UNIT 10 CAPITAL MARKET

Structure

10.0 OBJECTIVES

After studying this unit you should be able to :

- explain the nature of primary capital market;
- describe the methods of making fresh issue of securities;
- outline the importance and growth of primary capital market in India;
- explain the nature of secondary capital market;
- outline the functions and importance of stock market;
- explain the concept of listing of securities and its advantages;
- describe the traditional method of trading on the stock exchanges in India and the improvement affected by the modern method of online trading;
- describe the procedure of settlement for various types of contracts relating to purchase and sale of securities at the stock exchange and explain the concept of rolling settlement;
- explain the system of carry forward of transactions from one settlement day to another and its replacement by dealings in equity derivatives;

- describe the system of delivery and transfer of securities through electronic book entries and the advantages thereof;
- distinguish between a speculative and an investment transaction and outline the impact of excessive speculation on dealings at the stock exchange; and
- enumerate the various reform measures introduced during post-reform phase for promotion and regulation of stock market.

10.1 INTRODUCTION

You have learnt that the capital market signifies the institutional arrangement for raising long-term funds and providing facilities for marketing and trading of securities. Broadly speaking, the capital market in India is divided into gilt-edged market and corporate securities market. The gilt-edged market refers to the market for government and semi-government securities, backed by Reserve Bank of India, and the corporate securities market is the market for shares and debentures of companies. This market is further divided into the primary market and secondary market. The primary market deals with fresh issue of securities and is also known as 'new issue market', whereas the secondary market provides a place for purchase and sale of existing securities and is often termed as 'stock market' or 'stock exchange'. In this unit, you will learn about the nature and significance of both primary and secondary capital markets, and the working of stock exchanges in India including listing of securities, the method of trading and the method of settlement. You will also have an idea about the measures adopted in the post reform phase to put the Indian stock market on road to renewed growth.

10.2 THE PRIMARY CAPITAL MARKET

10.2.1 Nature

As stated earlier, the primary capital market (or new issue market), consists of an arrangement which facilitates the procurement of long-term funds through fresh issue of various types of securities called capital market instruments. While the demand for long-term funds comes predominantly from private sector companies, pubic sector undertakings and the governments, the supply comes largely from individual investors, corporate savings, banks insurance companies and the specialised financial institutions. These borrowers and the lenders are brought together through the primary market which works as a mechanism to facilitate the transfer of funds from the savers (investors) to the borrowers (issuers of securities). You know that the various types of securities through which the long term funds are usually raised are : (i) equity shares, (ii) preference shares, (iii) deferred / founders' shares, and (iv) debentures/bonds. You also know that the preference shares and the debentures/bonds can be of various types and that, in recent years, a variety of new financial instruments such as zero coupon bonds, deep discount bonds, PCDs/NCDs with buy back arrangement, NCDs with detachable equity warrants, secured premium notes (SPN), warrants, etc. have been introduced which are duly permitted by SEBI. It also needs to be recalled that the deferred/founders' shares can only be issued by private limited companies to its promoters and directors and that these are usually of small denominations and carry equal voting rights with equity shares which may be of higher denomination.

The companies usually make a fresh issue of securities at the formation stage and subsequently for expansion of their business, if need be. However, to sell securities is not an easy task as the companies have to fulfil various legal requirements and decide upon the appropriate timing and the method of issue. Hence it is quite normal to obtain the assistance of various intermediaries such as merchant bankers, underwriters, stock brokers, etc. to look after these aspects. It may be recalled that the public issue of securities is often arranged through merchant bankers who also play the role of advisory and certification intermediaries. The underwriters guarantee success of an issue by their skill in pricing the new issue and their access to a network of investors to whom they can distribute the issue. Then, there are stock broking firms and their sub-agents who assist the managers and underwriters to the issue by distributing and collecting the application forms from individual investors at different centres all over the country. All these intermediaries form an integral part of the primary capital market.

10.2.2 Methods of Making Capital Issue

The various methods usually adopted for making a fresh issue of securities are as follows.

1 **Public issue through prospectus :** The most common method of making a public issue of securities is through prospectus. The prospectus, as you know, is an invitation to the general pubic for subscribing to the shares and/or debentures of the issuing company. It provides complete information about the company, particulars of the issue, terms of payment, details of the project, management's perception of the risk factors, etc. An investor is expected to study the prospectus and, if convinced about the prospects of the company, may apply for shares.

2 **Offer for sale :** Under this arrangement, the company sells its shares or debentures en block to a financial institution or an issue house at an agreed price for sale to the public. The issue house publishes a document called an offer for sale, with an application form attached, offering to the public shares or debentures for sale at the same price or a little higher price. The document is deemed to be a prospectus. On receipt of applications from the public, the issue house renounces the allotment in favour of the applicants.

3 **Private placement :** A private company limited by shares is prohibited from inviting the public for subscription of shares or debentures. Hence, it issues shares privately to a small number of persons known to the promoters or related to them by family connections.

A public company can also raise its capital by placing the shares privately without inviting the public for subscription to its shares or debentures. In this kind of arrangement, an underwriter or a broker finds persons to buy shares. Since no public offer is involved, there is no need to issue any prospectus. However, such a company is required to file with the Registrar a statement in lieu of prospectus. In case of large placing, the services of merchant bankers or an issue house may also be used who can communicate with mutual funds, pension funds, insurance companies, FIIs etc. known as qualified institutional buyers (QIBs).

4 **Book building :** Initial public offer (IPO) of shares can also be made through the process of book building which implies collection of bids from the investors based on an indicative price. The issue price is fixed after the bid closing date. The concept of book building is based on the assumption that the price of any scrip depends mainly upon the perception of the investors about the issuing company.

Hence, the issue price is not fixed in advance. It is determined by the offer of the potential investors which they may be willing to pay for the issue. A company which intends to make an IPO, issues a draft prospectus which does not mention the issue price. The company, a day or two before opening of the issue, announces the price band. The companies are allowed a maximum of 20 per cent range in the price band. The investors can bid at a maximum of three price levels within this range in multiples of the minimum lot size. Alternatively, one can bid at the cut-off price (the actual issue price to be decided on allotment). In that case, the entire bid must be at this price and payment made at the time of application at the maximum price. It may be noted that, within the earmarked price band, the issuer and the merchant banker who collate the bids have the discretion to decide the cut-off price, and the only the bids at or above the cut-off price are considered for allotment.

The main advantage of the book building process, as against the normal IPO marketing process, is that it allows for price discovery and demand discovery. Further, the costs of public issue are reduced drastically and time taken for the completion of the entire process is far less as compared to that in the normal public issue. However, while the book building process has been in existence in the international capital market since long, in India it is only a decade old. SEBI announced its guidelines for the book building in October 1995, and later, issued the new guidelines effective from December 1, 2001. The ICICI Ltd was the first company which made its IPO through book building process in July 1996. Later, many companies followed this process for their IPOs. To name a few, these are public sector undertakings like ONGC, NTPC, GAIL and PNB, and the private sector companies like TCS, BIOCON and Reliance Petroleum. Now-a-days, it is the most common method used for public issue of shares.

5 **Rights issue :** The companies also make further issue of capital through rights issue to the existing shareholders. Under the rights issue, the shareholders have the right to a certain number of shares in proportion to the share already held by them.

In any case, for raising capital from the public by issue of shares or debentures, a public company has to comply with the relevant provisions of the Companies Act, the Securities Contracts (Regulation) Act including the Rules made thereunder, and the guidelines and instructions issued by the concerned government authorities the stock exchange where their shares are to be listed, and the SEBI. Of these, the most important is the set of guidelines issued by SEBI in this context, termed as `SEBI (Disclosure and Protection of Investors) Guidelines. These are discussed in the unit to follow which deals with regulation of capital markets.

10.2.3 Importance and Growth

In developing countries like India plagued by paucity of resources and increased demand for investment by industrial establishments, the importance of primary capital market is self-evident in mobilising the savings of various sections of the population for investment in corporate securities. It enables the investors to make investment in securities conveniently and helps companies to raise long term funds without much difficulty. In other words, it facilitates the transfer of resources from savers to users. This accelerates the rate of capital formation and stimulates individual growth and economic development in the country.

The intermediaries and financial institutions participating in the primary capital market provide a variety of services to the corporate sector. These are : (i) provisions of underwriting facilities, (ii) assistance in promotion of companies, (iii) participation in equity capital, and (iv) providing expert advice on management of capital issues which includes choice of the class of security to be issued, price of the issue in view of the market conditions, timing and magnitude of the issue, and the method of floatation.

It also promotes investor education for small investors who learn to apply for shares in a company only after reviewing its track record and assessing its prospects and justification of the premium charged. Thus, it enables them to act as a knowledgeable investors.

It may be noted that since independence, the Indian capital market has been expanding fast and the volume of savings and investment has shown steady improvement. An important indicator of the growth of capital market is the growth in joint stock companies. In 1951 there were only 28,500 companies with a paid up capital of Rs. 775 crore, while in 2000 there were 70,000 companies with a paid up capital of Rs. 2,00,000 crore. The rate of growth of investment has also been phenomenal in recent years. The number of new capital issues by the corporate sector was 1,040 in 1992-93 and the amount raised was Rs. 19,803 crore. These figures were 1,678 and Rs. 26,417 crore in 1994-95. However, the market for new capital issues became sluggish in later years, but the year 1999-2000 saw its revival which is evident from the fact that IPOs of most companies were oversubscribed. It is particularly true of companies related to information technology, telecom and entertainment. The number of shareholders also ran into several millions which indicates the growth of equity cult.

The various factors which contributed to the phenomenal growth of the primary capital market in India have been : (1) establishment of specialised financial institutions like IFCI, ICICI, IDBI, IRCI, UTI, etc., (2) repeal of Capital Issues (Control) Act, (3) setting up of SEBI, (4) resource mobilisation by mutual funds, (5) increasing awareness of investment opportunities among the general public, and (6) setting up of credit rating agencies like CRISIL, ICRA and CARE.

Check Your Progress A

1 Define primary capital market.

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2 Name three intermediaries who form part of the primary capital market.

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3 Fill in the blanks

(a) The most common form of making a public issue of securities in through ....

(b) A public company can also raise its capital by placing the shares privately without inviting the ....for subscription of its shares or debentures.

(c) Book building implies collection of bids from the investors based on an .... price.

(d) The companies make ....issue of capital by making a rights offer to the ....shareholders

(e) Where a company sells shares or debentures en block to a financial institution or an issue house at an agreed price for resale to the public, the method of making fresh issue is called ....

10.3 THE SECONDARY CAPITAL MARKET

10.3.1 Nature

A secondary capital market popularly known as stock exchange or stock market provides a place where different types of existing securities (shares, debentures/ bonds and government securities) can be bought and sold on a regular basis A stock exchange is organised as an association, a society or a company with a limited number of members. It is open for transactions only to its members, most of whom are brokers acting as agents for the buyers and sellers of securities.

The Securities Contracts (Regulation) Act, 1956 defines stock exchange as an "association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in securities". According to K.L Garg, stock exchange is "an association of persons engaged in the buying and selling of stocks, bonds and shares for the public on commission and guided by certain rules and regulations."

Based on the above definitions, the chief characteristics of stock exchanges are :

1 It is an organised market.

2 It provides a place where the existing and approved securities (shares, debentures/bonds and government securities) can be bought and sold.

3 In a stock exchange, transactions take place between members or their authorised agents on their own behalf or on behalf of the investors.

4 All transactions are regulated by rules and bye-laws of the concerned stock exchange.

5 It makes complete information available to the public with regard to prices and volumes of transactions taking place every day.

It may be noted that only those securities can be traded on a stock exchange which have been duly approved for the purpose (listed) by the stock exchange authorities.

10.3.2 Functions

The stock exchanges play a very important role in the economic development of a country by virtue of the key functions they perform. These functions are enumerated hereunder.

1 **Provides ready and continuous market :** By providing a place where listed securities can be bought and sold regularly and conveniently, a stock exchange ensures a ready and continuous market for the existing shares, debentures / bonds and government securities. This lends a high degree of liquidity to holdings in

these securities because the investors can encash their holdings as and when they want.

2 **Provides information about prices and sales :** A stock exchange maintains complete record of all transactions taking place in different securities every day and supplies regular information on their prices and sales volumes to press and other media. In fact, now-a-days, you can get information on minute to minute movement in prices of selected shares on TV channels like CNBC, Zee Business, NDTV Profit and Headlines Today. This enables the investors in taking quick decisions on purchase and sale of securities in which they are interested. Not only that, such information helps them in ascertaining the trend in prices and evaluating the worth of their holdings as and when they want . This enables them to conveniently get the bank loans, if required.

3 **Provides safety to dealings and investment :** Transactions on the stock exchange are conducted only amongst its members with adequate transparency and in strict conformity with its rules and regulations which include the procedure and timings of delivery and payment to be followed. This provides a high degree of safety to dealings at the stock exchange and there is little risk of loss on account of non-payment or non-delivery. SEBI regulates the business in stock exchanges in India and monitors the working of the stock brokers. This reinforces the security of transactions at the stock exchanges. Not only that, a stock exchange allows trading only in securities that have been listed with it; and for listing any security, it satisfies itself about the genuineness and soundness of the company and provides for disclosure of certain information on regular basis. Though this may not guarantee the soundness and profitability of the company, it provides some assurance on their genuineness and enables them to keep track of their progress.

4 **Helps mobilisation of savings and capital formation :** Efficient functioning of stock market creates a conducive climate for an active and growing primary capital market. Good performance of various shares in the stock exchanges imparts buoyancy to the new issue market. This helps in mobilising savings for investment in industrial and commercial establishments for meeting their financial requirements without much difficulty. Not only that, the stock exchanges, by virtue of providing liquidity and safety to dealings and investments in shares and arranging investors' education, encourages the habit of saving, investment and risk-taking among the common people and creates an equity cult. This greatly helps mobilisation of savings for investment in corporate and government securities and contribute to capital formation.

5 **Barometer of economic and business conditions :** Volume of business and the prevailing prices in sock exchanges reflect the changing conditions and the economic health of a country as the shares prices are highly sensitive to developments in economic, social and political environment. It is observed that, during periods of economic prosperity, the share prices tend to rise. Conversely, prices tend to fall when there is economic stagnation or the business activities slow down as a result of depression. Thus, the intensity of trading at stock exchanges and the corresponding rise or fall in the prices of securities act as the barometer of the economic health and prevailing business conditions in a country.

6 **Better allocation of funds :** As a result of stock market transactions, funds flow from the less profitable to more profitable enterprises and those with greater potential of growth. Thus, the stock exchanges provide mobility to capital and facilitates sound investment and, in the process, the financial resources of the economy are better allocated.

10.3.3 Importance

Having discussed the functions of stock exchanges, let us now look at their importance from the point of view of (a) the companies, (b) the investors, and (c) the society as a whole.

For companies : (i) The companies whose securities have been listed on a stock exchange enjoy a better goodwill and credit standing than other companies because they are supposed to be financially sound. (ii) The market for their securities is enlarged as the investors all over the world become aware of such securities and have an opportunity to invest in them. (iii) As a result of enhanced goodwill and higher demand, the value of their securities increases and so does their bargaining power in collective ventures, mergers, etc. (iv) While raising additional capital, the decisions regarding the mix of securities to be issued, their quantities, their prices and the timings of their issue become quite convenient.

For investors : (i) They enjoy the facility and convenience of buying and selling the securities at will and at an opportune time. (ii) Because of the assured safety in dealings at the stock exchanges, the investors are free from any anxiety about the delivery and payment problems. (iii) Availability of regular information on prices of securities traded at the stock exchanges, helps them in deciding on the timing of their purchase and sale. (iv) It becomes easier for them to raise loans from banks against their holding in securities traded at the stock exchange because banks prefer them as collateral on account of their liquidity and convenient valuation.

For society : (i) Availability of lucrative avenues of investment and the liquidity thereof induces people to save and invest in long-term securities which leads to increased capital formation in the country. (ii) Facility for convenient purchase and sale of securities at the stock exchange provide an indirect support to new issue market which helps in promotion and expansion of industrial activity and contribute to increase in the rate of industrial growth. (iii) Stock exchanges facilitate reallocation of financial resources to more profitable and growing industrial units because investors can easily reshuffle their investment. (iv) Volume of activity at the stock exchanges and the movement in share prices reflect the prevailing economic health. (v) Since government securities are also traded at the stock exchanges, the government borrowing is highly facilitated.

Check Your Progress B

1 State four characteristic features of stock exchanges.

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2 How does stock exchange provide safety to dealings in securities.

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3 How do companies benefit from the existence of secondary capital market ?

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10.4 STOCK EXCHANGES IN INDIA

The first organised stock exchange in India was started in Mumbai in 1875 known as Bombay Stock Exchange (BSE). It was followed by Ahmedabad Stock Exchange in 1894 and Kolkatta stock Exchange in 1908. The number of stock exchanges in India went upto 7 by 1939 and increased to 21 by 1945 on account of heavy speculative activity during Second World War. A number of unorganised stock exchanges also functioned in the country without any formal set-up and were known as kerb market. The Securities Contracts (Regulation) Act was passed in 1956 for recognition and regulation of stock exchanges in India. Most of the stock exchanges that mushroomed were derecognised and the number of stock exchanges was reduced to 7 only. By 1980, there were 9 stock exchanges in the country. As at present, however, we have 24 recognised stock exchanges in India. Of these, 22 are regional stock exchanges and 2 are national levels stock exchanges viz., National Stock Exchange (NSE) and Over the Counter Exchange of India (OTCEI). Both are located in Mumbai.

NSE was promoted by the leading financial institutions in India. It was incorporated in 1992 and commenced operations in 1994. This stock exchange has corporate structure, fully automated screen based trading, and nation wide coverage. OCTEI was also promoted by the financial institutions like UTI, ICICI, IDBI, IFCI, LIC, etc. in September, 1992, specially to cater to small and medium sized companies with equity capital of more than Rs. 30 lakh and less than Rs. 25 crore, and help entrepreneurs in raising finances for their new projects in a cost effective manner. It provides nation wide offices in all major cities of the country. On this stock exchange, the securities of those companies can be traded which are exclusively listed at OTCEI only. In addition, certain shares and debentures listed with other stock exchanges in India and the units of UTI and other mutual funds are also allowed to be traded at OCTEI as permitted securities. However, of late, turnover at this stock exchange has considerably reduced and steps have been afoot to revitalize it.
It may be noted that the two stock exchanges which actually enjoy nation wide coverage and handle most business in securities in the country are BSE and NSE.

In fact, ever since screen based and online trading have been introduced and regular information on all relevant development and movement of prices is available on TV channels, the distance has become irrelevant and so most clients prefer dealings at NSE and BSE. As a result, most regional stock exchanges have little business to handle.

10.5 LISTING OF SECURITIES

As stated earlier, all securities issued by companies and other bodies are not traded on the stock exchanges. Only those securities can be traded on a particular stock exchange which have been duly approved for the purpose i.e., listed on that stock exchange. Listing thus implies admission of securities of a company to dealings on a stock exchange. In other words, if a joint stock company or any other body wants its securities to be traded on a stock exchange and their prices duly published, it has to get the securities included in the list of the stock exchange. For listing, the company has to make an application and furnish the prescribed information to the stock exchange. Section 19(2) of the Securities Contracts (Regulation) Rules, 1957 lays down the minimum requirement with respect to listing of securities on a stock exchange. Moreover, every recognised stock exchange has the powers to make its own rules and bye-laws for the listing of the securities, suspension or withdrawal of securities subject and the prohibition of trading in any specified security to Central Government/SEBI approval. The basic eligibility criteria for listing of securities of a company are : (i) minimum issued equity capital should be Rs. 5 crore (Rs. 3 crore where trading is screen based and (ii) minimum public offer of equity capital shall not be less than 25% (10% if certain conditions are satisfied).

It may be noted that normally it is not obligatory for a company to get its shares listed on a stock exchange. But, according to Section 73(1) of the Companies Act, 1956 (as amended in 1988) to every company intending to offer shares or debentures to the public or subscription by issue of a prospectus shall, before such issue, make an application for listing of security to one or more recognised stock exchanges for permission for the securities intending to be so offered to be dealt with in the stock exchanges, and the information that permission has been obtained from the stock exchange or that an application has been made or will be made, shall be mentioned in the prospectus. Not only that, it may become mandatory for a company when the Central Government / SEBI requires a company to do so under Section 21 of the Securities Contracts (Regulation) Act, 1956 or when a public financial institution stipulate a condition to the loan for the borrowing company to have its securities listed on any recognised stock exchange.

The basic advantages of listing of securities are :

1 It improves public image of a company and enhances its prestige and creditworthiness.

2 It provides a continuous market for its securities and thus adds to their liquidity.

3 Banks and other financial institutions readily extend loan facilities to the company and so also to investors on the strength of such securities.

4 It ensures disclosure of important financial information about the company on a regular basis.

5 It leads to wide distribution of shares which helps in mobilisation of resources in future by way of further issues.

However, listing of securities does not guarantee the financial soundness or profitability of the company. It only indicates that at the time of listing the company was legally incorporated, met the stock exchange requirements for listing, and will continue to provide the requisite financial results to stock exchange and the investors at regular intervals.(quarterly). This creates a favourable climate for the listed securities.

10.6 TRADING

Only a member can transact business on a stock exchange either on his own behalf or on behalf of his clients. According to Section 13 of the Securities Contracts (Regulation) Act, all contracts in notified area (other than spot delivery contracts) entered into otherwise than between members of a recognised stock exchange or through a member of such stock exchange or with a member of such stock exchange are to be treated as illegal contracts. .As for persons dealing in securities in areas other than notified areas (whether on his own behalf or on behalf of any other person) is required to obtain a licence from SEBI in this behalf. SEBI (Stock Brokers and Sub-brokers) Rules, 1992 further provide that no person can act as a stock broker unless he holds a certificate granted by SEBI.

The stock exchanges have trading floors where buying and selling of securities take place. The member or his authorised clerk goes to the floor of the stock exchange to make his own quotation of purchase or sale of the security to the other member or his authorised clerk. The price acceptable to both the parties closes the bargain, and the authorised clerks make a note of the transaction in a small notebook called a day book or rhopri. The details of the business transacted during the day are entered into the Sauda Book from the day book and a copy sent to the stock exchange. Alongside, the contract notes in the prescribed form are prepared and sent to the clients. The contract note gives full details of scripts bought and/or sold, the prices at which transaction took place, and the brokerage charged.

The trading that takes place on the floor of the stock exchange called `open outcry system'; resembles an auction as members trying to sell strive to obtain the highest price possible while those trying to buy strive to obtain the lowest price possible through bid and offer strategy. When members announce their intention to buy or sell a certain number of shares of a company, they receive bids or offers from other members and accept the most suitable bid or hold until an acceptable bid is offered. It may be noted that transactions are facilitated by market makers who stand ready to buy or sell specific securities in response to customers orders. Liquidity of stock market is enhanced by market makers because they are required to make a market at all times in an effort to stablise prices. Whereas the brokers at the stock exchange match buyers and sellers, the market makers serve not only as brokers but also as investors.

The open outcry method of trade matching by calling out bids and offers in trading ring has been used for centuries. However, this physical order matching by them is now being replaced by screen based system whereby the participants can trade through the computer network. This has enabled a large number of participants spread through the country, at high speeds, with greater transparency and low costs. In fact, the NSE and OTCEI were set up with screen based system only and most stock exchanges in India have already switched over to the screen based trading popularly known as online trading. Not only that, the high penetration of computer and internet connections has contributed immensely to the drastic increase of online trading. Of late, internet based trading facility has also been allowed which enables the clients to buy and sell shares through the stock broker's website. This had made the transactions virtually paperless as the client's trading account is linked to his demat and bank accounts. It also ensures smooth transaction process and eases the normal procedure of a settlement in quick time as the process of issuing a delivery note in the case of a sale, or arranging payment in case of a purchase, is all taken care of the minute the order is executed. However, in terms of volumes, the internet based trading currently accounts for just 10-12% of trading at BSE and NSE. It is just the beginning as far as internet based trading goes. Increasing connectivity and awareness shall certainly lead to its further growth.

Check Your Progress C

1 State the circumstances under which listing becomes obligatory for a company.

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2 What do you mean by open outcry method of trading at the floor of the stock exchange. Is it still prevalent ?

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3 How does a market maker facilitate the transaction in securities the stock exchanges ?

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4 Which of the following statements are **True** or **False.**

(a) Every recognised stock exchange has the powers to make bye-laws for listing of securities or prohibition of trading in any security subject to Central Government /SEBI approval.

(b) Listing of securities on a stock exchange ensures the financial soundness and profitability of the company.

(c) The NSE and OTCEI have only the screen based system of trading.

(d) The `internet based trading' which enables the clients to buy and sell shares or debentures through the stock brokers web-site and `online trading' mean one and the same thing.

(e) In addition to the securities exclusively listed at OCTEI, certain shares and debentures listed with other stock exchanges in India and the units of mutual funds are also allowed to be traded at OCTEI.

(f) BSE, NSE and OCTEI are all located at Mumbai.

10.7 SETTLEMENT

Settlement involves the delivery of securities and the payment of the amount due. Earlier, in every stock exchange a particular day had been fixed for the settlement of transactions between buyers and sellers. This day could be every Monday or every Saturday of the week. In other words, settlement was done on weekly basis. During a settlement period, the buying and selling transactions in a particular share could be squared up and, at the end of the settlement period, settled on a net basis. Since the settlement period was 7 days and the settlement was for the net position, most of the transactions were squared up within the settlement period by payment of price differential.

From settlement point of view, the contracts relating to the purchase and sale of securities have been of three types as follows :

1 **Spot delivery contracts :** Such contracts are settled on the spot i.e., the delivery and payment made on the day of the transaction itself or latest by the following day This, however, has not been a common practice.

2 **Ready delivery contracts :** Such contracts are settled within a short period of time. The settlement takes place on the following settlement day and no postponement is allowed.

3 **Forward delivery contracts :** Such contracts are also due for settlement on the following settlement day but they can be postponed to the next settlement day, if so desired, on payment of the necessary charges. This facility is provided by the stock exchanges only in case of transactions in scrips that are included in the specified list (List A), and not in case of other securities.

10.7.1 Budla System and Derivatives

The settlement system in specified securities providing for carry forward of transactions from one settlement day to another has been known as budla system and the charges paid for carry forward termed as budla charges (contango or backwardation) the amount of which depended upon the class of security, its quantity, the amount involved and the interest rate prevailing in the market at the time of the transaction. All along, it had been felt that this system led to excessive speculation and, at times, to certain malpractices like price rigging, evasion of margins, and non-reporting of transactions. Hence, **it was abolished in December, 1993**. This led to a halt in trading of specified securities with carry over facilities and sharp decline in turnover on the stock markets resulting in a liquidity crunch. So, efforts were made to reintroduce the system in its revised and modified form subject to certain conditions and precautions. But, somehow, they did not click because of the inherent weaknesses of the system and a clamour for adopting other risk hedging devices. The experts preferred equity derivatives, in the form of futures and options as prevalent in advanced countries. As a result, in June 2000, index futures were launched at BSE and NSE followed by its other variants like index options, stock futures and stock options. It may be noted that NSE accounts for more than 90 per cent of India's equity derivatives volume which is largely due to its effective monitoring, surveillance, netting timely settlement and minimisation of settlement risks with the help of National Securities Clearing Corporation Ltd. (SSCCL) which offers high quality risk mitigation in settlement.

It may be noted that options are not all like budla. An option refers to a contract which gives the investor (its holder) a right, not the obligation, to buy or sell the specified quantity of a share at a specified price on or before a specified time called expiry date. However, future may seem like budla to some as just like a forward contract, it is a contractual obligation to buy or sell a standard quantity of a share at an agreed price at a future date. But, unlike budla where cash market and all future prices are mixed up in one price, the future markets trade differ from the cash market sc that each future prices and cash prices are different. Future markets, also do not have any counter party risk through the institution of the clearing house which guarantees the trade coupled with margining. This eliminates the risk premium which is embedded inside budla financing charges. Moreover, in case of budla expiration date is unclear moving from one settlement date to another, while in case of futures the expiration date is predetermined and the holder is under obligation to settle the transaction.

10.7.2 Depository System

Another important reform introduced meanwhile in respect of settlement of trades has been the introduction of delivery through electronic book entry facilitated by depositaries. Traditionally, trades have been settled by physical delivery of securities. This implies that the securities have to physically more from the seller to the seller's brokers, from seller's brokers to the buyer's broker (through the clearing house of the exchange or directly), and from buyer broker to the buyer. Then the buyer has to lodge the securities with the transfer agents of the company for getting them transferred in his name, and the process of transfer would take 2 to 3 months. This system involved huge paper work, high costs and long time. With introduction of holding securities in dematerialised (demat) form with the depositories, the transfer takes place by means of electronic book entries. It began with the establishment of National Securities Depositories Ltd., (NSDL), India's first depository, in 1996. It has helped elimination of all risks associated with physical certificates, no stamp duty, immediate transfer and registration of securities, and faster settlement cycle. Most companies worth the name have now provided for holding of their shares with depository participant in demat form. SEBI guidelines on public issue of capital issue require that, to make a public or right issue or an offer for sale of securities, it must enter into an agreement with a depository. This had made trading and settlement paperless, convenient, fast, safe and economical.

10.7.3 Rolling Settlement

For the capital market, rolling settlement is the next big landmark, after dematerialisation. A small beginning was made in December 1999 with rolling settlement introduced in 10 scrips. A rolling settlement refers to a system in which trades outstanding at the end of the day have to be settled at the end of the settlement period. In a T + 5 rolling settlement, for example, a transaction entered into on Monday, has to be settled on fifth working day after Monday i.e., on the following Monday. Similarly, a transaction entered into on Tuesday shall be settled the following Tuesday. This is in contrast with the account period settlement, the earlier practice, where positions are accumulated / squared up in a weekly cycle i.e., the transactions made on any of the five trading days, whether on Monday or on Tuesday, are permitted to be squared up and settled on the settlement day which may be Saturday or the following Monday, as the case may be. **It may be noted that the account period settlement has been discontinued since January 1, 2002 as per SEBI directive.** Rolling settlement in India started with T + 5 cycle which was later changed to T + 3 and ultimately to T + 2 with effect from April 1, 2003. This implies that, as of now, trades executed on Monday shall be settled on Wednesday (considering 2 working days from the trade day) when the pay-in and pay-out shall take place on the basis of the net obligation for the day. Pay-in means the payment or delivery of securities by the broker to the stock exchange, and pay-out means the payment and delivery of securities by the exchange to the broker. The exchanges have to ensure that payout of funds or delivery of securities to the client is done by the brokers within 24 hours of the pay-out.

Apparently, the rolling settlement requires electronic transfer of securities and funds which has been made possible by the introduction of depositories, computer network and internet connectivity and the system has been a great success.

Thus, now a days, only ready delivery contracts are in operation, budla system providing for carry forward of settlement has been replaced by trading in derivatives (futures and options), delivery is by book entries and settlement is rolling on T + 2 basis.

10.8 SPECULATION AND STOCK EXCHANGES

The word 'speculation' is derived from the Latin word 'speculate' which means to see from a distance or take a decision in anticipation of future happenings. However, in the context of share market, it means dealing in securities keeping in view the present and future prices with the object of making profit from the difference in the two prices. In the words of Emery, "Speculation consists of buying and selling commodities or securities or other property, in the hope of a profit from anticipated changes of value".

Speculative transaction is different from an investment transaction. While an investment transaction is based upon thorough analysis, promises safety of principal and a satisfactory return, Speculative transaction is based on limited analysis and involved high risk. Most often buyers and sellers at the stock exchange go in for both types of transactions. Some buy securities primarily to earn a regular income from such investment and possibly make some long term gain on account of price rise in future. They take delivery of the securities and make full payments of the price. Such transactions are investment transactions. But, many of them buy them with the sole object of selling them in future at higher prices, or sale now with the intention of buying at a lower price in future, are speculative transactions. The main objective of such transactions is to take advantage of price differential at different times. The stock exchanges also facilitate such transactions by allowing their squaring up i.e., the settlement of transactions by receiving or paying, as the case may be, just the difference in prices. For example, A bought 200 shares of Moser Baer Ltd at Rs. 210 per share and sold them at Rs. 235 per share. He does not take and give delivery of the shares, and settles the transactions by receiving the difference in prices amounting to Rs. 5,000 (25 X 200) minus brokerage. In another case, R bought 200 shares of Seshasayee Papers Ltd. at Rs. 87 per share and sold them at Rs. 69 per share. He settles these transactions by simply paying the difference in prices amounting to Rs. 3,600 (18 X 200) plus brokerage. However, now-a-days, under the system of rolling settlement, such facility is limited only to transactions of purchase and sale of a security made on the same day as no carry forward is allowed.

Though speculation and investment are different in some respects but, in practice, it is difficult to say who is a genuine investor and who is a pure speculator. Sometimes even a person who purchased the shares as a long term investment may suddenly decide to sell them to reap the benefit if the price of the shares goes up too high or he may do so to avoid heavy loss if the prices starts declining steeply. But, he cannot be called a speculator because his basic intention has been to invest. It is only when a person's basic intention is to take advantage of a change in prices, and not to invest, that the transaction may be termed as speculation. In strict technical terms, however, the transaction is regarded speculative only if it is settled by receiving or paying the difference in prices without involving the delivery of securities. It is so because, in practice, it is quite difficult to ascertain the intention.

It may be noted that speculation is duly recognised by law and is considered a prerequisite for the success of stock exchange operations. In fact, no stock exchange can operate on the basis of investment buying alone as pure investors cannot provide the requisite volume of business and the necessary liquidity to securities. However, excessive and reckless speculation degenerates into gambling and often leads to wide fluctuation in prices, market manipulations and malpractices by the vested interests.

This adversely affect the interest of genuine investors and cause considerable damage to their confidence in dealings at the stock exchanges. Harshad Mehta and Ketan Parekh episodes are still fresh in the memory of many investors who suffered heavily and are highly scared to stage a comeback. Hence, good amount of vigilance and control has to be exercised over stock exchange operations by the stock exchange authorities and the government. **As a matter of fact, excessive speculation is not the only problem area relating to stock exchange operations, there are many other negative features that have continued to plague the stock market. This led to strict control and regulation of capital market in India. This aspect shall be discussed in detail in Unit 11 to follow.**

Check Your Progress D

1 What is forward delivery contract ?

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2 State four advantages of holding shares in demat form.

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3 Tick Mark the correct answer.

(a) Prior to introduction of rolling settlement, the settlement on BSE and NSE was done on
   (i) fortnightly basis
   (ii) weekly basis
   (iii) monthly basis

(b) Budla system has been replaced by
   (i) trading in equity derivatives
   (ii) rolling settlement
   (iii) depository system

(c) Transfer of securities in demat form takes place through
   (i) transfer deed
   (ii) hand delivery
   (iii) electronic book entries

(d) Under T + 2 rolling settlement, for transactions made on Monday the pay-in and pay-out shall take place on
   (i) Wednesday
   (ii) Thursday
   (iii) Wednesday and Thursday respectively

(e) Normally, for a stock exchange operations, speculation is considered
   (i) harmful
   (ii) a pre-requisite for its success
   (iii) irrelevant to its success

(f) Index futures were launched at BSE and NSE in
   (i) April, 2003
   (ii) December, 1999
   (iii) June, 2000

10.9 RECENT DEVELOPMENTS

In the post-reform phase i.e., the period after 1991, the Indian stock market has witnessed a transformation and is firmly on the road to renewed growth. It is now placed among the mature securities market in the world. In fact, the constitution of SEBI heralded a new era in the Indian capital market with its heavy agenda to protect investors' interest and promote and regulate the stock market. Since 1995-96 SEBI has been showing a reformist will in more than one way. Several reform measures in conjunction with stock exchange authorities were introduced. These are summarised as follows.

1 Budla system has been replaced by trading in futures and options.

2 The establishment of depositories and introduction of delivery in demat form has made trading and settlement convenient, fast and economical. This has also enhanced the efficiency of the trading cycle.

3 Introduction of rolling settlement with T + 2 cycle has reduced the settlement period resulting in fast payout and delivery to clients

4 BSE transformed itself into a corporate entity from being a brokers' association in August, 2005.

5 The introduction of screen based and online trading has added to transparency and speed in conducting the transactions.

6 The governments has allowed foreign institutional investors (FIIs), pension funds, mutual funds, investment trusts, asset portfolio investment companies to invest in the Indian capital market.

7 SEBI has started the process of registration of intermediaries such as stock brokers, sub-brokers, share transfer agents, merchants bankers, etc. based on certain capital adequacy, and infrastructure norms.

8 SEBI has notified regulation on insider trading to protect and preserve the integrity of the stock markets and help investors' confidence in dealings at the stock exchanges.

9 The facility of buy back of securities has been subjected to regulations and guidelines laid down by SEBI.

10 National Securities and Cleaning Corporation has been set up which guarantees all trades at NSE. It has freed every trade from the risk of counterparty defaulting and payment crisis.

11 SEBI approved the establishment of Central Listing Authority for centralising the listing function that currently takes place at the exchange level.

12 A division has been set up within SEBI to monitor unusual movements in prices in coordination with all the stock exchanges which are required to set up surveillance departments.

13 The major stock exchanges are required to set up Investor Information Centres and educate the investors about their rights and obligations

14 SEBI has launched the Electronic Data Information Filing and Retrieval System (EDIFRS) website aimed at providing one point access to key information on all listed companies.

15 Empowerment of SEBI to regulate takeovers and its adoption of the modified takeover code has made the takeover process more transparent and ensures the protection of the minority shareholders' interests.

16 SEBI has changed the management structure of stock exchanges which were stock brokers dominated. Now, 50 per cent of the directors are nonbrokers. It is further mandated that a non broker professional be appointed as the Executive Director.

17 The process of book building has been introduced for initial public offers of shares which has not only reduced the costs of public issues but also the time taken for completion of the issue process.

18 SEBI has allowed private placement of listed securities to qualified institutional buyers (QIBs) which will not have any lock-in period.

The institutional changes effected in the Indian capital market in the post reform phase as outlined above have undoubtedly enhanced investors' confidence and helped the market to grow strong in recent years. The stock market which had remained subdued since February 2000, recorded a substantial rally in 2003. The BSE Sensex crossed the 4,000 mark in the August 2003, touched the 6,100 mark in January 2004 and has been hovering around 9,000 plus by the end of 2005.

10.10 LET US SUM UP

Capital market signifies the institutional arrangement for raising long-term funds and providing facilities for marketing and trading of securities. It consists of two parts, primary market and secondary market. While the primary market deals with fresh issue of securities, the secondary market provides facilities for purchase and sale of existing securities.

The primary market is also known as new issue market which acts as a mechanism for raising long-term funds with the assistance of various intermediaries like merchant bankers, underwriters and stock brokers who form an integral part of the primary market. The methods usually adopted for making fresh issue are : public issue through prospectus, offer for sale, private placement, and book building. For further issue of capital, the company can also go in for rights issue to the existing shareholders.

The importance of primary market is self-evident in mobilising the savings for investment in corporate securities. This accelerates the rate of capital formation and stimulates the industrial growth and economic development in a country. Since independence, the Indian capital market has been expanding fast. This has been made possible by the establishment of various financial institutions, setting up of SEBI and increasing awareness of investment opportunities among the public.

The secondary capital market is popularly known as stock exchange or stock market which provides a place where the existing and approved securities like shares, debentures and government securities can be bought and sold duly guided by certain rules and regulations. It provides a ready and continuous market lending a high degree of liquidity to holdings in securities and ensures safety to dealing. A stock exchange maintains a complete record of all transactions, and supplies regular information on prices and sales volumes. This helps the investors' in investment decisions and evaluation of the worth of their holdings. The volume of business and the trend in prices at the stock market also reflect the prevailing business conditions and the economic health of a country. In fact, the stock exchanges offer many advantages to the investors, the companies and the society at large.

At present, there are 24 stock exchanges in India. Of these, 22 are regional stock exchanges and 2 are national level stock exchanges viz., OCTEI and NSE. The OCTEI has its offices all over the country and caters only to small and medium sized companies that are exclusively listed with it. Ever since screen based online trading has been introduced, the investors prefer dealings at NSE and BSE which now handle most business in securities in the country.

Only those securities can be traded on a particular stock exchange which have been duly approved (listed) for the purpose. In order to get its shares listed on a stock exchange, the interested company has to make a formal application and meet the eligibility criteria and other requirements laid down by SRC Rules and the Bye-laws of the stock exchange concerned. The trading on a stock exchange can be conducted only by members of the stock exchange who can act on their own behalf or on behalf of their clients. SEBI (Stock Brokers and Sub-brokers) Rules further provide that any person acting as stock broker has to get himself registered and hold a certificate granted by SEBI.

All along, for trading at the stock exchanges, the physical order matching by calling out bids and offers in the trading ring has been used. But, it has now been replaced by screen based online trading. In fact, by virtue of high penetration of computers and introduction of dematerialisation of securities, the trading, has become literally paperless and eased the normal procedure of a settlement in quick time.

The settlement process at the stock exchanges involves delivery of securities and the payment due, which had been taking place on weekly basis with a fixed settlement day. The traditional settlement system provided for the carry forward of transactions in specified securities from one settlement day to another, popularly known as Budla. However, this system led to excessive speculation and certain malpractices at the stock exchanges to the detriment of the genuine investors. This resulted in its replacement by trading in equity derivatives in the form of futures and options. Another important reform introduced in respect of settlement has been the introduction of delivery through electronic book entries facilitated by depositories. The adoption of rolling settlement with T + 2 cycle in place of the 7-day account period settlement has been the next landmark. Thus, trading and settlement at stock exchanges has become highly convenient, safe and economical. In fact, in the post-reform phase i.e., the period after 1991, several other reformist measures have been introduced which have transformed the Indian stock market and put it firmly on the road to renewed growth.

10.11 KEY WORDS

Backwardation : Budla charges (udha badla) paid by a short seller against his sale to seek postponement of the transaction to the next settlement date. In the context of futures, it refers to a situation when the spot price is greater than the futures price.

Bid and Offer : Bid is the price of a share a prospective buyer is prepared to pay for a particular scrip, and offer is the price at which a share is offered for sale.

Book Building : A process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built up, and price for such securities is assessed.

Broker Dealer : A member of the stock exchange who is licensed to buy or sell securities on his own behalf.

Budla : Carry forward of a transaction from one settlement day to another on payment of some charges known as budla charges based on the value of the securities involved.

Contango : Budla charges (vyaj budla or seedha budla) paid to the seller for carrying forward a transaction of purchase of shares to next settlement based on the value of securities and the interest rate rates prevailing in the market.

Dematerialisation : The process by which securities in the physical form are cancelled and credit in the form of electronic balances are maintained at the depository.

Derivatives : The products or instruments whose values depend on the value of underlying assets which could be a stock index, a foreign currency, a commodity or an individual stock (equity share). Thus, when the underlying asset is equity share it is called equity derivative.

Futures : These are contractual obligations to buy and sell at an agreed price at a future date just like a forward contract. The contract terms are standardised by future exchanges and the obligation from both buyer and seller is confirmed when the initial deposit or margin changes hands.

Insider Trading : Trading in a company's share by a person having non-public (confidential) price sensitive information such as expansion plans, financial results, takeover bids etc. by virtue of his association with that company.

Kerb-market : Unofficial trading in securities outside the recognised stock exchange or after normal trading hours of the stock exchange.

Margin : A deposit made by a client with the broker to cover the anticipated loss and default risk.

Market Maker : Dealers who, unlike the general financial intermediaries, primarily act as principals buying and selling specific securities on their own account at all times in an effort to stablise prices in the market. They offer two way quotes for buying and selling and are rewarded through bid-offer spread i.e., the difference between the bid price at which they will buy a security and the higher offer price at which they will sell it.

Merchant Banker : An entity registered under SEBI (Merchant Bankers) Regulation, who float fresh securities on behalf of the companies or underwrite them, and act as managers to the issue undertaking issue management and advisory services.

Offer for Sale : An arrangement whereby a company allots or agrees to allot shares or debentures at a price to the financial institution or an issue house for sale to the public.

Open Outcry System : A system which resembles an auction where members trying to sell strive to obtain the highest possible price while those trying to purchase, strive to obtain the lowest price possible price through bid and offer strategy at the floor of the stock exchange.

Options : A contract which gives the holder the right to, but not the obligation, to buy or sell specified quantity of the underlying assets at a specified (strike) price on or before a specified time (expiration date). When the underlying asset is equity share, it is called stock option, and when it is stock index it is called index option.

Price Rigging : When a person or persons acting in concert with each other collude to artificially increase or decrease the prices of a security, the process is called price rigging.

Private Placement : The direct sale of securities between an issuer and an investor usually a financial institution, without using regular channels of capital market.

Qualified Institutional Buyer (QIB) : It refers to public financial institutions, scheduled commercial banks, mutual funds, foreign institutional investors, venture capital funds, multinational development financial institutions, and state industrial development corporations.

Screen based Trading : When buying and selling of securities is done using computers and matching of trades is done by a stock exchange computer.

Underwriter : An individual or an institution guaranteeing procurement of subscription, in part or in full, of a securities issue made to the public. If these are not taken by the public, they themselves take them up to the extent they are not subscribed by the public.

Squaring up : Settlement by a counter transaction and paying or receiving the amount based on the difference in prices.

10.12 ANSWERS TO CHECK YOUR PROGRESS

A	3	(a) prospectus (b) public (c) indicative (d) further, existing (e) offer for sale
C	4	(a) True (b) False (c) True (d) False (e) True (f) True
D	3	(a) – (ii) (b) – (i) (c) – (iii) (d) – (i) (e) – (ii) (f) – (iii)

10.13 TERMINAL QUESTIONS

1 Define stock exchange and describe its key functions.

2 Discuss the importance of stock exchanges for (a) the investors, (b) the corporate sector, and (c) the society.

3 What do you mean by listing of securities on a stock exchange ? State its advantages from the point of view of a company and an investor.

4 Describe the traditional method of trading on a stock exchange, and explain how has online trading improved the system of purchase and sale of securities and the settlement of transactions.

5 Distinguish between

(a) Primary Capital Market and Secondary Capital Market

(b) Speculative Transaction and Investment Transaction

(c) Budla System and Equity Derivatives

6 What are the three types of contracts allowed on stock exchange for the purchase and sale of securities from the settlement point of view? What is their position as at present ?

7 (a) Explain the depository system.

(b) What do you mean by rolling settlement ? Explain it with the help of an example.

8 What do mean by speculation? Do you consider it necessary for the success of stock exchange operations ? Give your views.

9 Write short notes on the following

(a) Importance of Primary Capital Market

(b) Stock Exchanges in India

(c) IPO through Book Building Process

Note :	These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the university for assessment. These are for your practice only.