes place between a company and its advisors on the one hand and investors on the other may also provide the information that allows the company or its advisors to change the amount of securities on offer. Therefore, new issues may include a 'greenshoe' option, that allows the underwriters to increase the offering, if demand is unexpectedly strong.

IPOs tend to occur more frequently during a bullish stock market when potential investors are more interested in purchasing new stocks. They also occur more frequently when other investment opportunities are not as attractive. Like merchant bankers, underwriters too are required to seek registration and meet capital adequacy norms.

Brokerage firms ask for allotments of IPO shares from securities firms underwriting the IPOs, so that they can offer IPO shares to individual investors. Brokerage firms may receive very small allotments and so they tend to make them available to their bigger clients. Stockbrokers may be sole proprietorships, partnerships or corporate bodies. They require, to be members of at least one stock exchange, meet capital adequacy standards, and registration by the regulatory authority. They may be permitted to transact with investors through sub-brokers, who in turn need to be certified by a regulatory authority. Sub-brokers may act as agents of the stockbroker or assist the latter in transacting business.

IPO information such as pricing, filings and well-performing IPOs are available on the internet. There is evidence that the stock price of an IPO, typically rises on the first day and then declines over time. Institutional investors may be tempted to purchase the stock at the time of the IPO and sell the stock shortly afterwards. This is called flipping. To discourage this, securities firms may make available future IPOs to institutional investors that retain the shares for relatively long periods.

From a long-term perspective, many IPOs are over-priced at the time of issue. Investors may be overly optimistic about firms that go public. Companies may not perform as well as the expectations of investors before issue. Also, a company's managers may have had limited access to funds before, and therefore, were more efficient with the use of funds. Companies may therefore take advantage of such situation to obtain more funds.

A secondary stock offering is that, which is offered by a company, that already has outstanding stock. The company is likely to hire a securities' firm to sell its shares. Because the company already has shares in the market, it can monitor the market price to anticipate the price at which it wishes to sell new shares. If it floods the market with more shares than what investors are willing to purchase, it can cause a decline in the equilibrium price of all its shares. Companies are more willing to issue new stock when the market price of their outstanding shares is relatively high.

In auctions of securities, participants are often required to submit sealed bids and have no opportunity to revise their bids in the light of bids submitted by others. Since, bidders form different views of the items' value and submit different sealed bids, the auctioneer needs to decide pricing and allocation rules. The two most common auction mechanisms are known as the discriminatory auction, and the uniform price auction. In both these formats, bidders can typically submit multiple bids, each individual bid consisting of a price-quantity pair. In both auction formats, the securities go to the highest bidders. However, in uniform price auctions, the winning bidders pay the same price equal to the lowest winning bid. In other words the auctioneer can determine the maximum price at which the total issue can be sold, and successful highest bidders will receive stock at a uniform price, which is the lowest price offered by a successful bidder. In the discriminatory auction the winning bidders pay the prices they bid. In the uniform auction, all bidders pay the same market-clearing price. In the discriminatory auction, the seller essentially acts as a price-discriminating monopolist, by awarding securities to the highest winning bidders and working down through the aggregate demand schedule until the entire issue is sold.

It might seem that the proceeds from a uniform price auction would be lower than that from a discriminatory auction. But, this fails to recognise that bidders will act strategically, when they submit their bids and are likely to bid at lower prices under the discriminatory format. In a sense, it is cheaper for bidders to submit higher bids in a uniform auction than in a discriminatory auction, since most bidders end up paying a lower price than they bid. In fact, under some conditions, auction revenue may be expected to be higher under the uniform format, than under the discriminatory format.

Ownership of shares is evidenced, by a share certificate which is freely transferable by the owner. Established channels for transfer include the broker, who brings together buyer and seller, and the transfer agent, who transfers the stock of a company for a bona fide buyer or seller of securities and keeps an up-to-date list of the shareholders on the books of the company.

When a share is purchased, the broker can keep the certificate “in street name” for convenience and safety. This means that, the certificates will be held by the brokerage firm for account of the investor. When dividends are paid, the broker must credit the account; when annual reports or rights issues are received, the investor must be notified. When the stock is to be sold, the investor merely calls the broker, and broker credits the proceeds to the account. If the investor wishes, he may receive the stock certificate directly and when the stock is sold, the form on the back of the certificate must be completed or a separate power of attorney signed. If, it is sold through a broker, the broker will be appointed as attorney to transfer it. This is done, by placing the broker's name on the appropriate line on the back of the certificate. The certificate is signed and dated, and sent to the broker, usually by registered mail. If the broker wishes to transfer the stock to a buyer, the broker need only fill in the name of the person to whom it will be transferred and send it to the transfer agent.

Scrutiny of applications for shares, consolidation of data gathered from the applications, intimation of allotment of shares and dispatch of certificates are often assigned to registrars to an issue, who are registered with the regulatory authority.

Several companies have now automated the process of transferring and issuing ownership shares. The computer prints the name and number of shares owned on the face of each non-denominational security. Some day the share certificate will be eliminated altogether, and the stockholder's ownership will be a statement of holdings supplied by the company's transfer agent, much like the statement, provided by mutual funds. Many people lose securities each year or have them stolen. Since it is costly and time consuming to replace them, certificates should be kept in safe places. If they are lost, stolen or otherwise destroyed, the transfer agent should be notified immediately. A new share certificate may be obtained, after indemnifying the company and applying for the same.

In India, government securities are issued by the Reserve Bank of India whenever funds are to be raised by the government. The purchase and sale of these may be effected through primary dealers registered with the Reserve Bank.

Depositories are authorized to hold securities in physical form in their vaults and credit securities through book entries. If securities are in the non-physical form, they are credited electronically through book entries.

Role of Stock Exchanges

A securities market is any place where buyers and sellers come together to trade in securities. A person who buys bonds issued by the government through the RBI is part of the securities market. The securities market is actually divided into two broad classes, the original securities exchange market, and the over the counter (OTC) market. The organised securities market is further divided into national, regional and local exchanges. The National Stock Exchange (NSC) and the Bombay Stock Exchange (BSE), Mumbai form part of the national stock exchanges. The over-the-counter market is the informal market and handles securities transactions in the office of brokers and dealers registered to engage in securities business.

Stock exchanges facilitate the trading of existing stocks in the secondary markets. Brokerage firms serve as intermediaries between the buyers and sellers in the secondary markets. Brokers receive orders from customers and pass the orders on to the exchange, through a telecommunication network. Orders, are frequently executed a few minutes later. Full service brokers offer advice to customers, on stock to buy or sell; discount brokers only execute the transactions desired by customers. Stock exchanges provide a secondary market, allowing investors, a flexibility in spending which would not be possible if they were to hold securities until they were redeemed. For example, investors who bought shares in a primary issue, intending to hold on to them, can nevertheless meet unforeseen cash requirements by selling securities to other investors. There is however, a price for this flexibility, which is that the price the seller receives depends upon market conditions which are uncertain. The variances of prices means that agents associated with secondary markets have to be very nimble to avoid risking their capital.

Stock exchanges provide a secondary market, allowing investors, a flexibility in spending which would not be possible if they were to hold securities until they were redeemed. For example, investors who bought shares in a primary issue, intending to hold on to them, can nevertheless meet unforeseen cash requirements by selling securities to other investors. There is however, a price for this flexibility, which is that the price the seller receives depends upon market conditions which are uncertain. The variances of prices means that agents associated with secondary markets have to be very nimble to avoid risking their capital.

The role of the secondary market is to provide liquidity and immediacy in a cost effective way. To an extent, it enhances the value of the securities it mediates, strengthens the primary market and lowers the cost of finance for companies and governments. As any market does, it performs this job by matching buyers and sellers and establishing a price at which equilibrium occurs. It offers a forum in which investors and traders interact and exchange securities according to their trade requirements and beliefs about the true value of the security. The price which clears the market therefore, offers a consensus view of the underlying value of the security.

Among the largest stock exchanges in the United States and the world, is the New York Stock Exchange (NYSE). In India, the largest is the Bombay Stock Exchange, Mumbai.

The functions of national exchanges have grown over the years; they now include far more than furnishing an area for trading and providing information about price and sales. National exchanges also assure the investor of basic financial information and protection. For example, they require a company to provide its shareholders with a statement of earnings and a balance sheet that summarises its assets and liabilities.

Stock exchanges are special because they organise trade in variable price securities such as equities and bonds and present a consensus view of the underlying value of the securities. A security price is said to be informationally efficient, if it reflects all of the information available to participants in the market. However, this efficiency is limited and this limitation can lead to serious handicap of the exchange's ability to perform these functions.

The exchange provides a continuous market for individual securities issues. This is perhaps its most important function. A continuous market is predicted on a large volume of sales and a narrow price range between the bid and the ask price, and between the previous sale, and the sale taking place, at the moment. It also depends upon the rapid execution of orders. These conditions are fostered by the trading rules of the exchange. There are also a sufficient number of buyers and sellers of shares of stock of each company traded and a sufficient number of brokers and other members of the exchange, transacting orders to assure a broad and active market. The effect of such a market, is to improve the liquidity and marketability of securities that are traded.

The price of a share of stock, is established in an auction market. It is not set by the traders on the floor of the exchange, or by negotiations off the floor; it is established, by a bidding process, and therefore, the price at any one time tends to reflect the fair market appraisal of the stock. Since the market for a security is continuous and since the price is established by supply and demand, securities have good collateral value for loans. Obviously, the ability of an exchange to provide a fair market price is limited, because current news or events can have a tremendous effect upon stock prices. A specific price may or may not be fair when long-range investment values are considered. All that we can expect from a market is a price established freely by competitive forces. The broad auction market tends to improve marketability, and this makes securities better collateral for loans.

A continuous market for shares competitively priced provides a favourable climate for raising capital. Even if, the securities are sold by investment bankers, off the exchange, the securities traded on the exchange establish a price pattern that serves as a standard of value. Such a comparison should aid in corporate financing. Since there will be a continuous market available after the securities have been sold, the new offering is more readily salable to investors. Most large corporations depend upon retained earnings or internally generated funds for financing. Their infrequent trips to the stock market, however are aided by the formal organised stock exchange.

Companies listed on the regional and local exchanges are usually small, but they may have their stock traded on a national exchange in addition to one or more local exchanges. The price of shares traded on local exchanges is usually low, the volume of trading is small, membership fees are inexpensive and there are few members of each exchange.

Listing of Securities on Stock Exchanges

Listing of securities, on a stock exchange, allows them to be traded there under an agreement between the exchange and the issuer of the stocks. Provisions of section 73(1) of the Companies Act 1956, as amended in 1988 set the regulatory framework in India for listing at the stock exchanges. Besides this, there are the provisions of the Securities Contracts (Regulation) Act 1956, which confers powers on a stock exchange.

Securities, offered to the public for subscription, have to be listed on a stock exchange. For this the stock exchange and/or the regulatory authority may require certain criteria to be satisfied, such as disclosure norms, names of the exchanges at which listings are sought, eligibility for an IPO, post-issue capital, promoters' minimum contribution and lock-in period for the same, minimum offer to public for subscription, pricing of the issue and credit rating.

Listing, a security on the stock exchange, instills a sense of confidence in the investing public, by signaling that the company has complied with certain basic requirements which govern among other things, administration of share certificates, registration of transfer of shares and new issues. These compliances are likely to create an environment conducive to wider investor participation and therefore, liquidity.

Stocks and bonds are traded on the stock exchanges. The two largest stock exchanges of the country are the Bombay Stock Exchange (BSE), Mumbai and the National Stock Exchange (NSE), New Delhi. Although it is not obligatory for stocks to be listed on a stock exchange, it becomes so, if the company declares in the prospectus, that it will seek listing.

The listing regulations are uniform for all stock exchanges in this country. Companies seeking listing of securities must meet conditions of minimum public offer, minimum issued capital, payment of interest on excess application money if not returned within 30 days from date of closure of the issue, maximum expenses permissible for an issue, restrictions on advertising, face value of shares, bonds and debentures, publication of half yearly results and its notification to the exchange. The application for listing, must be accompanied by a number of documents. The company is required to pay listing fees, which may vary from exchange to exchange.

Trading on Stock Exchanges

Exchanges have a trading floor where the buying and selling of securities take place. Individuals or firms (brokers) are required to purchase a seat or membership of the stock exchange in order to obtain the right to trade securities there. The trading that takes place on the floor of the stock exchange resembles an auction, as members trying to sell a client's stock strive to obtain the highest price possible, while those representing the buyer-clients strive to obtain the lowest price possible. When members announce their intention to buy or sell a certain number of shares of a certain stock, they receive bids or offers as the case may be from other members. Sellers accept the highest bid or hold shares until an acceptable bid is offered. A member can act as buyer or seller.

Only members can transact business at the posts, where securities are traded. The ‘open outcry’ offers a relatively simple method of trade-matching, that has been used for centuries, in commodities markets. In this, buyers and sellers match themselves up directly by calling out bid and offer price offers in the trading 'pit'. The physical order matching system, is now emulated by the new screen based exchanges. Trading pits are rapidly losing ground to the electronic system. The new electronic media, is used mainly by market-makers and corporates, to conduct large-scale transactions. Online trading systems are gaining popularity at the retail level as well.

The more progressive stock exchanges have electronic quotation systems that provide immediate price quotations. Companies that wish to have their prices quoted must meet specific requirements on minimum assets, capital and number of shareholders.

Specialists take positions in specific stocks and stand ready to buy or sell these stocks. They are expected to maintain a fair and orderly market, in the securities assigned to them. Floor brokers execute stock transactions for their clients.

Transactions are facilitated, by market-makers who stand ready to buy or sell specific stock in response to customers’ orders made through telecommunications network. Liquidity of the stock market is enhanced by market-makers, because they are required to make a market at all times in an effort to stabilise prices. Whereas, brokers on the exchanges match buyers and sellers, market-makers serve not only as brokers, but also as investors. Market-makers have a bid/ask spread, to charge for transactions they execute. Consequently, transaction costs become higher.

The market is created, from the flow of orders to buy or sell each stock. Investors communicate their orders to brokers by specifying name of the stock, whether to buy or sell it, number of shares to be bought or sold, and whether the order is a market order i.e. transact at the best possible price or limit order i.e. limit placed on the price at which a stock can be purchased or sold. In a limit order, investors may obtain a stock at a lower price but there is no guarantee that the price will reach that limit. Orders may be placed for a day or longer periods.

Investors can purchase stock on margin (with borrowed funds) by signing up for margin account with their broker. Investors can sell the stock short or short the stock when they anticipate that the price will decline. When they sell short, they are essentially borrowing the stock from an investor to whom they will have to provide it. Short sellers earn the difference between what they initially sold the stock for and what they pay to obtain the stock.

There is also the brokerage mechanism, which is employed in thin markets for heterogeneous instruments. This is quite adequate for traders with little immediacy or liquidity requirement, who trade frequently. Brokers use their knowledge of clientele to find buyers and sellers, or are approached by brokers' clients, without taking items on to their books. In an extreme case, where the process fails, an auction may be arranged. Small company shares, are usually traded on a 'matched bargains' basis, by small regional stockbrokers.

Matching methods are used, to make markets in equities and to determine opening prices for auctions. Client 'limit orders' which specify the size of the trade and an acceptable price range, are collected before the market opens. These buy and sell orders are then aggregated and the market clearing price is found at the level at which net demand is close to zero. A market-maker has the option of using this aggregate demand/supply schedule as an offer curve and can execute these limit orders against his own inventory.

Liquidity in these markets, is maintained by dealers in return for privileges, which they receive from the stock exchange. There are two main mechanisms for achieving liquidity - the quote-driven and the order-driven. In the quote-driven markets, dealers announce a 'bid' price at which they stand ready to buy up to some maximum quantity and an 'ask' (or offer) price at which they are prepared to sell. They then meet orders out of their inventory, adjusting prices accordingly.

In order-driven markets, dealers (known as intermediaries) submit limit orders on a continuous basis to the stock exchange computer. A limit order is an instruction to buy (or sell) shares up to a specified maximum at a price equal or below (or above) the specified level. These orders are 'crossed' or executed against existing limit orders if possible, but otherwise added to the order book, which forms the price schedule for the market. Similarly, clients can submit limit orders. They can also submit market orders, which are unconditional as to price, and are immediately matched against the most favourable limit order price, on the computer.

An individual wishing to buy or sell a security would contact a salesperson at a brokerage firm and place an order. The order must specify the name of the issuer of the security, types of security, whether order is for purchase or sale, the order size, type of order, and the price and length of time the order is to be outstanding. Under type of order, market, limit, short sale, stop order are to be specified.

Order size trading on the stock markets, is usually carried out in round lots. A round lot for most common stocks, is considered to be hundred shares. An odd lot is a quantity different from hundred shares. Orders can be for both, round or odd lots. Generally, odd lots have higher transaction costs. For securities other than common stock or ordinary shares, there is no differential categorization by order size, but there may be a minimum order size.

Market orders are the most common type of orders placed by an individual investor. A market order is an order to buy (or sell) at the least (or highest) price currently available. The purchase or sale price can differ from the bid or ask. First, consider a market buy order. Other investors could simultaneously be placing market orders to sell, and the shares could be traded inside the bid-ask price. Second, the bid-ask spread could change, between the time the order is placed and the time it is executed, because of other preceding trades or because new information caused a change in the bid-ask spread. Thus, an investor using a market order is insuring execution with some uncertainty as to price.

Limit orders are orders to buy or sell at a minimum or maximum price. Limit orders control the price paid or received, but the investor has no way of knowing, when and if the order will be filled. A limit order may be utilised by an investor, who observes the price to be varying within a range and tries to sell or buy the stock at a favourable price within the range, and is willing to bear the risk of not filling the order.

Short sale investors can sell shares they do not own. This type of trade is referred to, as a short sale. When an investor short sells a security, the security is physically sold. Since the investor does not own the security, the brokerage firm borrows it from another investor or lends it to the investor. The securities borrowed normally come from the securities held, at the brokerage firm, for other investors. Securities, kept at a brokerage firm by investors, are referred to as securities registered ‘in street name’. If the firm does not possess the shares they desire to sell, they would borrow the shares from someone else, often another broker. The investor, whose shares were borrowed and sold, normally would not know that the transaction had occurred and would definitely not know who had borrowed the shares. Since the shares are physically sold, the company would not pay dividend to the investor whose shares were borrowed, but instead pay the purchaser of the shares. For the investor, whose shares are borrowed, not to be hurt by the short sale, he or she must receive the dividends. The person who sold the shares short, is responsible for supplying the funds, so that the person whose shares were borrowed, can receive any dividend paid on the stock that was sold short. At a future time, the short seller repurchases the shares, and replaces the shares that were borrowed.

Stop orders are activated, only when the price of the stock reaches or passes through a predetermined limit. The price that activates the trade, is called stop price. Once a trade takes place at the stop price, the order becomes a market order. Thus, a stop loss order can be viewed as a conditional market order. A stop buy order becomes a market buy, when the trades of others equal or exceed the stop price. The investor might place a stop loss order increasing the stop price, if the shares continue to rise. As with all market orders, the actual price the shares will trade at, is uncertain because the trade prices might move below the stop price before the stop loss order can be executed.

A stop buy order is often used, in conjunction with a short sale. Since the share must be replaced following a short sale, any price increase harms the short seller. A stop buy order serves to limit the amount of loss, the short seller can incur.

An investor must specify the length of time an order is outstanding for orders other than market orders. A day order instructs the broker to fill the order by the end of the day. If, it is not filled by end of the day, it is automatically cancelled. If the investor does not specify the length of time, it is assumed to be, a day order. A week or month order is to be filled by the end of that period or cancelled. Good until cancelled orders, remain outstanding until the investor specifically cancels the order. Fill or kill order instructs the broker to fill the order immediately or to kill the order.

Spot transactions require settlement by delivery and payment on the date of contract, or next day. A clearing house facilitates, the clearing of contracts, delivery of securities, and payments between members.

Stocks, not listed on the organised exchanges, are traded in the over-the-counter (OTC) market. Like the organised exchanges, the OTC market also facilitates secondary market transactions but does not have a trading floor. Instead, buy and sell orders are completed through a telecommunication network. Because there is no trading floor, there is no need to buy a seat to trade on this exchange, but it is necessary to register with it.

Regulation of Stock Exchanges

It must be borne in mind that securities related laws, do not prevent investors from making poor investment decisions but only attempt to ensure informed decisions, protecting the investor against fraud.

Capital markets and institutions, of which the stock exchanges are a part, are prone to failure. Regulation can reduce the risk of failure. Legal and regulatory constraints can help shape a country's corporate and financial structures.

In addition to regulation of markets themselves, some aim at regulation of financial institutions participating in the markets. Some regulations apply to all financial institutions, whereas others may apply to specific types.

‘Chinese walls’ are sometimes put into place by corporates to inhibit communications, about takeover targets and the like, between different departments, which may typically include fund management, market-making and corporate finance, financial viability of secondary market-makers and their parents, and in particular counterparty risk to a firm’s clients in the event of failure. To minimise these risks the regulator has to see that these firms are adequately capitalised and that proper risk control systems are in place. Regulators are always keen to maintain reputation of industry and lay down minimum standards for its member companies and operatives. Rules, can typically, be laid down, for qualification and behavior of finance professionals. It may set entry requirements, rules of conduct for traders, registered representatives, directors of member-companies, prohibition of trading on the basis of information or analysis which is not in the public domain.

Performance, of various financial institutions, is linked to regulation. A common dilemma in regulating any type of financial institution is imposing enough regulation to ensure safety without imposing so much as to reduce competition and efficiency.

Securities are contracts, that allow investors to delegate the management of their assets to others. Investors have to retain full legal title to their assets, or get their funds back on demand, or surrender their assets in return for control rights that constrain directors and motivate them to pay dividend and interest. These precipitate problems of principal-agent, borrower-lender relationships. Capital markets solve these by providing, legal, accounting and regulatory systems.

The Securities Contracts (Regulation) Act 1956, provides for regulation of dealings in securities, which among others, empowers the Central Government to recognize stock exchanges, derecognise them, supercede their governing bodies and suspend business.

It empowers the stock exchanges themselves to adopt bye-laws covering maintenance of a clearing house, determination and declaration of market rates, limits for business by members, margin requirements, brokerage and fee payments.

Margin requirements i.e. portion of invested funds that can be borrowed versus paid in cash, are imposed to ensure that investors can cover their positions, if value of their investments decline over time. A major decline in stock prices is likely to cause defaults on loans from brokers and therefore will be less damaging to the financial system.

The Securities and Exchange Board of India (SEBI) was established by an act of parliament in 1992, to oversee exchange institutions and protect investor interest by stipulating conditions for disclosure of relevant financial information on publicly offered securities and prevent fraudulent practices in selling these securities. The act was called The Securities and Exchange Board of India Act 1992.

It empowered the Board to declare illegal a variety of deceptive practices such as misleading financial statements and trading strategies designed to manipulate market price. Some regulations may be imposed to reduce market volatility, such as temporary halt of trading in some securities or contracts, through circuit breakers.

The Board is assisted in its regulatory work by empowering it to call for information from the stock exchanges, and to inspect, investigate, enquire and audit them. It carries out its functions through various departments, manned by experts in related fields. The activities of the Board, are designed to protect the investing public from losses owing to fraud, unfair competition or unethical acts. It is the duty of the Board to inform but not to advise the public, about the investment worth of an individual company's securities. This it does through press releases as when needed.

Recent Developments

Besides the securities discussed in the foregoing sections of this unit there are derivative securities also traded in capital markets. Derivative securities are financial contracts, whose values are derived from underlying assets.

Most derivative securities have two main characteristics. One is they allow an investor to speculate on movements in the underlying assets without having to purchase those assets. This allows the investor to take on large investment positions without large initial outlays and therefore provides a high degree of financial leverage. Therefore, the returns from investing in derivatives securities are even higher than investments in the underlying assets themselves. Investors who speculate in derivative contracts can achieve higher returns, but they are also exposed to higher risk than if they had speculated in the underlying assets.

Two is that derivative securities can be used to generate gains, if the value of the underlying assets declines. Consequently, financial institutions and other companies can use derivative securities as a means of hedging their existing investments in securities.

Capital markets around the globe have become more internationally integrated, by the lowering of cross-country barriers, availability of information, lower transaction costs and the standardization of regulation. As markets get more integrated, they also become more susceptible to interest rate movements abroad.

Most stock exchanges have suspended, or are in the process of phasing out, the outcry system of trading in stocks and have replaced it with the screen-based trading system. The trend is towards a floorless exchange.

With the easing of regulation, prompted by competition for foreign direct investment with other developing countries, international issues of both debt and equity have taken off in recent years, in conjunction with the development of the domestic market for debt and equity.

Internet brokers accept orders online, provide real time quotes and information on firms. Trades are executed in cyberspace and orders submitted and executed by automated systems.

All new issues are to be in dematerialised (demat) form. The demat form ensures that there are no fake or forged shares, no bad deliveries and facilitates transfer of securities.

Terminal Questions

1) What purpose do capital markets serve?

2) What are the factors that would go into deciding whether a company should resort to debt or equity for financing its requirement of long-term funds?

3) Discuss the role of an underwriter in managing an IPO.

4) Why is a stock exchange an important institution of the capital markets?

5) What are the factors that go into making a company eligible for being listed on a stock exchange?

6) Discuss the various types of orders that an investor may place to buy or sell a security.

7) What means are employed to regulate stock exchanges?

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