



STUDY NOTE - 1

INTRODUCTION OF CAPITAL MARKET & CAPITAL MARKET INSTRUMENTS

This Study Note includes

- Introduction
- Financial System and Capital Market Instruments
- Capital Market/ Security Market
- Primary Market/ New Issue Market/ IPO Market
- Secondary Market/ Stock Market/ Stock Exchange
- Depositories
- Private placement of Shares/ Buy back of Share
- Forward Contract and Future Contract
- Issue Mechanism
- Clearing Mechanism and Settlement Cycle
- Stock Market Indices

1.1 INTRODUCTION

Financial market is a place or a system where financial assets or instruments are created and exchanged by market participants. Financial markets play a significant role in performing the resource management in an economy. They help capital creation by acting as a bridge between the savers and the spenders through various financial instruments like equity, debt or a mix of both. In the process it facilitates price discovery and providing liquidity for financial assets.

In every economic system, some units which may be individuals or institutions, are surplus-generating (savers) while others are deficit units (spenders). Savers can either invest or hold their savings in liquid cash. Holding liquid cash is required to meet transaction or precautionary or speculative needs. The surplus-generating units could invest in different forms. They could invest in physical assets viz. land and building, plant and machinery or in precious metal viz. gold and silver, or in financial assets viz. shares and debentures, units of the Mutual Funds, treasury bills, commercial papers, etc.,

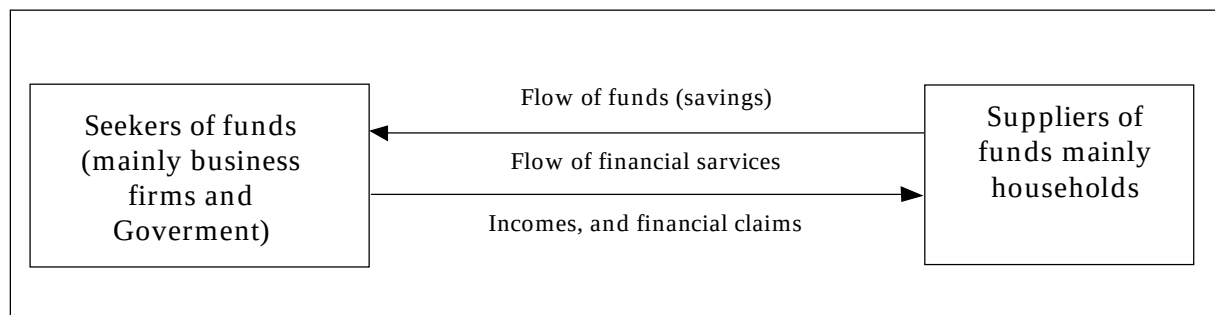


The financial assets are also called financial claims or financial securities or paper assets. These financial securities are issued by deficit units in exchange for their savings. It is this reason that surplus-generating units are called investors while deficit units are called issuers. These investors and issuers of financial securities constitute two important elements of the securities market. The third critical element of markets is the intermediaries who act as conduits between the investors and issuers. Regulatory bodies, which regulate the functioning of the securities markets, constitute the last but very significant element of securities markets. Thus, there are four important elements of securities markets namely investors, issuers, intermediaries and regulators. Now depending upon the nature of the relationship among these elements of securities markets, the markets are classified as primary and secondary. Further, depending upon the time, the markets are classified as short term and long term and depending upon the issuers, these are classified government securities or corporate securities. Government securities are also called gilt-edged securities. To pick up the right kind of securities, an investor or a portfolio manager should be fully conversant with the different segments of securities markets, different types of securities which are traded and different trading arrangement which exist in the market. In this unit, we shall distinguish between primary market and secondary market securities and discuss various traded securities and trading arrangements prevalent in India. Let us begin distinguishing primary and secondary markets.

1.2. FINANCIAL SYSTEMS AND CAPITAL MARKET INSTRUMENTS

The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate sector, government and household sector. While performing their activities these units will be placed in a surplus/deficit/balanced budgetary situations. There are areas or people with surplus funds and there are those with a deficit. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

Financial System;



The word “system”, in the term “financial system”, implies a set of complex and closely connected or interlinked institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation. These are briefly discussed below;

FINANCIAL MARKETS

A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset. Financial Assets or Financial Instruments represents a claim to the payment of a sum of money sometime in the future and /or periodic payment in the form of interest or dividend.

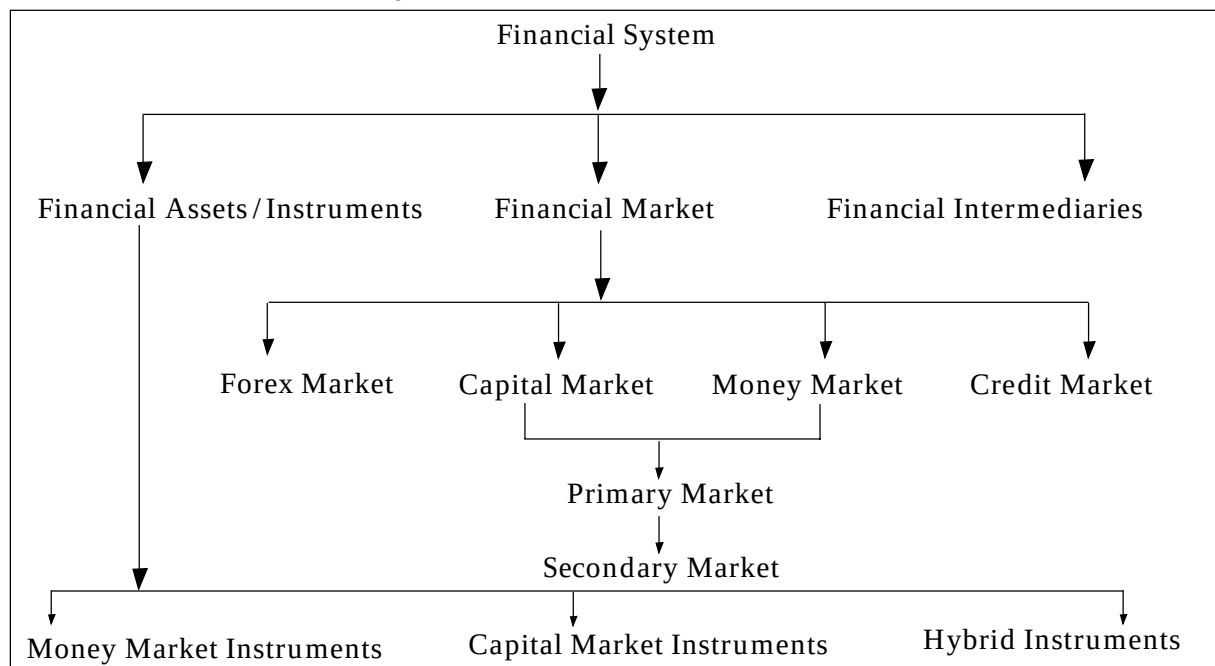
Money Market- The money market as a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

Capital Market - The capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.

Forex Market - The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe.

Credit Market- Credit market is a place where banks, FIs and NBFCs purvey short, medium and long-term loans to corporate and individuals.

Constituents of a Financial System





The Indian financial sector has two broad segments –Organized and Unorganized. The organized segment includes commercial banks, development financial institutions, insurance companies and other non-banking financial institutions including mutual funds, unit trusts, etc. The unorganized sector of the Indian financial market consists mainly of Indigenous bankers, money lenders, Nidhi's and chitfunds. The organized and the unorganized sector consist of the money market, debt market and the capital market. Money market is a mechanism through which short term funds are loaned and borrowed. The money market instruments comprise of call money, certificate of deposits CD, commercial paper, mutual funds, commercial bills, and treasury bills.

The capital market comprises of the primary market and the secondary. The primary market helps both corporate and the government raise funds by issuing securities. The secondary market through continuous trading activities, provide liquidity in the system. It is also a reflection of the changing mood and perception of investors. Mutual funds play an important role in both markets and strengthen the transfer mechanism.

FINANCIAL INTERMEDIATION

Having designed the instrument, the issuer should then ensure that these financial assets reach the ultimate investor in order to garner the requisite amount. When the borrower of funds approaches the financial market to raise funds, mere issue of securities will not suffice. Adequate information of the issue, issuer and the security should be passed on to market place. There should be a proper channel within the financial system to ensure such transfer. To serve this purpose, **Financial intermediaries** came into existence. Financial intermediation in the organized sector is conducted by a wide range of institutions functioning under the overall surveillance of the Reserve Bank of India. In the initial stages, the role of the intermediary was mostly related to ensure transfer of funds from the lender to the borrower. This service was offered by banks, FIs, brokers, and dealers. However, as the financial system widened along with the developments taking place in the financial markets, the scope of its operations also widened. Some of the important intermediaries operating in the financial markets include; investment bankers, underwriters, stock exchanges, registrars, depositories, custodians, portfolio managers, mutual funds, financial advisors, financial consultants, primary dealers, satellite dealers, self regulatory organizations, etc. Though the markets are different, there may be a few intermediaries offering their services in more than one market e.g. underwriter. However, the services offered by them vary from one market to another.

Intermediary	Market	Role
Stock Exchange	Capital Market	Secondary Market to securities
Investment Bankers	Capital Market, Credit Market	Corporate advisory services, Issue of securities
Underwriters	Capital Market, Money Market	Subscribe to unsubscribed portion of securities
Registrars, Depositories, Custodians	Capital Market	Issue securities to the investors on behalf of the company and handle share transfer activity
Primary Dealers Satellite Dealers	Money Market	Market making in government securities
Forex Dealers	Forex Market	Ensure exchange in currencies

DEFINITION OF CAPITAL MARKET

- It is a place where people buy and sell financial instruments be it equity or debt.
- It is a mechanism to facilitate the exchange of financial assets.

Examples of capital market

In India – BSE & NSE are the two most active Stock Exchanges constituting majority of the capital market transactions.

International - NYSE, LSE & TSE are the major Stock Exchanges.

FINANCIAL INSTRUMENTS

(A) Money Market Instruments

The money market can be defined as a market for short-term money and financial assets that are near substitutes for money. The term short-term means generally a period upto one year



and near substitutes to money is used to denote any financial asset which can be quickly converted into money with minimum transaction cost.

Some of the important money market instruments are briefly discussed below;

1. **Call/Notice Money**
2. **Treasury Bills**
3. **Term Money**
4. **Certificate of Deposit**
5. **Commercial Papers**

1. Call /Notice-Money Market

Call / Notice money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and /or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is “Call Money”. When money is borrowed or lent for more than a day and up to 14 days, it is “Notice Money”. No collateral security is required to cover these transactions.

2. Inter-Bank Term Money

Inter-bank market for deposits of maturity beyond 14 days is referred to as the term money market. The entry restrictions are the same as those for Call / Notice Money except that, as per existing regulations, the specified entities are not allowed to lend beyond 14 days.

3. Treasury Bills.

Treasury Bills are short term (up to one year) borrowing instruments of the union government. It is an IOU of the Government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue (14/91/182/364 days i.e. less than one year). They are issued at a discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

4. Certificate of Deposits

Certificates of Deposit (CDs) is a negotiable money market instrument issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by (i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI. Banks have the freedom to issue CDs depending on their requirements. An FI may issue CDs within the overall



umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

5. Commercial Paper

CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt obligation is transformed into an instrument. CP is thus an unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces. CP is freely negotiable by endorsement and delivery. A company shall be eligible to issue CP provided - (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore; (b) the working capital (fund-based) limit of the company from the banking system is not less than Rs.4 crore and (c) the borrowed account of the company is classified as a Standard Asset by the financing bank/s. The minimum maturity period of CP is 7 days. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies.

Indian Capital Market Participants

Securities market in India has grown exponentially as measured in terms of amount raised from the market, number of stock exchanges and other intermediaries, the number of listed stocks, market capitalisation, trading volumes and turnover on stock exchanges and investor population. Along with this, the profiles of the investors, issuers and intermediaries have changed significantly. The market has witnessed fundamental institutional changes resulting in drastic reduction in transaction costs and significant improvements inefficiency, transparency and safety. Indian market is now comparable to many developed markets. The state of primary market of late has not been very encouraging as far as the industry is concerned. The number of issues and the amounts mobilised through the primary market is predominantly by financial institutions and banks as opposed to industry. This is a clear reflection of recessionary trends in the economy over the 5 years. The current state of the Indian capital markets and its market intermediaries is in the statistical table 1.1 given below:


SEBI Registered Market Intermediaries

Market Intermediaries	As on 31 st March				
	2001	2002	2003	2004	2005
Stock Exchanges (Cash market)	23	23	23	23	22
Stock Exchanges (Derivatives market)	2	2	2	2	2
Brokers (Cash segment)	9,782	9,687	9,519	9,368	9,129
Corporate Brokers (Cash segment)	3,808	3,862	3,835	3,746	3,733
Sub-brokers (Cash segment)	9,957	12,208	13,291	12,815	13,68
Brokers (Derivative)	519	705	795	829	994
Foreign Institutional Investors	527	490	502	540	685
Custodians	14	12	11	11	11
Depositories	2	2	2	2	2
Repository Participants	335	380	438	431	477
Merchant Bankers	233	145	124	123	128
Bankers to an Issue	69	68	67	55	59
Underwriters	57	54	43	47	59
Debenture Trustees	37	40	35	34	35
Credit Rating Agencies	4	4	4	4	4
Venture Capital Funds	35	34	43	45	50
Foreign Venture Capital Investors	1	2	6	9	14
Registrar to an Issue and Share Transfer Agents	186	161	143	78	83
Portfolio Managers	39	47	54	60	84
Mutual Funds	39	38	38	37	39
Collective Investment Schemes	0	0	0	0	0
Approved Intermediaries (Stock Lending Schemes)	8	10	4	3	3



1.3. CAPITAL MARKET & CAPITAL MARKET INSTRUMENTS

The capital market generally consists of the following long term period i.e., more than one year period, financial instruments; In the equity segment Equity shares, preference shares, convertible preference shares, non-convertible preference shares etc and in the debt segment debentures, zero coupon bonds, deep discount bonds etc.

Section 85 of the Companies Act, 1956 permits public limited companies (having share capital) to have two kinds of shares namely - equity and preference. Section 86 furthers this position by declaring that “the share capital of a company limited by shares shall be of two kinds only, namely:

(i) Equity share capital

An equity interest in a company may be said to represent a share of the company’s assets and a share of any profits earned on those assets after other claims have been met. The equity shareholders are the owners of the business; they purchase shares, the money is used by the company to buy assets, the assets are used to earn profits, which belong to the ordinary shareholders. After satisfying the rights of preference shares, the equity shares shall be entitled to share in the remaining amount of distributable net profits of the company. The dividend on equity shares is not fixed and may vary from year to year depending upon the amount of profits available. The rate of dividend is recommended by the Board of Directors of the company and declared by shareholders in the Annual General Meeting. Equity shareholders have a right to vote on every resolution placed in the meeting and the voting rights shall be in proportion to the paid-up capital. Equity capital can either be ;

- (i) with voting rights; or
- (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed.

The Companies (Amendment) Act, 2000 amended the provisions of the Act permitting companies to issue shares with differential voting right. The Central Government came out with the Companies (Issue of Shares with Differential Voting Rights) Rules, 2001 permitting the companies limited by shares to issue shares with differential rights as to dividend, voting or otherwise subject to the following conditions:

- The company has distributable profits in terms of section 205 of the Companies Act for preceding three financial years preceding the year in which it was decided to issue shares.
- The company has not defaulted in filing annual accounts and annual returns for the three financial years immediately preceding the financial year of the year in which it was decided to issue such shares.
- The company has not failed to repay its deposits or interest thereon on due date or redeem its debentures on due date or pay dividend.



- The Articles of Association of the company authorises the issue of shares with differential voting rights.
- The company has not been convicted of any offence arising under SEBI Act, 1992. Securities Contracts (Regulation) Act, 1956, Foreign Exchange Management Act, 1999.
- The company has not defaulted in meeting investors' grievances.
- The company has obtained the approval of shareholders in General Meeting by passing resolution under section 94.

Every company which issues shares with differential rights shall maintain a register as required under section 150 of the Companies Act, 1956 containing the particulars of differential rights to which the holder is entitled to.

Abolition of Standard Denomination for Equity Shares

Previously the Central Government has issued various circulars directing the companies to have uniform denomination of Rs.10 or Rs.100 for equity shares. The SEBI has modified the denomination of securities as under:

- The companies shall have the freedom to issue shares in any denomination to be determined by them in accordance with section 13(4) of the Companies Act, 1956. While doing so, the companies will have to ensure that shares are not issued in denomination of less than a rupee or decimal of rupee.
- The companies which seek to change the standard denomination may do so after amending the Memorandum and Articles of Association, if required.
- The existing companies, which have issued shares at Rs.10 and Rs.100, may also change the standard denomination into any denomination not below Re.1 by splitting or consolidating the existing shares after amending their Memorandum and Articles of Association. At any given time there shall be only one denomination for the shares of a company.
- Only companies whose shares are dematerialised shall be eligible to alter the 'standard denomination' and get the benefit of this circular.
- The stock exchanges may also make necessary changes in their existing trading and settlement software to give effect to the above decision. It is clarified that the companies which are already listed on one or more stock exchanges would be allowed to change the standard denomination of their equity shares only if they are in the compulsory demat list for all the investors announced by SEBI from time to time.
- With a view to enable the investors to take informed investment decision, the stock exchanges are also directed to reflect the denomination value of the shares as fixed by the company alongwith the market quotations.
- The companies desirous to avail the facility would be required to adhere to disclosure and accounting norms as may be specified from time to time.

(ii) Preference share capital:

Preference share is a hybrid security because it has features of both ordinary shares and bonds. Preference shareholders have preferential rights in respect of assets and dividends. In the event of winding up the preference shareholders have a claim on available assets before the ordinary shareholders. In addition, preference shareholders get their stated dividend before equity shareholders can receive any dividends. The dividends on preference shares are fixed and they must be declared before a legal obligation exists to pay them. The fixed nature of dividend is similar to that of interest on debentures and bonds. The declaration feature is similar to that of equity shareholders dividends.

The general forms of preference shares are as follows:

Cumulative and Non-cumulative Preference Shares The cumulative preference share gives a right to demand the unpaid dividend of any year, during the subsequent years when the profits are ample.

Cumulative Convertible Preference Shares The cumulative convertible preference (CCP) share is an instrument that embraces features of both equity shares and preference shares, but which essentially is a preference share. The CCPs are convertible into equity shares at a future specified date at a predetermined conversion rate once it is converted into equity shares, it passes all the characteristics of an equity share..

Participating and Non-participating Preference Shares Participating preference shares are those shares which are entitled to a fixed preferential dividend and, in addition, carry a right to participate in the surplus profits along with equity shareholders after dividend at a certain rate has been paid to equity shareholders.

Redeemable and Irredeemable Preference Shares Subject to an authority in the articles of association, a public limited company may issue redeemable preference shares to be redeemed either at a fixed date or after a certain period of time during the life time of the company. The Companies Act, 1956 prohibits the issue of any preference share which is irredeemable or is redeemable after the expiry of a period of twenty years from the date of issue.

(iii) Deferred/Founders Shares

A private company may issue deferred or founder's shares. Such shares are normally held by promoters and directors of the company. That is why they are usually called 'founders shares'. These shares are usually of a smaller denomination, say one rupee each. However they are generally given equal voting rights with equity shares which may be of higher denomination, say Rs. 10 each. Thus, by investing relatively lower amounts, the promoters may gain control over the management of the company. As regards the payment of dividends to holders of such shares, the articles usually provide that these shares will carry a dividend fixed in relation to the profits available after dividends have been declared on the preference and equity shares.

**Shares Issued at a Premium**

Section 78 of the Companies Act, 1956 deals with the provisions relating to application of premiums received on issue of shares. When a company issues shares at a premium, whether for cash or consideration other than cash, the premium collected on those shares shall be transferred to a separate account called 'Securities Premium Account'. The provisions of the act relating reduction of share capital shall also apply to the Securities Premium Account as it were a paid-up share capital of the company.

Shares Issued for Consideration Other Than Cash

A company may also issue shares as partly paid or fully paid for consideration other than cash under the circumstances mentioned below:

- To the underwriters of shares and promoters by way of payment of remuneration or for expenses incurred.
- To the vendors from whom the running business is purchased, as purchase price or consideration.
- Issue of bonus shares out of the reserves to the existing shareholders of the company.

Sweat Equity Shares

Under section 79A of the Companies Act, 1956, a company can issue sweat equity shares to its employees or directors at discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value addition etc..

Hybrid Instruments

Hybrid instruments have both the features of equity and debenture. This kind of instruments is called as hybrid instruments. Examples are convertible debentures, warrants etc.

Financing from capital markets - There are two ways a company can raise money from the financial markets namely - Debt and Equity.

NEED FOR STOCK MARKET

1. It helps in the capital formation in the economy of the country
2. It facilitates and maintains active trading.
3. It provides liquidity to financial assets.
4. It also helps in price discovery process

SHORTCOMINGS OF STOCK MARKETS

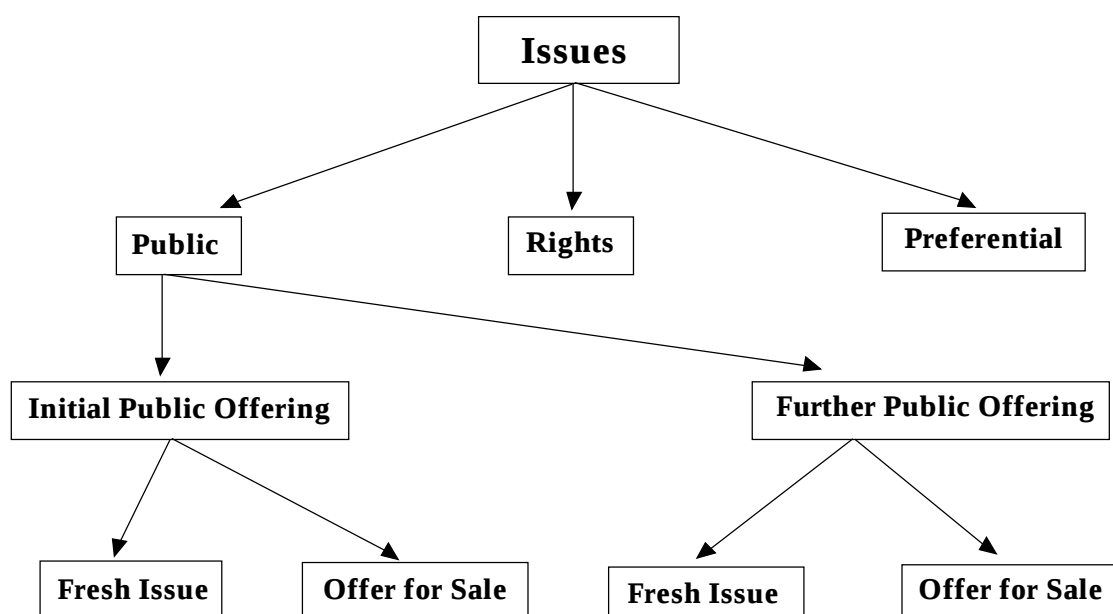
- Scarcity of floating stocks: Financial institutions, banks and insurance companies own 80 percent of the equity capital of the private sector.
- Speculation: 85 percent of the transactions on the NSE and BSE are speculative in nature.

- Price rigging: evident in relatively unknown and low quality scripts. Causes short term fluctuations in the prices.
- Insider trading: Obtaining market sensitive information to make money in the markets.

1.4. PRIMARY OR NEW ISSUE MARKET OR IPO MARKET

The Capital Market is broadly classified as Primary market and Secondary Market. The Primary market is the segment in which new issues are made whereas secondary market is the segment in which outstanding securities are traded. It is for this reason that the Primary Market is also called New issues Market or IPO / FPO market and the Secondary market is called Stock Market.

Classification of Issues



In the primary market, new issues may be made in five ways namely, public issue, rights issue, Bonus Issue, Preferential issue and private issue. **Public Issue** involves sale of securities to members of public either at par or at a premium. **Rights issue** involves sale of securities to the existing shareholders / debenture holders at a fixed price. **Bonus Issue** is to offer shares to existing share holders at free of cost. **Preferential Issue** is an offer of equity by a listed company to a particular or a group of investors at a specific price which may not be related to the existing market price. **Private placement** involves selling securities privately to selected investors generally by unlisted companies using the offer document called as information memorandum. In the primary market, equity shares, fully convertible debentures (FCD), partially convertible centers (PCD), and non-convertibles debentures (NCD) are the securities commonly issued. Table 3.1 shows year wise new issues during the past 20 years in terms of number of issues and also their value:



Table 3.1.

1989-90 to 2008-09 (20 years)		
Year	Amount (Rs. Crore)	No. of Issues
1989-90	2,793	187
1990-91	1,704	141
1991-92	1,898	196
1992-93	6,252	528
1993-94	13,443	770
1994-95	12,928	1,336
1995-96	11,663	1,407
1996-97	11,388	697
1997-98	3,061	62
1998-99	7,911	32
1999-00	7,673	65
2000-01	6,518	119
2001-02	6,423	19
2002-03	5,732	14
2003-04	22,131	34
2004-05	25,526	34
2005-06	23,676	102
2006-07	24,993	85
2007-08 (as on 31/01/08)	51,408	85
	—————	—————
	2,47,122	5,913



Source : SEBI Bulletin

Functions of new issue market

The main functions of new issue market is to facilitate transfer of resources from savers to the users. The savers are individuals, commercial banks, insurance companies etc. the users are public limited companies and the government. The new issue market plays an important role of mobilizing the funds from the savers and transfers them to borrowers for production purposes, an important requisite of economic growth. It is not only a platform for raising finance to establish new enterprises but also for expansion / diversification / modernizations of existing units. In this basis the new market can be classified as :

1. Market where firms go to the public for the first time through initial public offering (IPO).
2. Market where firms which are already trading to raise additional capital through seasoned equity offering (SEO).

The main function of new issue market can be divided into a triple service functions:

1. Origination
2. Underwriting
3. Distribution

Origination: Origination refers to the work of investigation, analysis and processing of new project proposals. Origination starts before an issue is actually floated in the market. There are two aspects in this functions:

1. A careful study of the technical, economic and financial viability to ensure soundness of the project. This is a preliminary investigation undertaken by the sponsors of the issue.
2. Advisory services which improve the quality of capital issues and ensure its success.

The advisory services include:

- a) Type of issue

This refers to the kind of securities to be issued whether equity share, preference share, debenture or convertible debenture.

- b) Magnitude of issue
- c) Time of floating of an issue
- d) Pricing of an issue – whether shares are to be issued at par or at premium
- e) Methods of issue
- f) Techniques of selling the securities



The function of origination is done by merchant bankers who may be commercial banks, all Indian financial institutions or private firms. Initially this service was provided by specialized division of commercial banks. At present, financial institutions and private firms also perform this service. Though this service is highly important, the success of the issue depends, to a large extent, on the efficiency of the market.

The origination itself does not guarantee the success of the issue. Underwriting, a specialized service is required in this regard.

Underwriting: Underwriting is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed then there is no liability for the underwriter. If a part of share issues remain unsold, the underwriter will buy the shares. Thus underwriting is a guarantee for the marketability of shares.

Method of underwriting

An underwriting agreement may take any of the following three forms:

1. Standing behind the issue

Under this method, the underwriter guarantees the sale of a specified number of shares within a specified period. If the public do not subscribe to the specified amount of issue, the underwriter buys the balance in the issue.

2. Outright purchase

The Underwriter, in this method, makes outright purchase of shares and resell them to the investors

3. Consortium method

Underwriting is jointly done by a group of underwriters in this method. The underwriters form a syndicate for this purpose. This method is adopted for large issue.

Advantages of underwriting

Underwriting assumes great significance as it offers the following advantages to the issuing company.

1. The issuing company is relieved from the risk of finding buyers for the issue offered to the public. The company is assured of raising adequate capital.
2. The company is assured of getting minimum subscription within the stipulated time, a statutory obligation to be fulfilled by the issuing company.
3. Underwriters undertake the burden of highly specialized function of distributing securities.

4. Provide expert advice with regard to timing of security issue, the pricing of issue, the size and type of securities to be issued etc.
5. Public confidence on the issue enhances when underwritten by reputed underwriters.

The underwriters in India may be classified into two categories :

- Institutional underwriters
- Non – institutional underwriters.

The institutional underwriters are

- Life Insurance Corporation of India (LIC)
- Unit Trust of India (UTI)
- Industrial Development Bank of India (IDBI)
- Industrial Credit and Investment Corporation of India (ICICI)
- Commercial banks and general insurance companies.

The pattern of underwriting of the above institutional underwriters differs vastly in India. LIC and UTI have purchased industrial securities from the new issue market with a view to hold them on their own portfolio. They have a preference for underwriting shares in large and well established firms. The development banks have given special attention to the issues in backward states and industries in the priority list. The thrust of the development banks is also towards small and new issues which do not have adequate support from other institutions. General insurance companies have shown preference in underwriting the securities of fairly new issues.

The non-institutional underwriters are brokers. They guarantee shares only with a view to earn commission from the company floating the issue. They are known to off load the shares later to make a profit. The brokers work profit motive in underwriting industrial securities. After the elimination of forward trading, stock exchange broker have begun to take an underwritten to the total private capital issue varies between 72 percent to 97 percent.

Distribution

Distribution is the function of sale of securities to ultimate investors. This service is performed by brokers and agents who maintain regular and direct contact with the ultimate investors.

Methods of floating of new issues

The various methods which are used in the floating of securities in the new issue market are :

- Public issues
- Offer for sale
- Placement
- Rights issues

***Public issues***

Under this method, the issuing company directly offers to the general public / institutions a fixed number of shares at a stated price through a document called prospectus. This is the most common method followed by joint stock companies to raise capital through the issues of securities.

1. Name of the company
2. address of the registered office of the company
3. existing and proposed activities
4. location of the industry
5. names of directors
6. authorized and proposed issue capital to the public
7. dates of opening and closing of the subscription list
8. minimum subscription
9. Names of brokers / underwriters / bankers / managers and registrars to the issue.
10. A statement by the company that it will apply to stock exchange for quotations of its shares.

According to the companies act, 1956 every application form must be accompanied by a prospectus. Now, it is no longer necessary to furnish a copy of the prospectus along with every application forms as per the companies Amendment Act, 1988. Now, an abridged prospectus is being annexed to every share application form.

Merits of issue through prospectus

1. Sale through prospectus has the advantage of inviting a large section of the investing public through advertisement.
2. It is a direct method and no intermediaries are involved in it.
3. Shares, under this method, are allotted to a large section of investors on a non-discriminatory basis. This procedure helps in wide dispersion of shares and to avoid concentration of wealth in few hands.

Demerits

1. It is an expensive method. The company has to incur expenses on printing of prospectus, advertisement, banks' commission, underwriting commission, legal charges, stamp duty, listing fees and registration charges.
2. This method is suitable only for large issues.

Offer for sale

The method of offer of sale constitute outright sale of securities through the intermediary of issue houses or share brokers. In other words, the shares are not offered to the public directly. This method consist of two stages : the first stage is a direct sale by the issuing company to the issue house and brokers at an agreed price. In the second stage, the intermediaries resell the



above securities to the ultimate investors. The issue houses or stock brokers purchase the securities at a negotiated price and resell at a higher price. The difference in the purchase and sale price is called turn or spread.

The advantages of this method is that the company is relieved from the problem of printing and advertisement of prospectus and making allotment of shares. Offer of sale is not common in India. This method is used generally in two instances:

- Offer by a foreign company of a part of it to Indian investors
- Promoters diluting their stake to comply with requirements of stock exchange at the time of listing of shares.

Follow on Public Offering (FPO)

When an existing listed company either makes a fresh issue of securities to the public or makes an offer for sale of securities to the public for the first time, through an offer document, such issues are called as '*Follow on Public Offering*'. Such public issue of securities or offer for sale to public is required to satisfy the stock exchange listing obligations along with SEBI guidelines.

Rights Issue (RI)

When a listed company proposes to issue securities to its existing shareholders, whose names appear in the register of members on record date, in the proportion to their existing holding, through an offer document, such issues are called '*Rights Issue*'. This mode of raising capital is best suited when the dilution of controlling interest is not intended.

Preferential Issue

A preferential issue is an issue of equity shares or of convertible securities by listed companies to a select group of persons which is neither a rights issue nor a public issue. The issuer company has to comply with the provisions of the Companies Act, as well as, SEBI's guidelines with reference to preferential issues as contained in Chapter XIII.

A company which makes any public or rights issue or an offer for sale can issue shares only in dematerialised form. A company shall not make a public or rights issue of shares unless all the existing partly paid shares have been fully paid-up or forfeited. A company which is making public issue of securities shall make an application to the stock exchange for listing of those shares.

Book Building

It is a capital issuance process which results towards a price discovery and also to assess demand analysis of the security. It is a process used for marketing equity shares of a company. (Fig.3.1)

Book-Building Process

- The Issuer nominates a merchant banker as book runner
- Specifies issue size and floor price
- Appoints syndicate members
- Investors place orders into the electronic book, termed as the process of bidding

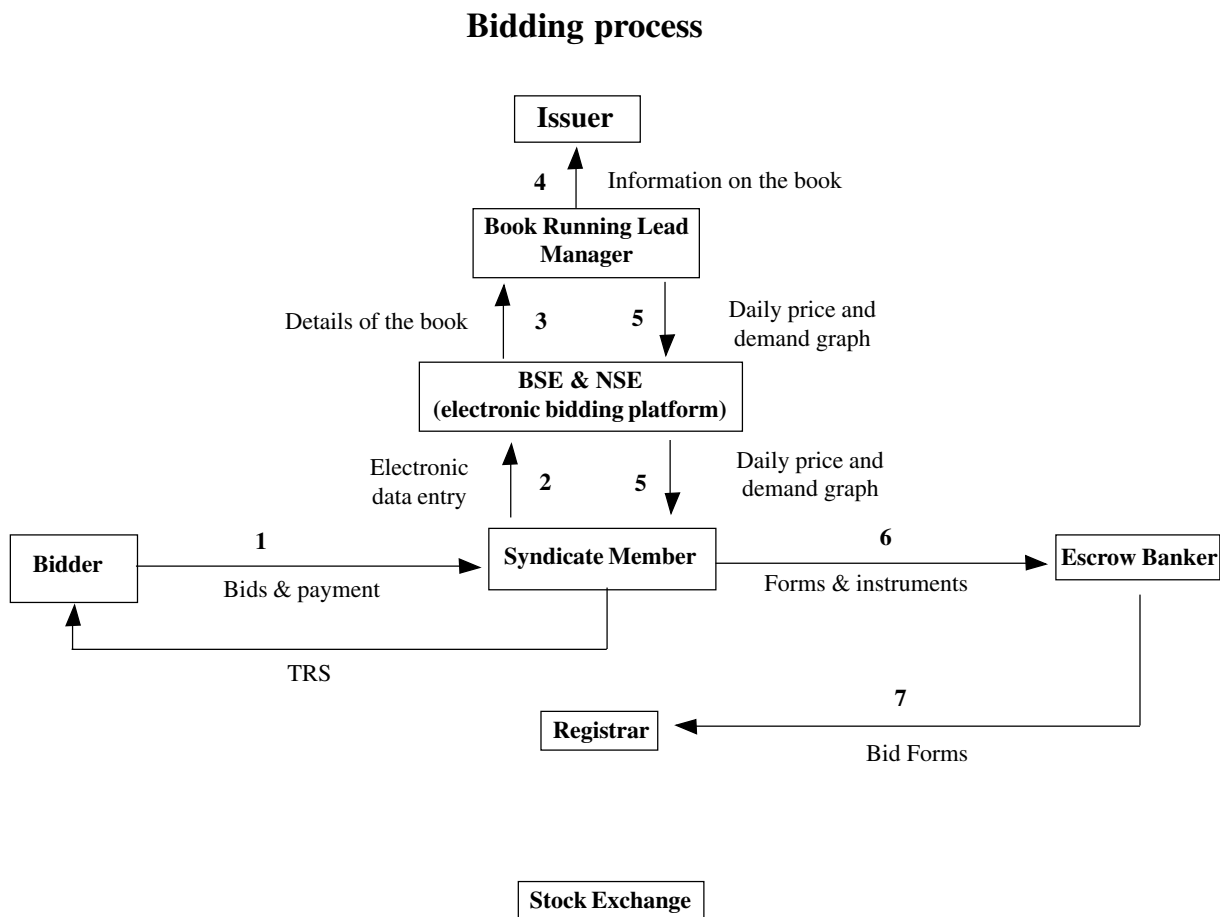


- Bids are entered, 'at' or 'above' the floor price
- Retail investors can bid at a cut-off price
- The price opted by majority of bidders shall be decided as the subscription price.

Fixed Price vs. Book-Building

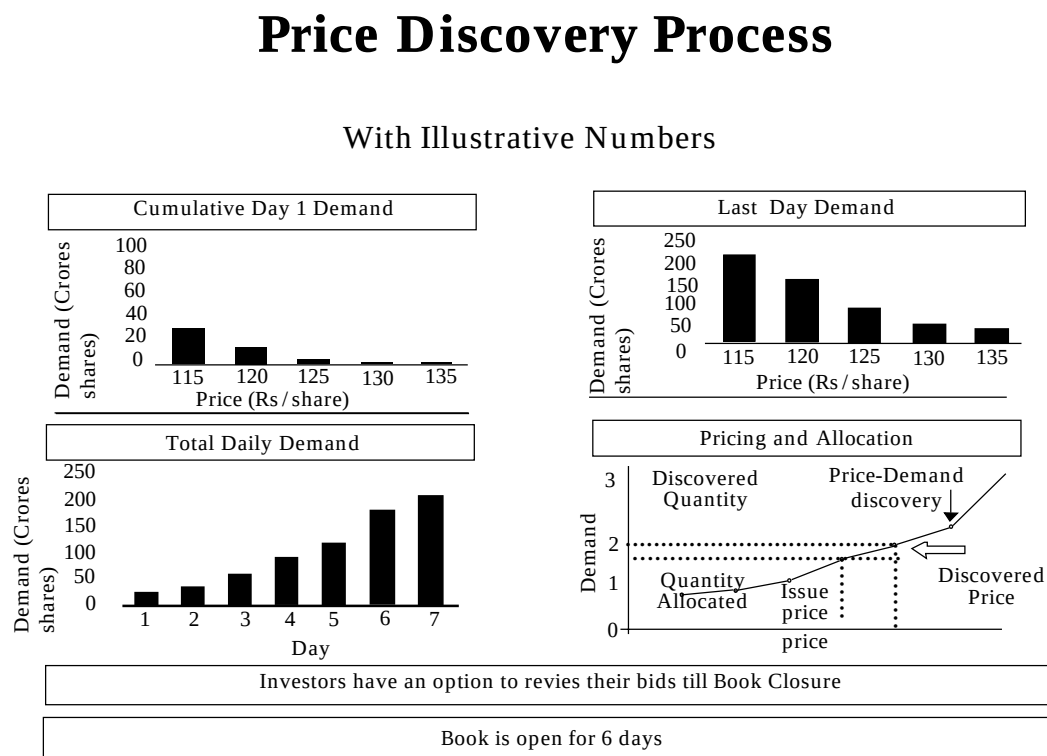
- | | |
|---|--|
| i) Offer price is known to investor in advance | i) Only the floor price and price range is known |
| ii) Demand for the securities known after issue closure | ii) Demand for the securities is visible online as the book is built |
| iii) Application money credited to issuer Account. | iii) Application money is credited to an escrow account |

Fig.3.1 – Bidding Process



Source: nse-india.com

Fig. 3.2 - Price Discovery Process - Illustration



Eligibility Norms for Public Issue

SEBI has laid down the eligibility norms for entities accessing the primary market through public issues. The entry norms for companies making initial public offer or Follow on Public offer, are summarised as follows (students are advised to refer to SEBI guidelines to have the latest norms):

Entry Norm I

The company shall meet the following requirements:

- Net tangible assets of atleast Rs. 3 crores for 3 full years.
- Distributable profits in atleast three years.
- Net worth of atleast Rs. 1 crore in three years.
- If change in name, atleast 50% revenue for preceding 1 year should be from the new activity.
- The issue size does not exceed 5 times the pre-issue net worth.



To provide sufficient flexibility and also to ensure that genuine companies do not suffer on account of rigidity of the parameters, SEBI has provided two other alternative routes to company not satisfying any of the above conditions, for accessing the primary market.

Entry Norm II

- (a) Issue shall be through book building route, with atleast 50% to be mandatorily allotted to the Qualified Institutional Buyers (QIBs).
- (b) The minimum post-issue face value capital shall be Rs. 10 crores or there shall be a compulsory market-making for atleast 2 years.

OR

Entry Norm III

- (a) The 'project' is appraised and participated to the extent of 15% by FIIs / Scheduled commercial banks of which atleast 10% comes from the appraiser(s).
- (b) The minimum post-issue face value capital shall be Rs. 10 crores or there shall be a compulsory market-making for at least 2 years

In addition to satisfying the aforesaid eligibility norms, the company shall also satisfy the criteria of having at least 1000 prospective allottees in its issue.

Green Shoe Option

Green Shoe Option denotes '**an option of allocating shares in excess of the shares included in the public issue**'. It is an option allowing the Issuing Company to issue additional shares when the demand is high for the shares when the flotation is on. SEBI guidelines allows the Issuing company to accept oversubscription, subject to a ceiling, say 15% of the offer made to public. In certain cases, the Green Shoe Option can be even more than 15%. It is extensively used in international IPOs to stabilise the post listing price of new issued shares. The concept has been introduced in the Indian capital market and is used in initial public offerings through book building process. SEBI has allowed the use of the option with a view to boost the investors' confidence and to put a check for speculative practices causing short-term volatility in post listing price. The Green Shoe Option facility would bring in price stability of initial public offerings.

Kinds of Offer Document

An offer document means 'prospectus' in case of a public issue or an offer for sale and '**Letter of offer**' in case of rights issue, which is required to be filed with the Registrar of Companies (ROC) and Stock Exchanges. An offer document covers all the relevant information to help an investor in making wise investment decisions.

Draft Prospectus - A company before making any public issue of securities, shall file a draft prospectus with SEBI, through an eligible merchant banker, atleast 21 days prior to the filing of prospectus with the Registrar of Companies. If any specific changes are suggested by SEBI



within the said 21 days, the Issuing company or the lead merchant banker shall carry out such changes in the draft prospectus before filing the prospectus with ROC.

Draft Letter of Offer - A listed company, before making any rights issue for an amount exceeding Rs. 50 lakhs (including premium) shall file a draft letter of offer with SEBI, at least 21 days prior to the filing of the letter of offer with regional stock exchange and shall carry changes as suggested by SEBI before the filing of the draft letter of offer with regional stock exchange.

Prospectus - A company issuing shares to public must issue a 'prospectus'. The prospectus is an 'invitation' to offer. It is an invitation to the public to take shares or debentures in the company or deposit money in the company. Section 2(36) of the Companies Act, 1956 defines prospectus as "any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate". Section 56 of the Companies Act provides that every prospectus must disclose matters specified in Schedule II.

Abridged Prospectus - Section 2(1) of the Companies Act, 1956 defines abridged prospectus means 'a memorandum containing such salient features of a prospectus as may be prescribed'. An abridged prospectus means the memorandum as prescribed in Form 2A under sub-section (3) of section 56 of the Companies Act. It contains all the salient features of a prospectus. A company cannot supply application forms for shares or debentures unless the form is accompanied by abridged prospectus.

Shelf Prospectus - Sometimes, securities are issued in stages spread over a period of time, particularly in respect of infrastructure projects where issue size is large as huge funds have to be collected. In such cases, filing of prospectus each time will be very expensive. In such cases, section 60A of the Companies Act, 1956 allows a prospectus called 'Shelf Prospectus' to be filed with Registrar of Companies. At subsequent stages only 'Information Memorandum' is required to be filed. The shelf prospectus shall be valid for a period of 1 year from the date of opening of first issue of securities under that prospectus.

Information Memorandum - The Information Memorandum shall contain all material facts relating to new charges created, changes in the financial position as have accrued between the first offer, previous offer and the succeeding offer. The Information Memorandum shall be filed with a period of 3 months prior to making of second or subsequent offer of securities under Shelf Prospectus. The Information Memorandum shall be issued to the public along with Shelf Prospectus filed at the first stage of offer. Where an update of Information Memorandum is filed every time an offer of securities is made, such memorandum together with the Shelf Prospectus shall constitute the Prospectus.

Red-Herring Prospectus: A prospectus is said to be a red-herring prospectus which contains all information as per prospectus contents but does not have information on price of securities offered and number of securities (quantum) offered through such document. Thus, a red-herring prospectus lacks price and quantity of the securities offered. This is used in book building issues only. In the case of book built issues, it is a process of price discovery and the price



cannot be determined until bidding process is completed. Hence, such details are not shown in Red-herring prospectus filed with ROC in terms of the provisions of the Companies Act. Only on completion of the bidding process, the details of the final price are included in the offer document. The offer document filed thereafter with ROC is called a '*prospectus*'.

Disadvantages of Floatation

The disadvantages of flotation include the following:

- There are considerable costs in flotation and listing.
- It takes lot of management's time, before and after flotation and listing.
- The company must comply with the stringent stock exchange regulations.
- It will be necessary to meet the regulatory requirements for disclosure of information, including details of managerial remuneration.
- A dilution of management control will result from the widely held shares of the company.
- The affairs of the company are subject to public scrutiny and fluctuations in share price may some time cause adverse image in the public.
- Since the costs of flotation are higher, other ways of raising finance would reduce the cost of funds.
- Listed company status will put additional burden on the managerial staff.
- The buying and selling of shares by the directors and other related persons may attract the provisions of 'insider trading'.
- There will always be pressure from shareholders to declare dividends, which may not be in the interests of the company.
- The adverse campaigns against the company may drive down the share price, it is technically called 'bear raids'.
- The investors always expect the rise in the share price. The company's growth and profitability may not afford the increase in share price always.

Promoters

The '*promoter*' has been defined as a person or group of persons who are instrumental in formation of the company, who enable the company to start its commercial operations by bringing in the necessary funds required for the concern. The promoters are in the overall control of the company, whose names are mentioned in the offer document. Any director or officer discharging their functions in their professional capacity cannot be termed as promoter. The meaning of the term '*promoter*' is wide enough to cover the following relationships:



- 'Promoter group' includes promoter, an immediate relative of the promoter (i.e. any spouse of that person, or any parent, brother, sister or child of the person or of the spouse).
- In case promoter is a company, a subsidiary or holding company of that company.
- Any company in which the promoter holds 10% or more of the equity capital or which holds 10% or more of the equity capital of the promoter.
- Any company in which a group of individuals or companies or combinations thereof who holds 20% or more of the equity capital in that company, also holds 20% or more of the equity capital of the issuer company.
- In case the promoter is an individual, any company in which 10% or more of the share capital is held by the promoter or an immediate relative of the promoter or a firm or HUF in which the promoter or any one or more of his immediate relative is a member.

Promoter Contribution

Promoters contribution in any public issue shall be in accordance with the following provisions under SEBI's DIP Guidelines:

- *Unlisted companies* - In the public issue, the promoters shall contribute not less than 20% of the post issue capital.
- *Offers for sale* - The promoters share holding after offer for sale shall not be less than 20% of post issue capital.
- *Listed companies* - The promoters shall participate either to the extent of 20% of the proposed issue or ensure post-issue shareholding to the extent of 20% of the post-issue capital.
- *Composite issues of listed companies* - The promoters contribution shall at the option of the promoters be either 20% of the proposed public issue or 20% of the post issue capital. Rights issue component of the composite issue shall be excluded while calculating the post issue capital.

1.5. SECONDARY MARKET / STOCK MARKET / STOCK EXCHANGE

One of the criteria in investment management which is considered as very important next to risk assessment is the liquidity. After the investors get the shares allotted through the primary market they need some platform or market place to provide liquidity for their investment. Thus, secondary market offers liquidity to investment made in the primary market. Both, primary and secondary markets co-exists, i.e. to say one depends on the other for its survival and growth. There are two broad segments of the stock markets (i) The organised stock exchanges and (ii) The Over-the-Counter (OTC) market. The primary middlemen in the stock market are brokers and dealers. The distinction between them is, the broker acts as an agent, whereas the dealer acts as a principal in the transaction. Stock markets are said to reflect the overall health of the country's economy. On the other hand, major economic indicators determine stock market movements to a large extent. From a thorough analysis of the various economic Indicators



and its implications on the stock markets, it is known that stock market movements are largely influenced by broad money supply, inflation, credit/ deposit ratio and fiscal deficit apart from political stability. Besides, fundamental factors like corporate performance, industrial growth, etc. always exert a certain amount of influence on the stock markets. Because the stock market involves the trading of securities initially sold in the primary market, it is providing liquidity to the individuals who acquired these securities. The trends in stock market will have impact on the primary market. The secondary market in India comprises of 23 Stock Exchanges and more than 10000 listed companies out of which BSE has about 4888 and NSE has 1225 companies listed with them as on 29th February 2008. A large volume of transactions on the secondary markets are transacted through BSE and NSE. Presently, the BSE & NSE put together account for more than 99% of the total turnover as compared to less than 1% by the other Stock Exchanges.

Reasons for Transactions on Secondary Market

There are two main reasons why individuals transact in the secondary market: **Information Motivated Reasons** : Information motivated investors believe that they have superior information about a particular security than other market participants. This information leads them to believe that the security is not being correctly priced by the market. If the information is good, this suggests that the security is currently under-priced, and investors with access to such information will want to buy the security. On the other hand, if the information is bad, the security will be currently overpriced, and such investors will want to sell their holdings of the security.

Liquidity Motivated Reasons: Liquidity motivated investors, on the other hand, transact in the secondary market because they are currently in a position of either excess or insufficient liquidity. Investors with surplus cash holdings (e.g., as a result of an inheritance or adequate savings of their income) will buy securities, whereas investors with insufficient cash (e.g., to purchase a car or any other assets) will sell their securities.

The Securities which are traded in the secondary market may be classified as follows.

1. On the basis of issuer, Securities may be classified as

- Industrial securities,
- Government securities
- Financial intermediaries securities.

Industrial securities issued by industrial and common undertakings in the private and public sector whereas government securities include securities issued by State governments, municipalities and public utilities. Government securities are generally considered risk-free, low return securities compared to the Industrial securities. Besides these two classes of issues, the Financial Intermediaries are emerging as the third important group. The securities issued by Financial Institutions and Banks would fall, in terms of risk-return features, somewhere in between the industrial securities and government securities.



On the basis of maturity, securities may be classified into **short term** and **long term** or Money Market and Capital Market securities. Treasury bills, commercial bills, commercial papers, certificate of deposits are short- term or money market securities. Equities, Preference shares, Debentures and Bonds are long term or capital market securities. On the basis of settlement of deals, securities may be classified into Forward securities and cash securities. Forward securities are those in which the settlement date can be shifted from one settlement date to other by paying the badla charges. Cash securities are those for which settlement dates cannot be shifted. The Forward securities are known by different names viz. specified shares or group A shares or Forward section. Cash securities are also known as Non-specified shares or group B shares or cash section.

Stock Market in India

From scattered and small beginnings in the 19th Century, India's stock market has risen to great heights. In 1990, we had 19 stock exchanges in the country. There were around 6,000 listed companies and the invested population stood around 15 million. You might be interested in knowing more about the growth of stock market in India. What functions does it perform? What is the form of organization of stock exchange in India? How are they administered? What is the trading system followed on these exchanges? We shall discuss these and other questions in the following sections.

Role and Functions of Stock Exchanges:

The history of stock exchanges shows that the development of joint stock enterprise would never have reached its present stage but for the facilities which the stock exchanges provide for dealing with the securities. Stock exchanges have a very important function to fulfill in the country's economy.

The stock exchange is really an essential pillar of the private sector corporate economy. It discharges essential functions in the process of capital formation and in raising resources for the corporate sector.

First the stock exchange provides a market place for purchase and sale of securities viz., shares, bonds, debentures etc. It, therefore, ensures the free transferability of securities which is the essential basis for the stock enterprise system. The private sector economy cannot function without the assurance provided by the exchange to the owners of shares and bonds that they can be sold in the market at any time. At the same time, those who invest their surplus funds in securities for long-term capital appreciation or for speculative purpose can also buy scripts of their choice in the market.

Secondly, the stock exchange provides the linkage between the savings in the household sector and investment in corporate economy. It mobilizes savings, and channelize them in the form of securities into those enterprises which are favored by the investors on the basis of such criteria as future growth prospects, good returns and appreciation of capital.



Thirdly, by providing a market quotation of the prices of shares and bonds – a sort of collective judgement simultaneously reached by many buyers and sellers in the market-the stock exchange serves the role of barometer, not only of the state of health of individual companies, but also of the nation's economy. The changes in share prices are brought about by a complex set of factors, all operating in the market simultaneously. Share values as a whole are subject to secular trends set by the economic programme of the nation, and governed by factors like general economic situation, financial and monetary policies, tax changes, political environment, international - economic and financial development, etc.

Membership, organization and Management

Nature of the century-old traditional stock exchanges are a highly organized and smoothly functioning network in the world. The membership of stock exchanges initially comprised of individuals and partnership firms. Later on the corporate entities and financial institutions were also allowed to become members. A number of financial institutions are now members of Indian Stock Exchanges. Over the years, stock exchanges have been initiated in various forms. For example, while the Ahmedabad Stock Exchange and M.P. (Indore) Stock Exchange were started as Non-profit making association of persons, the Calcutta Stock Exchange, Delhi Stock Exchange, U.P. Stock Exchange, Cochin Stock Exchange, Gauhati Stock Exchange, Bangalore Stock Exchange, Jaipur Stock Exchange and (Mangalore) Stock Exchange were established as public limited companies. Quite a few others have been started as Company limited by guarantee.

The entrance fee is different for different stock exchanges. Membership deposit and annual fees also varies from exchange to exchange. The entrance fee is different for different members among various exchanges based on their status like individual or corporate. The internal governance of exchange rests in a governing board comprising members of the board and Executive Director. The Members of the governing boards include brokers and SEBI Nominees called Public Representatives. The Chairman is expected to ensure the position of Executive Director can't be expected to be very strong because if he really tries to be may bring him into conflict with influential broker-members who may also be on the exchange's board which determines Executive Director's terms and conditions of service and his re-appointment on this term. It is not human nature to displease one's appointing authorities and it may be too much Executive Director's to be strict under the present scheme of things. Subject to the previous approval of the law, governing bodies of stock exchanges have wide powers to make bye-laws. Governing bodies furnish, censure and also expel any member, any remiser, and authorized clerk and employee. It has to adjudicate disputes. Above all, it has the power to make, amend, suspend and enforce rules, bye-regulations and supervise the entire functioning of a stock exchange.

To rationalize the functioning of the stock exchanges during the year 2007 all the exchanges in India were de-mutualized under a compulsory scheme brought out by SEBI in the year 2005. Except NSE all other exchanges were managed by the brokers who were members of the exchange by having major stake in the composition of the Governing Board. After the de-mutualization, management of the exchange rests with the owners (non-brokers) with more than



50% representation in the board and minority representation of the Trading Members and SEBI nominees. All the exchanges have become from Not-for profit organization to that of for-profit organizations. Those exchanges which have failed to complete the de-mutualisation within the stipulated time frame as given by SEBI were cancelled of their re-cognition as an exchange and hence, they have lost their identity as exchange and cease to exist.

Trading System

Trading on stock exchanges is done through brokers and dealers. All members can act as brokers and for this purpose they have to maintain a minimum security deposit and additional security deposit also called as base capital which will decide on the trading exposure that the said broker will be allowed to. Brokers act as agents for buying and selling on behalf of their clients, for which they receive brokerage / commission at stipulated rates. The maximum brokerage that can be charged is restricted to 2.5% of the value of transaction done and there is no minimum stipulated but it cannot be nil, except when the transactions are done for charitable organizations. Dealers act as principals and buy and sell securities on their own accounts. However, members cannot enter into contract with any person other than the member without prior permission of the governing Body. The Trading system of NSE has enhanced its efficiency, liquidity and transparency, by introducing a nation-wide on-line fully-automated screen based trading system (SBTS) (Fig.4.1) where a member can input into the computer trading terminal, the quantities of the securities he wanted to buy or sell and the prices at which he likes to transact and the transaction is executed as soon as it finds a matching sale or buy order from a counter party.

SBTS electronically matches orders on a strict price/time priority and hence cuts down on time, cost and risk of error, as well as on fraud resulting in improved operational efficiency. It allows faster incorporation of price sensitive information into prevailing prices, thus increasing the informational efficiency of markets. It enables market participants, irrespective of their geographical locations, to trade with one another simultaneously, improving the depth and liquidity of the market. It provides full anonymity by accepting orders, big or small, from members without revealing their identity, thus providing equal access to everybody. It also provides a perfect audit trail, which helps to resolve disputes by logging in the trade execution process in entirety.

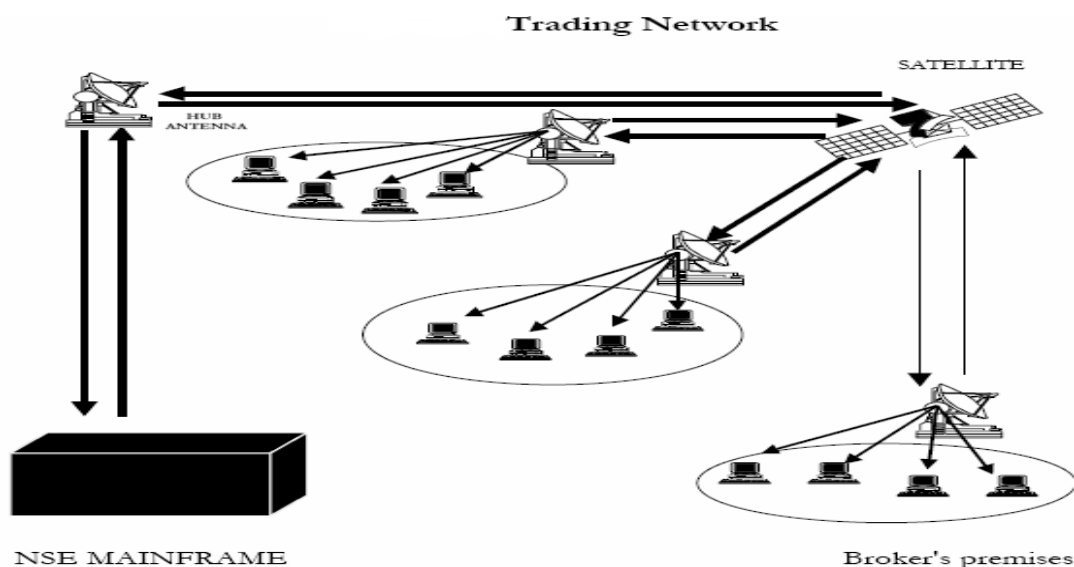


Fig: 4.1 Source: nseindia.com

In the very first year of its operation, NSE became the leading stock exchange in the country, impacting the fortunes of other exchanges and forcing them to adopt SBTS also. Today India can boast that almost 100% trading take place through electronic order matching. Technology was used to carry the trading platform from the trading hall of stock exchanges to the premises of brokers. NSE carried the trading platform further to the PCs at the residence of investors through the Internet and to handheld devices through WAP for convenience of mobile investors. This made a huge difference in terms of equal access to investors in a geographically vast country like India. The trading network is depicted in Figure 1.1. NSE has main computer which is connected through Very Small Aperture Terminal (VSAT) installed at its office. The main computer runs on a fault tolerant STRATUS mainframe computer at the Exchange. Brokers have terminals (identified as the PCs in the Figure 1) installed at their premises which are connected through VSATs/leased lines/modems. An investor informs a broker to place an order on his behalf. The broker enters the order through his PC, which runs under Windows NT and sends signal to the Satellite via VSAT/leased line/modem. The signal is directed to mainframe.

National Stock Exchange of India Ltd

The National Stock Exchange of India Limited (NSE) was promoted by IDBI, ICICI, IFCI, GIC, LIC, State Bank of India, SBI Capital Markets Limited, SHCIL and IL & FS as a Joint Stock Company under the Companies Act, 1956, on November 27, 1992. The Government of India has granted recognition with effect from April 26, 1993, initially for a period of five years. The GOI has appointed IDBI as a lead promoter. To form the infrastructure of NSE, IDBI had appointed a Hongkong Bound consulting firm M/s. International Securities Consulting Limited



for helping in setting up of the NSE. The main objective of NSE is to ensure comprehensive nationwide securities trading facilities to investors through automated screen based trading called NEAT and automatic post trade clearing and settlement facilities. The NSE encourages corporate trading members with dealer networks, computerised trading and short settlement cycles. It has three segments, one dealing with wholesale debt instruments, the second to deal with capital market instruments called cash segment and the third for Futures and Options or Derivatives Market. The Clearing Corporation of India Limited (CCIL) an Electronic Clearing and Depository System (ECDS) set up by the Stock Holding Corporation of India Limited (SHCIL) provides the requisite clearing and settlement systems.

Features The recommendations of the High Power Committee on setting up of the National Stock Exchange, a 'Model Exchange' at New Mumbai to act as a National Stock Exchange (NSE) to provide access to all investors from across the country on an equal footing, and work as Integral component of the National Stock Market System. Hence, NSE is having the following vital features:

- NSE is promoted by Financial Institutions, Mutual Funds, and financed on a self-sustaining basis through levy of membership fees. The capital outlay of 30 crores of rupees was financed by admitting 1,000 members with an entry fee of Rs. 10 lakhs each. Fees for corporate and Institutional members was at a higher level of Rs. 25 lakhs.
- NSE is a company incorporated under the Companies Act of 1956. It is constituted by the Board of Directors (Board) and managed by it. 50 per cent of the Managing Board of the Exchange comprise of professionals who are not members. These professionals must be from a cross section of finance and industry, and must actively contribute to ensuring that the stock exchange functions in a balanced and fair manner.
- It is trading on large & medium sized securities of equity shares and debt instruments.
- It is a separate ring altogether. For the first time in our country, debt instruments were traded to become an active part in the secondary market of the nation.
- NSE made its debut with the debt market. The debt market is predominantly a market in Government Securities. The Central Government moving over to auctions at market-related rates of interest, the primary market has become active with the well informed and fine-tuned bidding at the auctions.
- It is having full support from the National Clearing and Settlement divisions, SHCIL and the Securities Facilities Support Corporation. It is using modern computer technology for the clearance and settlement procedures.
- Better transparency system for the securities trading & settlement.

The BSE is also providing similar facilities with more number of securities being listed especially low capital companies with limited equity shares floating in the market. Both BSE and



NSE have national presence and they dominate the stock markets. All other exchanges have created a platform by having either an alliance with or cross holding with these two premier exchanges or trading facility provided to their members through a subsidiary of the main exchanges.

Over The Counter Exchange of India (OTCEI)

Indeed in mid-eighties itself the G.S. Patel Committee on Stock Exchange reforms and the Abid Holi Committee on Capital Markets had recommended for the creation of a second tier stock market that will solve some of the problems of present stock exchanges. Over The Counter Exchange of India (OTCEI) was been promoted by ,UTI, IDBI, IFCI, LIC, GIC, SBI Capital Market and Canbank Financial Services as a non profit-making company under Section 25 of the Companies Act, 1956. The OTCEI is a recognized Stock Exchanges under section 4 of the Securities Contracts (Regulation) Act, 1956. Hence companies listed on the OTC Exchange enjoy the same status as companies listed on any other stock exchanges in the country.

OTC Exchange of India has picked the model from the NASDAQ system (National Association of Security Dealers-Automated Quotations) prevalent in the United States of America. Modifications suited to Indian conditions been adopted from OTC in America was an offshoot of their government's efforts to regulate the unlisted securities act. The Indian version of NASD-National Associations of Securities Dealers is what is called OTC Exchange of India. Unlike in the regular exchange, listing on OTCEI is a national listing from day one. Wherever and whenever counters start operating in the country they can trade in all the scripts of OTCEI. Separate listing in those regular places is not needed at all.

All said and done the OTCEI did not take off and was not successful due to many reasons like lower end technology, low liquidity, less participation by investors in small cap companies, etc.

Inter-connected Stock Exchange of India

Inter-connected Stock Exchange of India Limited (ISE), has been promoted by 15 Regional stock exchanges to provide trading linkage /connectivity to all the participating exchanges to widen their market. Thus, ISE is a national level exchange providing trading, clearing, settlement, risk management and surveillance support to the Inter-Connected Market System (ICMS). ISE aims to address the needs of small companies and retail investors with the guiding principle of optimising the infrastructure and harnessing the potential of regional markets to transform these into a liquid and vibrant market through the use of technology and networking. The participating exchange in ISE have in all about 4500 traders. In order to leverage its infrastructure as also to expand its nation-wide reach, ISE has also appointed dealers across various cities other than the participating exchange centers. These dealers are administratively supported through strategically located regional offices at Delhi, Calcutta, Chennai and Nagpur. ISE, thus expects to emerge as a low cost national level exchange in the country for retail investors and small intermediaries. ISE has also floated a wholly-owned subsidiary namely, ISE Securities and Services Limited (ISS) to take membership of NSE and other premier exchanges, so that traders and dealers of ISE can access other markets in addition to the local market and ISE. This will provide the investors in smaller cities with a solution for cost-effective and effi-

cient trading in securities.

Core objectives of the Inter-connected Stock Exchange include creation of single integrated national level solution with access to multiple markets for providing high quality, low cost services to millions of investors across the country, a liquid and vibrant national level market for all listed companies in general and small capital companies in particular and providing trading, clearing and settlement facilities to the traders and dealers across the country at their doorstep with decentralised support system. Some of the features which make ISE a new age stock exchange are as follows:

- ISE is a national level recognised stock exchange having moderate listing fees and granting listing and trading permission to small and medium sized companies having a post public issue paid-up capital of Rs. 3 crore to Rs. 5 crore (subject to the appointment of market makers) besides companies with a capital of above Rs. 5 crore.
- All traders and dealers of ISE have access to NSE through ISE Securities and Services Ltd. (ISS), which ensures continuous attention of investors.
- Proposing to introduce the 'IPO Distribution System' for offering primary market issue.
- ISE has set up an 'Investors Grievance and Service Cell' which looks after all types of complaints of investors located across the country and provides decentralised support.
- Listing of stocks with ISE would give the company an advantage of being identified as a technology-savvy and Investor-friendly company.

The below Table 4.1 shows the distribution of Turnover on Cash segments of stock Exchanges, out of which you find the highest turnover in value in NSE and next being in BSE.

**Table: 4.1 -Distribution of Turnover on Cash segments of Exchanges (Rs. crores)**

Stock Exchange	2002-03	2003-04	2004-05	2005-06
1. Ahmedabad	54,035	14,844	15,459	4,544
2. Bangalore	6,033	70	0.0	0.05
3. Bhubaneswar	0.01	0.0	0.0	0.0
4. Calcutta	3,55,035	27,076	6,540	1,928
5. Cochin	187	27	0.0	0.0
6. Coimbatore	0.0	0.0	0.0	0.0
7. Delhi	83,871	5,828	11	3
8. Gauhati	0.04	0.03	0.1	0.0
9. Hyderabad	978	41	5	2
10. ICSE	233	55	65	0.05
11. Jaipur	0.0	0.0	0.0	0.0
12. Ludhiana	9,732	857	0.0	0.0
13. Madhya Pradesh	2	16	0.0	0.0
14. Madras	109	24	0.0	101
15. Magadh (Patna)	2	0.0	0.5	0.1
16. Mangalore	0.0	0.0	0.0	0.0
17. Mumbai (BSE)	10,00,032	3,07,292	3,14,073	150,26,108
18. NSE	13,39,511	5,13,167	6,17,989	160,99,534
19. OTCEI	126	4	0.1	16
20. Pune	6,171	1,171	1.8	0.0
21. SKSE	0.0	0.0	0.0	0.0
22. Utter Pradesh	24,747	25,237	14,763	11,751
23. Vadodara	1	10	3	0.1

Source: SEBI Bulletin,.

Demutualization of Stock Exchanges

Historically stock exchanges were formed as 'mutual' organisations, which were considered beneficial in terms of tax benefits and matters of compliance. They are generally 'not-for-profit' and tax exempted entities. The trading members who provide broking services, also own, control and manage such exchanges for their common benefit, but do not distribute the profits among themselves. The ownership rights and trading rights are clubbed together in a membership card which is not freely transferable and hence this card at times carries a premium. In contrast, in a 'demutual' exchange, three separate sets of people own the exchange, manage it and use its services. The owners usually vest in management constituting a board of directors which is assisted by a professional team. A completely different set of people use trading platform of the exchange. These are generally 'for-profit' and tax paying entities. The ownership rights are freely transferable. Trading rights are acquired / surrendered in terms of transparent rules. Membership cards do not exist. These two models of exchanges are generally referred to as 'club' and 'institution' respectively.

There are 23 recognised exchanges in the country. Three of them are 'Association of Persons', while the balance 20 are companies, either limited by guarantee or by shares. Except one ex-



change (NSE), all exchanges, whether corporates or association of persons, are not-for-profit making organisations. Except for two (OTCEI and NSE), all exchanges are 'mutual' organisations. An expert committee appointed by SEBI has recently recommended demutualisation of stock exchanges since stock exchanges, brokers, associations and investors association have overwhelmingly felt that such a measure was desirable. The committee has accordingly suggested the steps for such demutualisation.

The most important development in the capital market is concerning the demutualisation of the stock exchanges. Demutualisation of exchanges means segregating the ownership from management. This move was necessitated by the fact that brokers in the management of the stock exchange were misusing their position for personal gains. Demutualisation would bring in transparency and prevent conflict of interest in the functioning of the stock exchanges. The Minister of Finance in his union budget speech of 2002-03 has made important announcement that the process of demutualisation and corporatisation of stock exchanges is expected to be completed during the course of the current year. Now, all the stock exchanges in India are demutualised entities.

Money market

A money market is a mechanism which makes it possible for borrowers and lenders to come together. Essentially it refers to a market for short term funds. It meets the short term requirements of the borrowers and provides liquidity of cash to the lenders.

Money market is the market in which short term funds are borrowed and lent. The money market does not deal in cash or money but in trade bills, promissory notes and government papers which are drawn for short periods. These short term bills are known as near money.

Importance of money market

- Dealing in bills of exchange and commercial papers
- Acting as an outlet for the excess short term funds of commercial banks
- Dealing in treasury bills and short dated government securities
- Guiding central banking policies
- Making central banking policies effective
- Reduction of disparities in interest rates
- Influencing the capital market

Features of a Developed Money Market

- Existence of an efficient and effective central bank
- Well organized commercial banking system
- Existence of specialized sectors



INTRODUCTION OF CAPITAL MARKET & CAPITAL MARKET INSTRUMENTS

- Free flow of funds between the various sub markets
- Adequate facilities for transfer of funds
- Uniformity in interest rates
- Availability of ample funds
- Availability of ample short term credit instruments
- Sensitiveness to internal and external events
- Existence of specialized financial institutions

Features and Weakness of Indian Money Market

- Existence of unorganized money market
- Absence of integration
- Diversity in money rates of interests
- Seasonal stringency of money
- Highly volatile call money market
- Absence of the bill market
- Absence of well organized banking system
- Availability of credit investments

Money market is the market in which short term funds are borrowed and lent. The money market does not deal in cash or money but in trade bills, promissory notes and government papers which are drawn for short periods. These short term bills are known as near money.

Money Market Instruments

Analysing specifically, the money market deals with the transactions of raising and supplying money in a short period not exceeding one year through various instruments. The following are important money market instruments:

- Treasury Bills (T-Bills)
- Central Government Securities (Gilt-edged Securities)
- State Government and Public Sector Instruments
- Municipal Bonds
- Commercial Paper
- Certificates of deposit
- Bills Rediscounting

- Call / Notice Money Market
- Repurchase Agreements (Repos)
- Inter Bank Participation
- Bank deposits
- Term Money
- Corporate Debentures and Bonds
- Bankers Acceptance
- Commercial Bills
- Fringe Market

Call Money Market

Call money refers to that transaction which is received or delivered by the participants in the call money market and where the funds are returnable next day. The call money transactions are also referred to as overnight funds. Notice money on the other hand is a transaction where the participants will take time to receive or deliver for more than two days but generally for a maximum of fourteen days. In both the cases the transaction is unsecured. Therefore, as a prudential measure, a counter-party exposure limits are listed according to which the lender lends money. In short, resorting to the call / notice money transactions reflect temporary mismatch of funds during the short period of one to fourteen days. The participants, who have surplus, lend their money to shed the mismatch for the relative period. The participants who are short of funds, would borrow funds for the relative period. The rate at which the funds will be deployed or borrowed will be determined on the basis of the market conditions at a given point of time. When the market is highly liquid, the funds would be easily available where as the funds will be difficult to obtain in a tight money market conditions. The rates are low in an easy money or liquid market and the rates would be high in a tight money market. A liquid market may fluctuate even overnight due to sudden changes in the financial environment, change in policy of the central monetary authority or the Government or even due to any other external factor which has an implication on the financial market. The document by which the call / notice money are carried out is the call / notice money receipt which is exchanged against Banker's Cheque / Reserve Bank Cheque. The following day or on a day fixed according to the notice, the reversal takes place by repayment from the borrower to the lender against return of the call / notice money receipt duly discharged by the lender.

Repurchase Agreements (Repos)

Repurchase agreements are simply called as 'repos' arise when one party sells a security to another party with an agreement to buy it back at a specified time and price. Repos are active between the commercial banks. In a ready forward deal or repos transaction, a bank avails itself of funds against the pledge of securities. Basically it is pledge transaction, with the bank committing itself to buy back the security, therefore, paying back the amount borrowed on pledge at a mutually agreed price after a specified period. This period ranges between one and



14 days. The difference between the sale and buy-back price is the interest cost. The basic advantage of a repo is that a collateral security is offered to the lender eliminating counterparty risk, especially in a volatile market. Repo is a risk free short-term instrument for balancing short-term liquidity needs. Banks have often resorted to ready forward deals among themselves, as also with Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI) to overcome short-term funds mismatches. At present, the RBI permits repos between banks, cooperative banks and eligible institutions, ie., the DFHI and the STCI.

Other Money Market Instruments

Term Money - RBI has permitted some of the Financial Institutions like IDBI, ICICI, IFCI, HBI, SIDBI, NABARD, EXIM-Bank etc. to borrow from the market for a period of 3 months and upto a period of not more than 6 months within the stipulated limits. The rate of interest on the term money is determined between the parties by mutual negotiation. The investment in term money is unsecured and the limits are fixed by RBI. The term money is accepted by their institutions at a discounted value. On the due date the payment will be equal to the face value of the instrument, which for all purpose consist of term deposit receipt.

Corporate Debentures and Bonds The debentures and bonds issued by private sector companies for periods from five to seven years for long-term funding requirements. They have a similar target market like PSU bonds but are less liquid as the banks are not permitted to buy debentures and bonds of corporates in the secondary market.

Bank Deposits The banks are permitted to keep deposits with other banks for a period of 15 days and above. The rate of interest of such deposits is freely determined by the two banks between themselves through negotiations. These deposits are not reckoned for the purpose of cash reserve ratio (CRR) requirements. Like the call/notice money transactions, the transactions relating to the bank deposit is evidenced by way of deposit receipt. These deposits are not transferable, but they could be prematurely closed at the discretion of the lender.

Bankers Acceptance A banker's acceptance is a draft against a bank ordering the bank to pay some specified amount at a future date. The banker's acceptance is very safe security and is used as a money market instrument.

Commercial Bills - Purchase and discounting of commercial bills is a way by which banks provide funds for working capital required by commerce, trade and industry. The financial instrument trading in the bills market is the bill of exchange. It is a written instrument containing unconditional order signed by the maker, directing to pay a certain amount of money to a particular person, or to the bearer of the instrument. It is a negotiable self-liquidating instrument with low degree of risk. Its liquidity is exceeded only by T-bills, call loans and cash, in that order. The spread between the face value of the bill and ready money paid is the discount rate. Till the bill matures, the banks can use the same process of discounting to get ready cash. The eligibility criterion is that the bill should arise out of a genuine trade transaction and the maturity period should fall within 90 days from the date of discounting.

Fringe Market The fringe market is a disorganised money market, deemed to include everything that is outside the scope of the money market (i.e., the institutional money market). The fringe market includes activities like the Inter-Corporate Deposit (ICD) market, small scale trade financing, financing of investments in the stock market, discounting and lending against IOUs or promissory notes, etc. The ICDs market is the most visible feature of the fringe market. As its name indicates it essentially involves short-term borrowing and lending of funds amongst the corporations. Generally the fringe market exist, wherever the main borrowers and lenders of the funds are based, i.e., at the location of the industrial, corporate and trading establishments. The interest rates at which the funds can be lent in the fringe market are generally higher than those operating in the money market. The risk level of the fringe market is higher too - the people who borrow at exorbitant rates are the ones who are most likely to default.

Illustration 1.

- (i) Gold Luck Ltd. has an excess cash of Rs. 16,00,000 which it wants to invest in short-term marketable securities. Expenses relating to investment will be Rs. 40,000.

The securities invested will have an annual yield of 8%.

The company seeks your advice as to the period of investment so as to earn a pre-tax income of 4%.

- (ii) Also, find the minimum period for the company to break-even its investment expenditure. Ignore time value of money.

Solutions:

- (i) Pre-tax Income Required on Investment of Rs. 16,00,000

Let the period of investment be 'P' = Rs. 16,00,000X 4% = Rs. 64,000

$$\begin{aligned} \left(16,00,000 \times \frac{8}{100} \times \frac{P}{12} \right) - 40,000 &= 64,000 \\ 10,662.40 P - 40,000 &= 64,000 \\ 10,662.4 P &= 40,000 + 64,000 \\ P &= 9.754 \end{aligned}$$

To earn 4% pre tax return of Rs.16,00,000 should be invested in the shorter marketable securities for a period 9.754 months

- (ii) break-even its investment expenditure



$$\begin{aligned} \left(16,00,000 \times \frac{8}{100} \times \frac{P}{12} \right) - 40,000 &= 0 \\ 10,662.40 P - 40,000 &= 0 \\ 10,662.4 P &= 40,000 \\ P &= 40,000 / 10,662.40 = 3.75 \end{aligned}$$

∴ The minimum period to break-even its investment expenditure is 3.75 months.

STOCK EXCHANGE

The stock exchange is a market for existing securities i.e. those which have been already issued and listed on a stock exchange. These securities purchased and sold continuously among investors without direct involvement of companies. Stock exchange provides not only free transferability of shares but also makes continuous evaluation of securities traded in the market.

Distinctions between new issue market and stock exchange

The distinction between new issue market and stock exchange can be made on three grounds.

1. Functional difference
2. Organisational difference
3. Nature of contribution to industrial finance

1. Functional difference

New Issue market deals with new securities which are issued for the first time for public subscription. The stock exchange provides a ready market for buying and selling of already issued securities.

2. Organisational difference

The stock exchange have physical existence and are located in particular geographical areas. Stock exchange is a place where dealers of security meet regularly at appointed time announced by the market. It is well established organization with rules and regulations for conduct of the business. The members are supplied with information about companies and daily changes in prices of stocks.

New issue market enjoys neither any tangible form nor any administration organizational set up nor is subject to any centralized control and administration for the execution of the business. It renders services to the lenders and borrowers of funds at the time of any particular operation and the services are taken up entirely by banks, brokers and underwriters.

3. Nature of contribution to industrial finances

The new issue market provides the issuing company with funds for starting new enterprises or for either expansion or diversification of an existing one by marking direct link between



companies which require funds and the investing public. So, the contribution of new issue market is direct. The role of stock exchange in providing capital is indirect as it provides marketability to the shares.

Relationship between new issue market and stock exchange

Despite the above mentioned differences, the new issue market and stock exchange are inseparably connected and work in conjunction with each other.

The new issues first placed in the new issue market can be disposed of subsequently in the stock exchange. The stock exchange provides the mechanism for regular and continuous purchase and sale of securities. This facility is of immense utility to potential investors who are assured that they will be able to dispose of the allotment of shares at any time. Thus the two markets are complimentary in nature.

Both the markets are connected to each other even at the time of new issue. The companies which makes new issue apply for listing of shares on a recognized stock exchange. Listing of shares adds prestige to the firm and widens the market for the investors. The companies which want stock exchange listing have to comply with statutory rules and regulations of the stock exchange to ensure fair dealing in them. The stock exchange, thus, exercise considerable control over the organization of new issues.

The new issue market and stock market are economically an integral part of a single market i.e, industrial securities market. Both are susceptible to the common influence of the environment conditions such as political stability, economic conditions, monetary policy of the central bank and the fiscal policy of the government. The two markets act and react upon each other in the same direction. When the stock prices go up in the market, the new issues increase and when the stock prices show a downward trend the new issues decline. The new issue market also depends on the stock exchange to find out price movements and general economic outlook and to forecast the climate for the success of new issues.

Price Band

The issuer company can mention a price band of 20% (cap in the price band should not be more than 20% of the floor price) in the offer document filed with SEBI and actual price can be determined at a later date before filing the offer document with ROC.

Lock-in Period

'Lock- in' indicates the freeze on transfer of shares. SEBI (Disclosure and Investor Protection) Guidelines, 2000 have stipulated lock-in requirement as to specified percentage of shares subscribed by promoters with a view to avoid unscrupulous floating of securities and to ensure the promoters involved in the issue continue to have controlling interest in the company, who can be subjected for legal compliances. The lock-in requirement provisions are contained in Chapter IV of the said guidelines as summarised below:

***Lock-in of Minimum Specified Promoters Contribution in Public Issues***

- In case of any issue of capital to the public the minimum promoter contribution shall be locked in for a period of 3 years.
- The lock-in shall start from the date of allotment in the proposed public issue and the last date of the lock-in shall be reckoned as 3 years from the date of commencement of commercial production or the date of allotment in the public issue whichever is later.
- ‘*The date of commencement of commercial production*’ means the last date of the month in which commercial production in a manufacturing company is expected to commence as stated in the offer document.

Lock-in of Excess Promoters’ Contribution

- In case of public issue by unlisted company, if the promoter’s contribution in the proposed issue exceeds the required minimum contribution, such excess contribution shall also be locked-in for a period of one year.
- In case of public issue by a listed company, participation by promoters in proposed public issue in excess of the required minimum percentage shall also be locked-in for a period of one year.
- In case short-fall in the firm allotment category is met by the promoter, such subscription shall be locked-in for a period of one year.
- The securities forming part of promoters contribution and issued last to the promoters shall be locked-in first for the specified period.
- The securities issued to the financial institutions appearing as promoters, if issued last, shall not be locked-in before the shares allotted to the other promoters.

Lock-in of Pre-issue Share Capital of an Unlisted Company

- The entire pre-issue share capital, other than that locked in as promoters contribution, shall be locked-in for a period of one year from the date of commencement of commercial production or the date of allotment in the public issue, whichever is later.
- The above provision is not applicable to the pre-issue share capital held by venture capital funds and foreign venture capital investors.
- The above provision is also not applicable if shares are held for a period of at least one year at the time of filing draft offer document with SEBI and being offered to the public through offer for sale.

e-IPO

The companies are now allowed to issue capital to the public through the on-line system of the stock exchanges. For making such on-line issues, the companies should comply with the provi-



sions contained in Chapter 11A of SEBI (Disclosure and Investor Protection) Guidelines, 2000. The appointment of various intermediaries by the Issuer includes a prerequisite that such members / registrars have the required facilities to accommodate such an on-line issue process.

Qualified Institutional Buyers (QIBs)

Qualified Institutional Buyers are those institutional investors who are generally perceived to possess expertise and the financial muscle to evaluate and invest in the capital market. As per the SEBI guidelines QIBs shall mean the following:

- Public Financial Institution as defined in section 4A of the Companies Act, 1956
- Scheduled Commercial Banks
- Mutual Funds
- Foreign Institutional Investors registered with SEBI
- Multilateral and Bilateral Development Financial Institutions
- Venture Capital Funds registered with SEBI
- Foreign Venture Capital Investors registered with SEBI
- State Industrial Development Corporations
- Insurance Companies registered with the Insurance Regulatory and Development Authority (IRDA)
- Provident Funds with minimum corpus of Rs. 25 crores
- Pension Funds with minimum corpus of Rs. 25 crores.

These entities are not required to register with SEBI as QIBs. Any entities falling under the categories specified above are considered as QIBs for the purpose of participating in primary issuance process.

Placement

Under this method, the issue houses or brokers buy the securities outright with the intention of placing them with their clients afterwards. Here the brokers act as almost wholesalers selling them in retail to the public. The brokers would make profit in the process of reselling to the public. The issue houses or brokers maintain their own list of client and through customer contact sell the securities.

Placement has the following advantages:

1. Timing of issue is important for successful floatation of shares. In a depressed market conditions when the issues are not likely to get public response though prospectus, placement method is a useful method of floatation of shares.
2. This method is suitable when small companies issue their shares.



The main disadvantage of this method is that the securities are not widely distributed to the large section of investors. A selected group of small investors are able to buy a large number of shares and get majority holding in a company.

This method of private placement is used to a limited extent in India. The promoters sell the shares to their friends, relatives and well wishers to get minimum subscription which is a precondition for issue of shares to the public.

Safety Net

Safety net is a scheme under which a person or a company (generally a finance company) undertakes to buy shares issued and allotted in a new issue from the allottees at a stipulated price. This is an agreement in relation to an issue of equity shares. The main feature of the safety net is to provide the equity investors safety of their investments from fall of the share price below the issue price. This facility will be generally provided in the bear market environment. Closely held companies who are going to issue shares to the public for the first time may also provide safety net facility to the investors in their shares where the investors has no benchmark price to go by and therefore the safety net would provide him a sort of confidence regarding safety of their investment into equity shares. The safety net scheme generally puts provision for buying back the shares at a price lower than the issue price, and the difference will be the premium to the buyer for the risk taken in purchase of shares back from the investors.

Stock invest

In case of oversubscription of issue, there have been inordinate delay in refund of excess application money and large amounts of investors' funds remain locked up in companies for long periods affecting the liquidity of the investing public. To overcome the said problem a new instrument called 'stockinvest' is introduced. The Stockinvest is a non-negotiable bank instrument issued by the bank in different denominations. The investor who has a savings or current account with the bank will obtain the stockinvest in required denominations and will have to enclose it with the share/debenture application. On the face of the instrument provides for space for the investor to indicate the name of the issues, the number and amount of shares/debentures applied for and the signature of the investor. The stockinvests issued by the bank will be signed by it and the date of issue will also be indicated on the instruments. Simultaneously with the issue of stockinvest, the bank will mark a lien for the amounts of stockinvest issued in the deposit account of the investor. On full or partial allotment of shares to the investor, the Registrar to issue will fill the columns of stockinvest indicating the entitlement for allotment of shares/debentures, in terms of number, amount and application number and send it for clearing.

The investor's bank account would get debited only after the shares/debentures allotted. In respect of unsuccessful applicants, the funds continue to remain in their account and earn interest if the account is a savings or a term deposit. The excess application money of partly successful applicants also, will remain in their accounts. There will be lien on the funds for a maximum of four months period. The stockinvest is intended to be utilised only by the account holders and the stockinvest should not be handed over to any third party for use. In case the cancelled/partially utilised stockinvest is not received by an investor from the registrar, lien will



be lifted by the issuing branch on expiry of four months from the date of issue against an indemnity bond from the investor.

Rights Issues

If an existing company intends to raise additional funds, it can do so by borrowing or by issuing new shares. One of the most common methods for a public company to use is to offer existing shareholders the opportunity to subscribe further shares. This mode of raising finance is called '*Rights Issues*'. The existing shareholders have right to entitlement of further shares in proportion to their existing shareholding. A shareholder who does not want to buy the right shares, his right of entitlement can be sold to someone else. The price of rights shares will be generally fixed above the nominal value but below the market price of the shares. The issue of quoted shares at below the nominal value is not allowed, and it would be rare for this to happen for unquoted shares. Section 81 of the Companies Act provides for the further issue of shares to be first offered to the existing members of the company, such shares are known as 'Right shares' and the right of the members to be so offered is called the '*right of pre-emption*'.

Section 81 of the Companies Act, 1956 deals with the provisions relating to rights issues.

- Any Company
 - (i) which has completed two years after its incorporation or
 - (ii) which has completed one year from the first allotment of shares after its incorporation
- whichever is earlier, if it proposes to increase its subscribed capital by allotment of further shares, then the subsequent provisions shall apply.
- Those further shares shall be first be offered to the existing shareholders in proportion to the shares held by them in the paid up capital, on the date of such offer.
- At least 15 days notice shall be given from the date of offer. The notice shall specify the number of shares offered and the limiting time of the offer.
- The notice shall mention that if the offer is not accepted within the time of offer, will be deemed to have been declined.
- Unless the articles of the company otherwise mention, such offer has the right of renunciation.
- The notice of offer shall contain a statement a renunciation.
- If it is declined to accept the offer, the Board of directors may dispose of those shares in such manner as they think most beneficial to the company.



Bought Out Deal

Bought Out Deal (BOD) is a process of investment by a sponsor or a syndicate of investors / sponsors directly in a company. Such direct investment is being made with an understanding between the company and the sponsor to go for public offering in a mutually agreed time. Bought out deal, as the very name suggests is a type of wholesale offer of equities by a company. A company allots shares in full or in lots to a sponsors at a price negotiated between the company and the sponsor(s). After a particular period of agreed upon between the sponsorer and the company the shares are issued to the public by the sponsorer with a premium. The holding cost of such shares by the sponsor may either be reimbursed by the company or the sponsor may absorb the profit in part or full as per the agreement, arising out of the public offering at a premium. After the public offering the shares are listed in one or more stock exchanges.

Advantages Bought out deal is not only advantageous to the company going for it but also to the sponsors and common investors.

- The company has the advantage of using the fund immediately without waiting as in the case of direct public issue. In case of BOD the company instantly gets funds and is able to focus its attention on project implementation without worrying for source of investment. Bought out deals are ideally suited in circumstances when money needs to be arranged fast without which the project may suffer. Lowering or eliminating issue cost from the preliminary expenses is another advantage to the company.
- The time taken to raise money in the capital market by a company takes as much as six months and this time is very high for a company in an infancy stage. The waste of time in the initial stage can be avoided by going for BOD.
- In case of a new and untried product it is easier to convince an investment banker for an investment in the company rather than the general public. Hence BOD is an innovative method of financing for such companies.
- When the market sentiment is low and the secondary market is undergoing a bear phase, a company may not like to come to the market with a public issue. In such case BOD is a superior process to get fund for the company.
- The merchant bankers also gain handsomely from a BOD. The merchant banks expect a return of around 30% from a BOD whereas private financing institutions expect a return of 40% to 60% from a BOD. The gains can be tremendous provided the sponsors select proper issues and price it attractively to the investors.
- The investors also gain from the BOD in a way that they get good issues where some merchant banker has already invested in it. The common investors do not have enough scope and information for proper evaluation of a company. The merchant bankers are professionals and can make proper appraisal of a company.

1.6 DEPOSITORIES

The depositories are an important intermediaries in the securities market that is scrip-less or moving towards such a state. In India, the Depositories Act defines a depository to mean “a company formed and registered under the Companies Act, 1956 and which has been granted a



certificate of registration under sub-section (IA) of section 12 of the Securities and Exchange Board of India Act, 1992.” The principal function of a depository is to ematerialize securities and enable their transactions in book-entry form.

Dematerialisation of securities occurs when securities, issued in physical form, are destroyed and an equivalent number of securities are credited into the beneficiary owner’s account. In a depository system, the investors stand to gain by way of lower costs and lower risks of theft or forgery, etc. They also benefit in terms of efficiency of the process. But the implementation of the system has to be secure and well governed. All the players have to be conversant with the rules and regulations as well as with the technology for processing. The intermediaries in this system have to play strictly by the rules.

A depository established under the Depositories Act can provide any service connected with recording of allotment of securities or transfer of ownership of securities in the record of a depository. A depository cannot directly open accounts and provide services to clients. Any person willing to avail of the services of the depository can do so by entering into an agreement with the depository through any of its Depository Participants.

Depository is an organisation which holds securities of investors in electronic form at the request of the investors through a registered Depository Participant. It also provides services related to transactions in securities.

Bank and Depository

It can be compared with a bank, which holds the funds for depositors. A Bank – Depository Analogy is given in the following table:

BANK-DEPOSITORY – AN ANALOGY

BANK	DEPOSITORY
Holds funds in an account	Hold securities in an account
Transfers funds between accounts on the instruction of the account holder	Transfers securities between accounts on the instruction of the account holder
Facilitates transfer without having to handle money	Facilitates transfer of ownership without having to handle securities
Facilitates safekeeping of money	Facilitates safekeeping of securities



Types of Depositories registered with SEBI

At present two Depositories viz. National Securities Depository Limited (NSDL) and Central Depository Services (I) Limited (CDSL) are registered with SEBI.

Benefits of availing depository services

The benefits are enumerated below:-

1. A safe and convenient way to hold securities;
2. Immediate transfer of securities;
3. No stamp duty on transfer of securities;
4. Elimination of risks associated with physical certificates such as bad delivery, fake securities, delays, thefts etc.;
5. Reduction in paperwork involved in transfer of securities;
6. Reduction in transaction cost;
7. No odd lot problem, even one share can be sold;
8. Nomination facility;
9. Change in address recorded with DP gets registered with all companies in which investor holds securities electronically eliminating the need to correspond with each of them separately;
10. Transmission of securities is done by DP eliminating correspondence with companies;
11. Automatic credit into demat account of shares, arising out of bonus / split / consolidation / merger etc.
12. Holding investments in equity and debt instruments in a single account.

1.7 BUY BACK OF SHARES

A **treasury stock** or **reacquired stock** is stock which is bought back by the issuing company, reducing the amount of outstanding stock on the open market ("open market" including insiders' holdings).

Stock repurchases are often used as a tax-efficient method to put cash into shareholders' hands, rather than pay dividends. Sometimes, companies do this when they feel that their stock is undervalued on the open market. Other times, companies do this to provide a "bonus" to incentive compensation plans for employees. Rather than receive cash, recipients receive an asset that might appreciate in value faster than cash saved in a bank account. Another motive for stock repurchase is to protect the company against a takeover threat.

Benefits of BBS

If efficient market theory is correct, a company buying back its stock should have no effect at all on its stock price. If the market fairly prices a company's shares at \$50/share, if a company buys back 100 shares for INR 5000, it now has INR 5000 less cash but there are 100 fewer shares outstanding; the net effect should be that the value per share is unchanged. However, buying back shares does improve certain per-share ratios, such as price/earnings (earnings per share is increased due to fewer shares outstanding), but that is only because valuing a company's shares according to those ratios is not accurate when a company is holding a lot of cash. If a company's shares are underpriced, then a company can benefit its other shareholders by buying back shares. If a company's shares are overpriced, then a company is actually hurting its remaining shareholders by buying back stock.

Incentives

One other reason for a company to buy back its own stock is to reward holders of stock options. Option holders are hurt by dividend payments, since, typically, they are not eligible to receive them. A share buyback program *may* increase the value of remaining shares (if the buyback is executed when shares are underpriced); if so, option holders benefit. A dividend payment short term *always* decreases the value of shares after the payment, so, on the day shares go ex-dividend, option holders *always* lose. Finally, if the sellers into a corporate buyback are actually the option holders themselves, they may directly benefit from temporarily unrealistically favorable pricing.

After buyback

The company can either retire the shares (however, retired shares are not listed as treasury stock on the company's financial statements) or hold the shares for later resale. Buying back stocks reduces the number of outstanding shares. To see this, note that accompanying the decrease in the number of shares outstanding is a reduction in company assets, in particular, cash assets, which are used to buy back shares.

Investors in IPOs:

The investors in any Initial Public Offering (IPO) constitute retail Investors, Qualified Institutional Buyers and Non-Institutional Investors. As per the existing SEBI regulations, the allocation of shares to QIBs, NIIs and retail investors has to be in the ratio of 50:15:35. Under NIIs, resident Indian individuals, HUFs, NRIs, societies and trusts, whose application size in terms of value is more than Rs 1 lakh, are allowed to bid. According to sources in investment banking circles, QIBs and 'bulge bracket' sponsors (HNIs) ensure the success of public issues in the market. This is evident from the fact that public issues with higher NII participation invariably list at a higher premium.

Qualified Institutional Buyer - QIB

QIBs primarily refer to institutions that manage at least \$100 million in securities including banks, savings and loans institutions, insurance companies, investment companies, employee benefit plans, or an entity owned entirely by qualified investors. Also included are registered



broker-dealers owning and investing, on a discretionary basis, \$10 million in securities of non-affiliates.

High Net Worth Individual – (HNI)

A classification of an investor, to denote an individual or a family with high net worth. High net worth is generally quoted in terms of liquid assets over a certain figure. The exact amount differs by financial institution and region. The categorization is relevant because high net worth individuals generally qualify for separately managed investment accounts instead of regular mutual funds.

The most commonly quoted figure for membership in the high net worth "club" is \$1 million in liquid financial assets. An investor with less than \$1 million but more than \$100,000 is considered to be "affluent", or perhaps even "sub-HNWI". The upper end of HNWI is around \$5 million, at which point the client is then referred to as "very HNWI". More than \$50 million in wealth classifies a person as "ultra HNWI".

HNWIs are in high demand by private wealth managers. The more money a person has, the more work it takes to maintain and preserve those assets. These individuals generally demand (and can justify) personalized services in investment management, estate planning, tax planning, and so on.

Objective Questions:

1. The price at which a company's shares are offered initially in the primary market (Issue Price ; Listing Price ; Market Price)
2. The market value of a quoted company, which is calculated by multiplying its current market price by the number of outstanding shares is referred as _____ (Price rigging ; Market Capitalization ; Stock Invest)
3. Shares normally held by promoters and directors of the company (Preference shares ; Deferred Shares ; Convertible Bonds)
4. Issue of shares to its employees or directors at discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value addition. (Sweat Equity ; Green Shoe option ; Seasoned Equity)
5. A _____ which contains all information of the company contents but does not have information on price of securities offered and number of securities (quantum) offered through such document to the Public. (Offer for sale ; Bought out Deal ; Red –Herring Prospectus)
6. _____ is an unsecured promissory note privately placed with investors, freely negotiable by endorsement at a discount rate to face value determined by market forces. (Certificate of Deposit ; Commercial Paper ; Treasury Bill)



7. A company allots shares in full or in lots to a sponsor at a price negotiated between the company and the sponsor(s). (Bought Out Deal ; Buy Back of Shares ; Irredeemable Preference shares)
8. An option allowing the Issuing Company to issue additional shares when the demand is high for the shares when the flotation is on.
(Follow on Offer ; Green Shoe option; Call option)
9. The investors who tend to purchase a company's stock usually based on relationships between the current market price of the company and certain business fundamentals.(Growth Investing ; Value Investing ; Stock Invest)
10. A Custodian is basically an organisation, which helps register and safeguard the securities of its clients. (Depository ; Trustee ; Stock exchange)
11. A _____ can be seen as a method for company to invest in itself by buying shares from other investors in the market. (Initial Public Offer ; Rights issue ; Buy back)
12. A _____ is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form. (Depository ; SafetyNet ; eIPO)
13. _____ is the process by which physical certificates of an investor are converted to an equivalent number of securities in electronic form and credited to the investor's account with his *Depository Participant* (DP). (Demutualisation ; Dematerialization ; Rematerialisation)
14. The responsibility for regulating the securities market is shared by _____. [Department of Economic Affairs (DEA) Department of Company Affairs (DCA) Reserve Bank of India (RBI) Securities and Exchange Board of India (SEBI). All the above (c) and (d)]
15. The Securities and Exchange Board of India (SEBI) is the regulatory authority in India established under Section 3 of SEBI Act, _____. (1990 ; 1992 ; 1991)
16. An issue where an allotment is made to less than 50 persons (Rights Issue ; Bought out deal ; Private Placement ;)
17. Lead Manager stipulates the floor price or a price band and leave it to market forces to determine the final price. (Remutualisation ; Book Building ; Fixed Price)
18. SBTS stands for _____ (Stock Buy Trading System Screen Based Trading System Screen Bolt Trading System)
19. An existing listed company either makes a fresh issue of securities to the public or makes an offer for sale of securities to the public for the first time. (Initial Public Offer ; Follow on offering; Green Shoe option)



20. First exchange in the world to use satellite communication technology for trading. Its trading system, called _____ (SBTS ; NEAT ;)
21. _____ refers to the legal structure of an exchange whereby the ownership, the management and the trading rights at the exchange are segregated from one another. (Rematerialisation ; Demutualisation ; Dematerialisation)
22. An _____ shows how a specified portfolio of share prices are moving in order to give an indication of market trends. (Forex ; Index ; CommodityEx)
23. An outright sale of securities through the intermediary of issue houses or share brokers where, the shares are not offered to the public directly. (Offer for sale ; Follow on offer ; Secondary Offer)
24. Bond issued at a discount and repaid at a face Value. (Eurobonds ; Yankee Bonds ; zero –coupon bonds)
25. The Securities market essentially has three categories of participants, namely, _____ (NSDL , SEBI , Investors. ; RBI ; Brokers ; Companies ; Issuers , Investors in securities , Intermediaries)

[Answers: 1. a ; 2. b ; 3. b ; 4. a ; 5. c ; 6. b ; 7. a ; 8. b ; 9. b ; 10. a ; 11.c ; 12.a ; 13.b ; 14. e ; 15 b ; 16. c ; 17. b ; 18. b ;

19.b ; 20. b ; 21. b ; 22. b ; 23.a ; 24. c ; 25. c]

1.8. FORWARD CONTRACT AND FUTURE CONTRACTS

Forward Contract

A forward contract is an agreement made today between a buyer and seller to exchange the commodity or instrument for cash at a predetermined future date at a price agreed upon today. The agreed upon price is called the 'forward price' with a forward market the transfer of ownership occurs on the spot, but delivery of the commodity or instrument does not occur until some future date. In a forward contract, two parties agree to do a trade at some future date, at a stated price and quantity. No money changes hands at the time the deal is signed. For example, a wheat farmer may wish to contract to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such transaction would take place through a forward market. Forward contracts are not traded on an exchange, they are said to trade over the counter (OTC). The quantities of the underlying asset and terms of contract are fully negotiable. The secondary market does not exist for the forward contracts and faces the problems of liquidity and negotiability.

Problems in Forward Contracting

The forward contracts are affected by the problems like (a) Lack of centralisation of trading (b) Illiquidity (c) Counter party risk.

Futures Contract

The futures contract is traded on a futures exchange as a standardised contract, subject to the rules and regulations of the exchange. It is the standardisation of the futures contract facilitates the secondary market trading. The futures contract relates to a given quantity of the underlying asset and only whole contracts can be traded, and trading of fractional contracts are not allowed in futures contracting.

The terms of the futures contracts are not negotiable. A futures contract is a financial security, issued by an organised exchange to buy or sell a commodity, security or currency at a predetermined future date at a price agreed upon today. The agreed upon price is called the 'futures price'.

Types of Futures Contract

Futures contracts may be classified into two categories:

Commodity Futures: Where the underlying is a commodity or physical asset such as wheat, cotton, butter, eggs etc. Such contracts began trading on Chicago Board of Trade (CBOT) in 1860's. In India too, futures on soyabean, black pepper and spices have been trading for long

Financial Futures: Where the underlying is a financial asset such as foreign exchange, interest rates, shares, treasury bill or stock index.

Standardised Items in Futures The standardised items in any futures contract are:

- (a) Quantity of the underlying
- (b) Quality of the underlying (not required in financial Futures)
- (c) The date and month of delivery
- (d) The units of price quotation (not the price itself) and minimum change in price (tick-size)
- (e) Location of settlement

Important Features of Futures Contract:

The important features of futures contract is given below:

Standardisation: The important feature of futures contract is the standardisation of contract. Each futures contract is for a standard specified quantity, grade, coupon rate, maturity etc. The standardisation of contracts fetches the potential buyers and sellers and increases the marketability and liquidity of the contracts.

Clearing house: - An organisation called 'futures exchange' will act as a clearing house. In futures contract, the obligation of the buyer and the seller is not to each other but to the clearing house in fulfilling the contract which ensure the elimination of the default risk on any transaction.



Time Spreads: - There is a relationship between the spot price and the futures price of contract. The relationship also exists between prices of futures contracts which are on the same commodity or instrument but which have different expiry dates. The difference between the prices of two contracts is known as the 'time spread' which is the basis of futures market

Margins: - Since the clearing house undertakes the default risk, to protect itself from this risk, the clearing house requires the participants to keep margin money, normally ranging between 5% to 10% of the face value of the contract.

Uses of Forward and Future Contracts

The uses of forward and futures contracting are as follows:

Hedging: The classic hedging application would be that of a wheat farmer forward / futures selling his harvest at a known price in order to eliminate price risk. Conversely, a bread factory may want to buy wheat forward / futures in order to assist production planning without the risk of price fluctuations.

Price discovery: Price discovery is the use of forward / futures prices to predict spot price that will prevail in the future. These predictions are useful for production decisions involving the various commodities.

Speculation: - If a speculator has information or analysis which forecasts an upturn in a price, then he can go long on the forward / futures market instead of the cash market, wait for the price rise, and then take a reversing transaction. The use of forward / futures market here gives leverage to the speculator.

Forward Contract vs. Future Contract

Forward contracts are private bilateral contracts and have well established commercial usage. Future contracts are standardised tradable contracts fixed in terms of size, contract date and all other features. The differences between forward and Futures contracts are given below:

Forward contracts	Future contracts
1. The contract price is not publicly disclosed and hence not transparent. 2. The contract is exposed to default risk by counterparty. 3. Each contract is unique in terms of size, expiration date and asset type / quality. 4. The contract is exposed to the problem of liquidity. 5. Settlement of the contract is done by delivery of the asset on the expiration date.	1. The contract price is transparent. 2. The contract has effective safeguards against defaults in the form of clearing corporation guarantees for trades and daily mark to market adjustments to the accounts of trading members based on daily price change. 3. The contracts are standardised in terms of size, expiration date and all other features. 4. There is no liquidity problem in the contract. 5. Settlement of the contract is done on cash basis.

Participants in Futures Market

The major players in the futures market are Hedgers, Speculators and Arbitrageurs.

Hedgers	- Hedgers wish to eliminate or reduce the price risk to which they are already exposed. The hedging function solely focuses on the role of transferring the risk of price changes to other holders in the futures markets.
Speculators	- Speculators are those class of investors who willingly take price risks to profit from price changes in the underlying.
Arbitrageurs	- Arbitrageurs profit from price differential existing in two markets by simultaneously operating in two different markets.

Mechanism in Futures Contracts

- Buy a future to agree to take delivery of a commodity. This will protect against a rise in price in the spot market as it produces a gain if spot prices rise. Buying a future is said to be going long.
- Sell a future to agree to make delivery of a commodity. This will protect against a fall in price in the spot market as it produces a gain if spot prices fall. Selling a future is said to be going short.

A futures contract is a contract for delivery of a standard package of a standard commodity or financial instrument at a specific date and place in the future but at a price which is agreed when the contract is taken out. Certain futures contracts, such as on stocks or currency, settled in cash on the price differentials, because clearly delivery of this particular commodity would be difficult.

The futures price is determined as follows:

Futures Price = Spot Price + Costs of Carrying

The spot price is the current price of a commodity. The costs of carrying of a commodity will be the aggregate of the following:

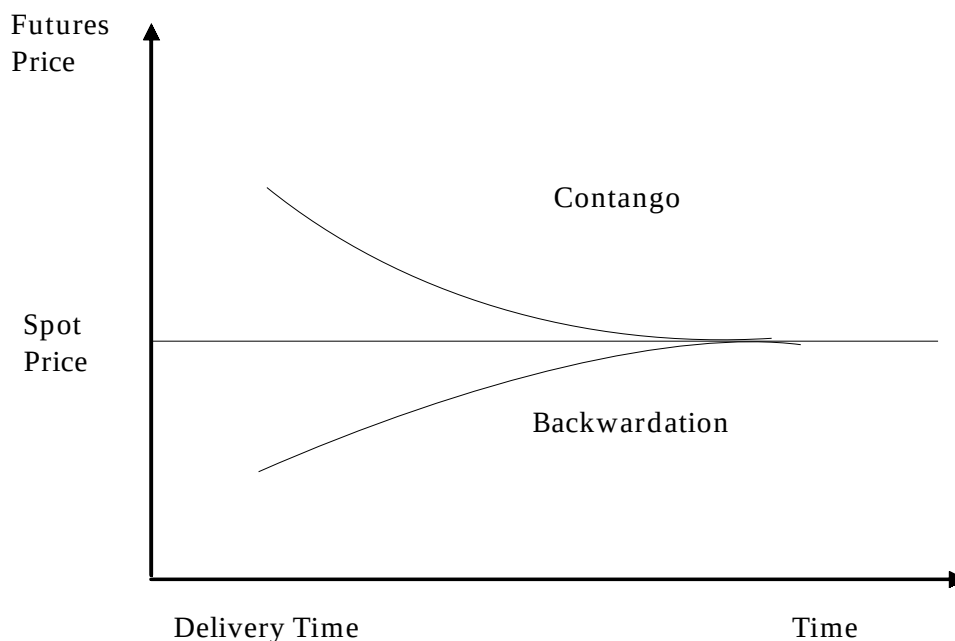
- (a) Storage
- (b) Insurance
- (c) Transport costs involved in delivery of commodity at an agreed place.



(d) Finance costs ie., interest forgone on funds used for purchase of the commodity.

Basis = Futures – Spot Price

Although the spot price and futures price generally move in line with each other, the basis is not constant. Generally basis will decrease with time. And on expiry, the basis is zero and futures price equals spot price. If the futures price is greater than the spot it is called *contango*. Under normal market conditions futures contracts are priced above the spot price. This is known as the contango market. In this case, the futures price tends to fall over time towards the spot, equalling the spot price on delivery day. If the spot price is greater than the futures price it is called '*backwardation*'. Then the futures price tends to rise over time to equal the spot price on the delivery day. So in either case, the basis is zero at delivery. This may happen when the cost of carry is negative, or when the underlying asset is in short supply in the cash market but there is an expectation of increased supply in future - example agricultural products. The direction of the change in price tends to hold for cycles of contracts with different delivery dates. If the spot price is expected to be stable over the life of the contract, a contract with a positive basis will lead to a continued positive basis although this will be lower in nearby delivery dates than in far-off delivery dates. This is a normal contango (Fig. 7.1) Conversely, normal backwardation is the result of a negative basis where nearer maturing contracts has higher futures prices than far-off maturing contract.



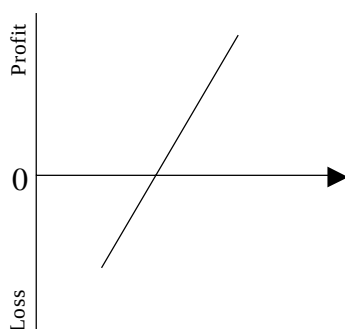
FUTURES CONTRACTS –CONTANGO AND BACKWARDATION

Simple Payoff Positions in Futures The buyer of a futures contract is said to ‘go long’ the future, whereas the seller is said to ‘go short’. With a long position, the value of the position rises as the asset price rises and falls as the asset price falls. With a short position, a loss ensues if the asset price rises but profits are generated if the asset price falls.

Buyer’s Payoff The buyer of futures contract has an obligation to purchase the underlying instrument at a price when the spot price is above the contract price the buyer will buy the instrument for the price ‘C and can sell the instrument for higher spot price thus making a profit. When the contract price is above spot price, a loss is made by the buyer of the contract.

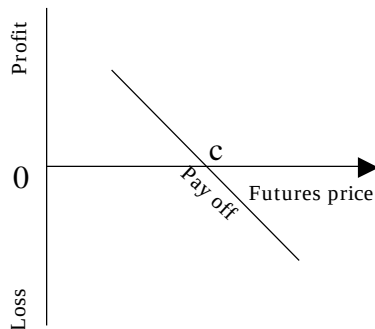
Seller’s Payoff The seller of the contract makes a profit when the contract price is above the spot price. The seller will purchase the instrument at the spot price and sells at the contract price. The seller makes loss when the spot price is above the contract price

Long position



C = Contract price

Short position



C = Contract price

PAY OFF IN LONG AND SHORT FUTURES POSITION

Illustration 3

Suppose a trader has bagged an order for which he has to supply 2,000 tonnes of aluminium sheet to the buyer within next two months.

After obtaining the order the trader is observing a rise of price of aluminium sheet in the open market and, if such a rise continues, the profit margin of the trader may get shrunk, even he may land on a huge loss just because of the rise of procurement price of the aluminium sheet. But if the trader under the circumstances purchases aluminium sheet futures, then any loss for the rise of price of aluminium to be bought by the trader for the supply order could be then off-setted against profit on the future contract, and, however, if there is a fall of price, extra profit



on fall of price of aluminium sheet can also be offset against cost or loss of future contract. So hedging technique is equivalent of insurance facility against market risk where price is always volatile.

1.9 ISSUE MECHANISM

Stock market or securities market is a market where securities issued by firms in the form of shares, bonds and debentures can be bought and sold freely. It consists of primary market and secondary market.

Primary market or the new issues market is the market which is concerned with the issue of new securities. Companies often raise funds through the primary market for setting up or expanding their business. The various methods through which capital can be raised are:-

- **By prospectus:-** Capital can be raised from the general public by the issue of prospectus. The prospectus is an invitation to the general public for subscribing to the capital. It contains various details regarding the particulars of the company, its financial position, etc.
- **By offer for sale:-** This method is almost similar to the prospectus except the difference that initially shares are taken up by a third party in bulk. Later, a statement like prospectus is issued for sale of shares to the public.
- **By private placing:-** Shares are sold to individuals or institutions directly by making a private appeal to them.
- **By offering rights issue:-** Companies may also raise capital from the existing shareholders by making a rights issue. Under the rights issue, the shareholders have the right to a certain number of shares in proportion to the shares held by them.

Secondary market or stock exchange is a highly organised market for the purchase and sale of second hand quoted or listed securities ('quoting' or 'listing' of a particular security implies incorporating that security in the register of the stock exchange). It is an association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities.

The various instruments of stock market include:-

- Shares, which represents the interests or rights of the investors (measured in terms of money) to participate in the profits made by the company while it is a going concern, or in the assets of the company when it is wound up
- IPOs or Initial Public Offerings is the first sale of a company's common shares to public investors for the purpose of raising capital in the primary market



- Mutual Funds is a mechanism of mobilizing the savings and resources of various individual investors, especially small investors and investing them in shares and securities of the companies
- Bond is a security representing a long-term promise to pay a certain sum of money at a certain fixed time or over the course of the loan, with a fixed rate of interest payable to the bond holder.

The rating of stock market implies evaluating the various options of issuing securities in the primary as well as the secondary market. It is a tool which enables the investor to check the future capability of each stock as well as that of its issuer. It is focussed on communicating to the investors the relative ranking of the profits or loss probability for a given fixed income investment in comparison with other related instruments. However, the evaluation of the security issues are not recommendations to buy or sell or to indicate the suitability of any particular security for the investor.

The rating of the bonds issued by corporates, government, etc. is called the bond rating. The rating of preference share issued by a company is called preference share rating. whereas, the rating of equity shares issued by a company is called equity rating.

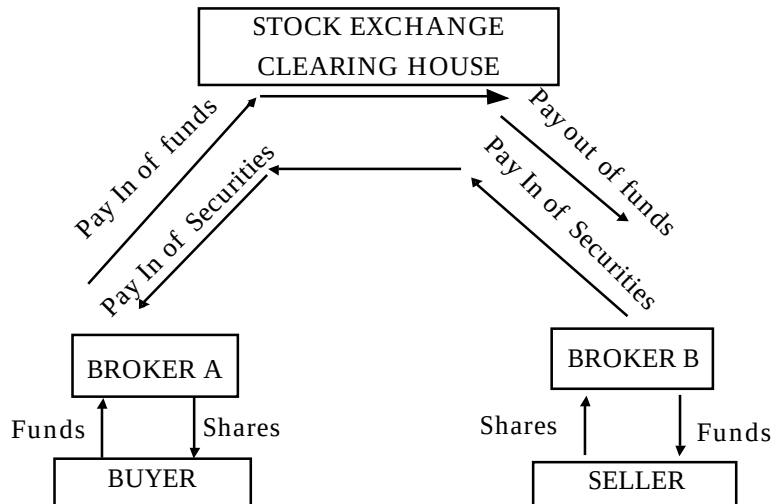
1.10 CLEARING AND SETTLEMENT MECHANISM

Settlement mechanism

Once you have bought or sold shares, the transaction is complete only when you have taken delivery of the shares you have purchased, or received money for the shares you have sold. This is called settlement in stock market parlance. The stock exchanges have a complex mechanism in place to ensure that every trade is properly matched, and shares are received or delivered properly. In case of a shortfall of securities, an auction is resorted to close out the difference. The mechanism through which all parties to a transaction get their receivables i.e. either funds or shares is known as 'clearing and settlement' or simply 'settlement'. (Fig. 9.1)



Settlement Process



Settlement agents

On each of the exchanges, thousands of orders get matched with each other during the course of a trading cycle. Even though for each trade there is a buyer broker and a seller broker, they never interact with each other for the settlement of that trade. Their interaction is only with the settlement agency of their exchange. When an investor enters into a transaction with a broker, either the shares or funds have to be delivered to the broker. In turn, the broker delivers these to the settlement agent on 'pay-in day' (explained in the next section). Having made sure that it has received shares and funds from all brokers, it processes the deliveries and earmarks the shares for delivery to the buyer broker. So on the pay-out day (explained in the next section) it is able to deliver shares to the respective buyer broker and funds to the respective seller broker.

For trades on BSE, the settlement agent is called as '**Clearing House (CH)**' while on NSE it is '**National Securities Clearing Corporation Ltd. (NSCCL)**'

Clearing House – Settlement Agent of the BSE

The clearing and settlement operations of the BSE is managed by a company called BOI Share Holding, which is a subsidiary of Bank of India and BSE and is known as Clearing House. All settlements for securities are through the Clearing House on a delivery versus payment (DVP) basis.

Trading Mechanism in Stock Exchanges

The bye-laws of the stock exchanges does not permit an outsider, who is not a member to transact business directly. Buying and selling of securities could be engaged only through a broker, who is a member of a stock exchange. The trading mechanism follows the following procedure:

- i) **Choosing a broker** - selecting a broker can be based on either a known member or proximity / popularity .
- ii) **Engaging the broker** – Complying with the legal terms and signing an agreement with the broker of your choice
- iii) **Opening an account with broker** – A DP account to be opened becomes necessary for opening an account with the broker.
- iv) **Placing the order** – An order is placed with the broker for buying or selling a specific number of securities
- v) **Exercising of the choice of orders** – The orders placed are executed for which a certain percentage of brokerage charges are levied

The transaction cycle for placing an order is as given below in Fig.9.2

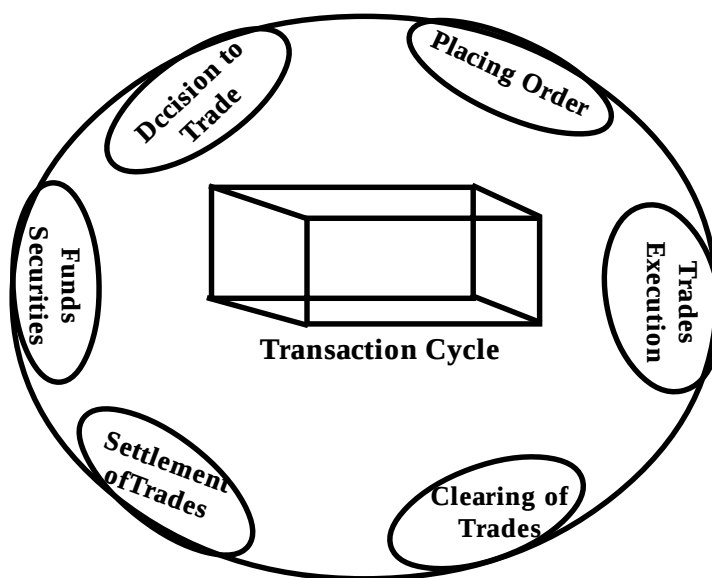


Fig.9.2 – Transaction Cycle



- vi) Giving Margin money to broker** – A margin money is deposited with the broker to take exposure on any loss incurred on transacting a contract
- vii) Preparing Contract Note** - After execution of the contract a contract note is issued to the client.
- viii) Settlement of the contract** – The payment of funds by the buyer is made for the shares bought and the delivery of securities sold is done by the seller thus settling the contract entered with the broker.

Types of Orders

- i. Market orders or Best Rate orders** – instructions given to brokers to buy or sell at the best possible price. Example : Buy 1000 shares of Suzlon at the best price.
- ii. Limit Orders** - instructions to brokers to buy or sell at a stated price. It specifies the maximum or minimum price the investor is willing to accept for his trade. This protects the clients against paying more or selling for less than intended price. Example: Buy 1000 shares of RPL at Rs. 164 each.
- iii. Discretionary Order** – instructed to buy or sell the stock within a range of price. **Example :** Buy 500 SBI shares around Rs.1800
- iv. Stop- Loss order** - this type of order is used to limit the amount of losses or to protect the amount of capital gains useful to both investors and speculators. The order is executed once the its price reaches the specified point to avoid further loss. Example: sell RPL at Rs. 65, stop loss @ Rs.62 to limit the loss on sale.

Executions of Trade:

- A . Settlement Cycle
- B. Rolling settlement
- C. Price filters / circuit filters
- D. Intraday Price bands

The settlement cycle on the BSE is Trade plus two days, or T+2, as per a SEBI directive implementing this new cycle from April 1, 2003. Earlier a settlement cycle consisted of five days trading period within which any transaction buy / sell must be completed. There are two types of settlement, namely, Fixed and Rolling. The settlement cycle or trading cycle was reduced to one week from the earlier pattern of 14 to 30 days of trading cycle. This long trading cycle had been adversely affecting the trading system, leading to investor defaults due to price variations.

A) A Fixed settlement cycle starts on a particular day and ends after five days. For instance, in NSE the settlement cycle starts on Wednesday of one week and ends on Tuesday of the following week, whereas in BSE it starts on Monday and ends on Friday. A pay-in –day and a pay-out-day follows the settlement cycle. The pay-in-day refers to all the buyer brokers depositing

the money for the purchase of shares. The pay-out-day refers to the exchange handing over the proceeds to the seller brokers. Subsequently, the Rolling Settlement on T+5 basis was introduced effectively reducing the trading cycle to one day. Since April 2003, all stock exchanges follow a T+2 rolling settlement system.

B) Rolling Settlement:

The rolling settlement was introduced by SEBI on January 10, 2000. Ten stocks were selected initially and SEBI has announced a list of 156 stocks which was included in rolling settlement made by the first fortnight of May 2000. In a rolling settlement of a T+5 period trades are settled 5 days from the date of transaction. If an investor purchases 500 shares of RIL and sells 400 shares on Monday he would be asked to settle the net outstanding of 100 shares on the following Monday. This means all open positions are squared up on the fifth or sixth day from the trading date.

In the T+2 rolling settlement, trades are settled on the second working day. For example, trades taking place on Monday are settled on Wednesday, etc.

	Activity	Day
Trading	Rolling Settlement Trading	T (Eg. Monday)
Clearing	Custodial confirmation	T+1 working days
	Delivery Generation	T+1 working days
Settlement	Securities and Funds Pay in	T+2 working days
	Securities and Funds Pay out	T+2 working days

C) Price Filters / Circuit Breakers:

The index-based market-wide circuit breakers were implemented in compulsory rolling settlement with effect from July 02, 2001.

The index-based market-wide circuit breaker system applies at 3 stages of the index movement, either way viz. at 10%, 15% and 20%. These circuit breakers when triggered bring about a coordinated trading halt in all equity and equity derivative markets nationwide. The market-wide circuit breakers are triggered by movement of either the BSE Sensex or the NSE S&P CNX Nifty, whichever is breached earlier. The % movement of the index and the time frame of the trading halt is given below:

- 10% movement - a one-hour market halt if the movement takes place before 1:00 p.m.
 - at or after 1:00 p.m. but before 2:30 p.m., a trading halt for ½ hour.
 - at or after 2:30 p.m. there will be no trading halt and market shall continue trading.



- 15% movement - a two-hour halt if the movement takes place before 1 p.m.
 - on or after 1:00 p.m., but before 2:00 p.m., a trading halt of one hour
 - on or after 2:00 p.m. the trading shall halt for remainder of the day.
- 20% movement - trading shall be halted for the remainder of the day.

D) Intraday Price Bands

Daily price bands are applicable on securities as below:

- Daily price bands of 2% (either way) on securities as specified by the Exchange.
- Daily price bands of 5% (either way) on securities as specified by the Exchange.
- Daily price bands of 10% (either way) on securities as specified by the Exchange.
- Price bands of 20% (either way) on all remaining scrips (including debentures, warrants, preference shares etc).
- No price bands are applicable on: scrips on which derivative products are available or scrips included in indices on which derivative products are available..

E) Margins:

i) Daily Margin - For the purpose of imposition of the daily margins, the members of the Exchange are categorised into two categories, i.e., Type -I members who are allowed to carry-forward their trades in 'A' group scrips from one settlement to another and Type-II members who have not opted to carry-forward their trades.

The Type-I members are required to pay daily margin on their trades in 'A' group scrips both for delivery as well as carry-forward at the rate of 10%. The members also have to pay mark-to-market margin on their positions in these scrips provided the mark-to-market margin amount exceeds the amount already paid on daily margin as specified above, and in such cases the difference between the two margins is required to be paid. The Exchange collects daily margins from Type-I members for their transactions in 'B1' and 'B2' group scrips and from Type-II members for their transactions in 'A', 'B1' and 'B2' group scrips based on the outstanding positions in the market. The margins are computed on the basis of gross exposure of the members and the higher of the gross exposure margin or MTM margin is payable.

Computation of daily Margin: The higher of the Gross Exposure Margin (GEM) and Mark to Market Margin (MTM) is taken and the Volatility Margin (VM) is added to it to arrive at the daily margin payable :

Daily Margin Amount = Higher of (GEM, MTM) + VM

Daily margins are payable by afternoon of T+1 day, where 'T' is the trade day, and 1 is the succeeding working day. Margins on Friday's positions are payable on Monday. This margin is debited to member's accounts normally in the evening.

Margins are required to cover the trade exposures of the members of the stock exchange. They play a predominant role in controlling the Liquidity and safety of trades in the stock market. Higher the margin requirement, better the safety of the transaction but lower the liquidity in the market and vice versa. Lower the margin requirement will encourage speculative trading thereby enhancing liquidity in the market. “Margin trading” allows the investor to trade on borrowed funds from a bank or a broker to buy shares.

A member entering an order, needs to enter the client code. Based on this information, margin is computed at the client level, which will be payable by the trading members on T+1 basis.

The different forms of daily margins levied by the Clearing Corporation:

- a. Gross Exposure margin (GEM)
- b. Mark to Market margin (MTM)
- c. Additional Volatility margin (AVM)

a. Gross Exposure margin:

Exposure is a cumulation of net outstanding open positions of all market sub-segments. This cumulation is done only till the actual pay-in day of each of these sub-segments and includes positions in securities that are in no delivery. As and when the pay-in day of a particular trading cycle is reached, the net outstanding open positions of that cycle are excluded from the calculation of GE one day prior to the pay-in day of that segment. The GE on Monday, excludes the positions pertaining to the settlement for which trading was completed on the previous Tuesday. Margins calculated on Friday’s trades which are payable on Monday also exclude the positions pertaining to the settlement for which trading was completed on the previous Tuesday.

Computation of Gross Exposure margin:

The net outstanding position in every security is first computed by taking the difference of the Buy Value and Sell Value. The total outstanding gross exposure is then arrived at by summing up all the security-wise net outstanding positions in value terms irrespective of whether the net outstanding position is a net buy or net sell position across all securities traded – $G.E. = \sum (Buyvalue - Sellvalue)$.

The following example will clarify the calculation of gross exposure utilized:

The following example will clarify the calculation of gross exposure utilized:



Security	Buy Value	Sell Value	Buy Value – Sell Value
A	20,00,000	10,00,000	+10,00,000
B	10,00,000	30,00,000	-20,00,000

$$GE = S (| 10,00,000 | + | -20,00,000 |) = 30,00,000$$

b. Mark to Market Margin: The mark-to-market (MTM) margin is collected by the stock exchange in addition to the daily margin. While calculating MTM all notional profits of the members are ignored and all notional losses are collected on a daily basis. The members are, thus, required to pay the higher of daily margin or MTM margin. By introducing MTM margin, the management of risk on the outstanding position of the members has considerably improved. The margins are debited to the members bank accounts on the next day of the trade (i.e., T+1). In case of delay in payment of daily margin, a late fee @ 1% of the amount involved is imposed.

Mark to market margin is calculated by marking each transaction in a scrip to the closing price of the scrip at the end of trading. In case the security has not been traded on a particular day, the latest available closing price at the NSE is considered as the closing price. In the event of the net outstanding position of a member in any security being nil, the difference between the buy and sell values would be considered as notional loss for the purpose of calculating the mark to market margin payable. In case of a net loss, the same is collected as the MTM margin over and above the daily VaR margin and if there is a profit the same is ignored for the purpose of computing the MTM margin.

Example:

The difference between the close price and the price at which the trade was executed (trade price) multiplied by the cumulative buy and sell open position in each security would give us the Mark to Market Profit/loss in each security. Mark to market profit/loss can be calculated using the formula given below:

$$\text{MTM Profit/Loss} = [(\text{Total Buy Qty} * \text{Close price}) - \text{Total Buy Value}] + [\text{Total Sell Value} - (\text{Total Sell Qty} * \text{Close price})]$$

Sr. No.	Security	Buy Quantity	Buy Price	Sell Quantity	Sell Price	Close Price	Mtm Profit/Loss Per Security
1	A	1000	50000.00	2000	90000.00	56.00	-16000
2	B	1600	64000.00	1800	73800.00	36.00	2600
3	C	600	3000.00	300	1500.00	5.00	0
4	D	0	0.00	2000	30000.00	14.00	2000
5	E	1000	6300.00	0	0.00	5.00	-1300
6	F	800	32000.00	500	19250.00	35.00	-2250

MTM Profit / Loss for A = $[(1000 * 56) - 50000] + [90000 - (2000 * 56)] = -16000$

MTM Profit / Loss for all other securities have also been calculated in the same manner.

Further, if there are frequent delays or non-payment of margins by the members, the intra-day trading limits and gross exposure limits of members are curtailed and their BOLT Trading Work Stations (TWSs) are deactivated for a specified period. Such cases are also referred to the Disciplinary Action Committee for taking disciplinary action against members.

Earlier, the daily margins were computed manually by the members and paid to the Exchange on the following day. Hence, there was a scope for evasion of margins by the members. Since November 1996, the daily margins are computed by the Exchange (a software was developed for calculation of daily margins) and the same are downloaded by the members in their back-office system. This has almost entirely eliminated the possibility of margin evasion by any member and has resulted in better risk management.

c) Additional Volatility Margin

In order to control volatility in the prices of scrips and to provide an exit route to Investors, SEBI had, inter alia, directed the Stock Exchanges to introduce additional margin called Volatility Margin on a graded basis. Volatility in any scrip is computed on a rolling basis over a period of six weeks.

Volatility in percentage terms	Percentage of volatility margin applicable
40% and above but less than 50%	5%
50% and above but less than 70%	10%
70% and above but less than 90%	15%
90% and above	20%



The AVM is computed on the net outstanding position of the members in the scrip which has attracted this margin. If a scrip attracts Additional Volatility Margin and Mark-to-Market margin, then higher of the two is recovered. Additional Volatility Margin is not computed for scrips quoting below Rs. 40/-.

The computation of volatility and the percentage of Additional Volatility Margin applicable are as under:

Volatility Margin is charged on the net outstanding value of a security as per the applicable volatility margin percentage for that security. Therefore,

Volatility margin = Absolute of [(Buy Value – Sell Value) * Volatility margin percentage] or,
Mod | (Buy Value – Sell Value) * Volatility margin percentage |

To arrive at the appropriate volatility margin percentage, the volatility percentage of the security is first calculated in the following manner:

Volatility percentage of a security = (High price – Low price) * 100 / Low price where the high price and low price considered are the highest and lowest traded prices of the security for the past 6 weeks.

Appropriate adjustments are made for price variations on account of calls, bonuses, rights, mergers, amalgamations and other corporate benefits, and when securities are traded ex-benefits, for the purpose of computing volatility percentage.

The volatility percentage for all securities is calculated on the last day of every normal settlement. Then, on the basis of the volatility percentage slabs, the volatility margin percentage corresponding to the volatility percentage of the security is identified and applied on that security for the next settlement.

ii) Value at Risk-based Margin (VaR) - is the maximum loss not exceeded with a given probability defined as the confidence level, over a given period of time. The VaR rate is applied to gross exposure to determine VaR-based margin. The VaR margin calculation is based on the volatility of the index (either sensex or Nifty) as the higher of scrip VaR and index VaR multiplied with a suitable multiplier. The computation of the VaR rate as well as the gross exposure on which VaR rate is applied is explained below:

Scrip-wise VaR : The scrip-wise daily volatility is calculated using the exponential moving weighted average method for preceeding six months. The volatility (v_t) at the end of the day t, is estimated using the previous volatility estimate (V_{t-1}) at the end of the previous day t-1, and the return (r_t) observed in the market for the day t is calculated as given below:

$$6v_t^2 = p \times V_{t-1}^2 + (1-p) \times r_t^2$$

Where 'p' is a parameter which indicates how rapidly volatility estimate Changes, which is a value estimated as 0.94 used by BSE, as specified in the JR Varma report.

Index VaR: The volatility of Index VaR is calculated in the same manner as given above.



The VaR calculated for Nifty as above is then compared with the Sensex VaR for the Day. The higher of the two is considered as Index VaR. However a Minimum Index VaR of 5% is stipulated by SEBI.

iii) Special Margin

Since February, 1996, with a view to curtail unwarranted rise in the prices and volumes, special margins have been introduced. The special margins, which may range from 25% to 100% are imposed on net cumulative purchases in scrips in which rise in price is abnormal and high volumes are noticed.

iv) Special Ad-hoc Margin

In order to caution the members from building position in low cap and infrequently traded B2 group scrips, the Exchange recovers special ad-hoc margin if a member build up a buy or sell position in a single B2 group scrip beyond Rs. 3 millions and Rs. 15 millions in all B2 group scrips in a settlement. The rate of special ad-hoc margin varies between 25% and 100%.

v) Ad-hoc Margin

As a risk management measure, Ad-hoc margins are imposed on members over and above the daily margins in case members have excessive purchase positions, concentrated purchase positions in some scrips or their financial position does not appear to be sound vis-a-vis their exposure in the market.

The purpose of the margin, as in case of other margins, is to ensure safety of the market. The statistics of 1997 and 1998 of surveillance action initiated against members show that compliance level in payment of margins has improved substantially.

Financial markets across the world are traded on an exchange and presided over by a regulator. For each contract there is a system of margining and leverage. It is important to emphasise, that the margining/leverage system is not unique to India. The margin requirements of few other countries are as shown in Table 9.1, given below:



Table: 9.1 – Margin Requirements in various countries

Country / Exchange	Margin requirements ¹			Margin Ratio ²		
	Dec 13, 2007	Jan 18, 2008	Jan 22, 2008	Dec 13, 2007	Jan 18, 2008	Jan 22, 2008
Europe / Stoxx	3,300	3,300	3,300	7.5	8.2	8.7
Germany / DAX	14,603	14,603	14,603	7.3	7.9	8.5
Hong Kong / H-Shares	136,780	120,590	120,590	16.9	16.7	20.1
Hong Kong / Hang Seng	170,100	159,850	159,850	12.3	12.8	14.7
India/NIFTY	32,964	29,955	40,154	10.7	10.1	15.4
Japan / Nikkei	5,000	5,000	5,000	6.4	7.4	7.7
Korea	18,109	16,598	15,368	15.0	15.0	15.0
Malaysia	4,600	4,600	4,600	6.6	6.4	6.9
Singapore	5,875	5,000	5,000	6.9	6.6	7.1
Taiwan	2,625	2,500	2,500	8.2	7.9	8.8
UK / FTSE	3,000	3,000	3,000	4.7	5.1	5.2
USA / Nasdaq	12,500	12,500	12,500	5.9	6.8	7.0
USA / S&P 500	22,500	22,500	22,500	6.1	6.8	6.9
1: All figures are in local currency units for contract lots, which differ from country to country 2: Margin ratio is the ratio of required absolute margin value to the size of contract value						

Margins based on turnover & Exposure limits (Initial margins)
Intra-day turnover limit:

Members of stock exchange are subject to intra-day trading limits. Gross turnover (buy+sell) intra-day of the member should not exceed thirty three and one-third ($33 \frac{1}{3}$) times the base capital (cash deposit and other deposits in the form of securities or bank guarantees with NSCCL and NSE). Members violating the intra-day gross turnover limit at any time on any trading day are not be permitted to trade forthwith. Member's trading facility is restored from the next trading day with a reduced intra-day turnover limit of 20 times the base capital till deposits in the form of additional deposits (additional base capital) is deposited with NSCCL. Members are given a maximum of 15 days time from the date of the violation to bring in the additional capital.

Upon members failing to deposit the additional capital within the stipulated time, the reduced turnover limit of 20 times the base capital would be applicable for a period of one month from the last date for providing the margin deposits. Upon the member violating the reduced intra-day turnover limit, the above mentioned provisions apply and the intra-day turnover limit will be further reduced to 15 times. Upon subsequent violations, the intra-day turnover limit will be further reduced from 15 times to 10 times and then from 10 times to 5 times the base capital. Members are not permitted to trade if any subsequent violation occurs till the required additional deposit is brought in.

Gross Exposure Limits :

Members are also subject to gross exposure limits. Gross exposure for a member, across all securities in rolling settlements, is computed as absolute (buy value – sell value), i.e. ignoring +ve and -ve signs, across all open settlements. Open settlements would be all those settlements for which trading has commenced and for which settlement payin is not yet completed. The total gross exposure for a member on any given day would be the sum total of the gross exposure computed across all the securities in which a member has an open position.

The total base capital being the base minimum capital (cash deposit and security deposit) and additional deposits, not used towards margins, in the nature of securities, bank guarantee, FDR, or cash with NSCCL and NSE.

Trading and Exposure Limits

NSCCL (national Securities Clearing Corporation Ltd.) imposes limits on turnover and exposure in relation to the deposits (funds and securities) available with the Exchange / NSCCL. The members are subject to limits on trading volumes in a day as well as exposure at any point of time. Gross intra-day turnover (Buy + Sell) of a member shall not exceed $33\frac{1}{3}$ times of the capital available with NSCCL. Similarly, gross exposure (aggregate of cumulative net outstanding positions in each security, at any point of time) of a member shall not exceed 8.5 times of free base capital up to Rs. 1 crore.

If a member has free capital in excess of Rs. 1 crore, his exposure shall not exceed Rs. 8.5 crore plus 10 times of the capital in excess of Rs. 1 crore.

Determination of Gross Exposure: The gross exposure of a member is computed across all securities and across all open settlements in rolling settlement. Open settlements are all those settlements for which trading has commenced and for which pay-in is yet to be completed. It is arrived at by adding up the absolute values of the products of net cumulative values and the specified adjustment factor, for all securities in which a member has an open position. For this purpose, scrips have been classified in to four groups, based on market capitalisation, impact cost and number of trades.

Exposure Limit Violation: Members exceeding the gross exposure limit are not permitted to trade with immediate effect (trading terminals are disabled automatically) until the member's cumulative gross exposure is reduced to below the gross exposure limits as defined above or any such lower limits as applicable to the members. Alternatively, a member may bring in additional base capital resulting in enhanced gross exposure limit.



Listing of Securities

Listing means admission of the securities to dealings on a recognised stock exchange. The securities may be of any public limited company, Central or State Government, quasi governmental and other financial institutions / corporations, municipalities, etc.

The objectives of listing are mainly to :

- provide liquidity to securities;
- mobilize savings for economic development;
- protect interest of investors by ensuring full disclosures.
- Making a quotation available for a company's share to be traded.
- Trading on a SE – Public Ltd. Companies with minimum paid up capital of Rs. 5 Crores
- Trading on BSE / NSE - Minimum paid up capital of Rs. 10 Crores

Listing of securities have to be in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956, Securities Contracts (Regulation) Rules, 1957, Companies Act, 1956, Guidelines issued by SEBI and Rules, Bye-laws and Regulations of the Exchange.

Settlement Cycle

At the end of each trading day, concluded or locked-in trades are received from NSE by NSCCL. NSCCL determines the cumulative obligations of each member and electronically transfers the data to Clearing Members (CMs). All trades concluded during a particular trading period are settled together. A multilateral netting procedure is adopted to determine the net settlement obligations (delivery / receipt positions) of CMs. NSCCL then allocates or assigns delivery of securities inter se the members to arrive at the delivery and receipt obligation of funds and securities by each member. On the securities pay-in day, delivering members are required to bring in securities to NSCCL. On pay out day the securities are delivered to the respective receiving members. Settlement is deemed to be complete upon declaration and release of pay-out of funds and securities.

Exceptions may arise because of short delivery of securities by CMs, bad deliveries or company objections on the pay-out day. NSCCL identifies short deliveries and conducts a buying-in auction on the day after the pay-out day through the NSE trading system. The delivering CM is debited by an amount equivalent to the securities not delivered and valued at a valuation price (the closing price as announced by NSE on the day previous to the day of the valuation). If the buy-in auction price is more than the valuation price, the CM is required to make good the difference. All shortages not bought-in are deemed closed out at the highest price between the first day of the trading period till the day of squaring off or closing price on the auction day plus 20%, whichever is higher. This amount is credited to the receiving member's account on the auction pay-out day.

National Securities Clearing Corporation – Settlement Agent of NSE

The clearing and settlement operations of the NSE are managed by its wholly owned subsidiary, the National Securities Clearing Corporation Limited, also known as Clearing Corporation.

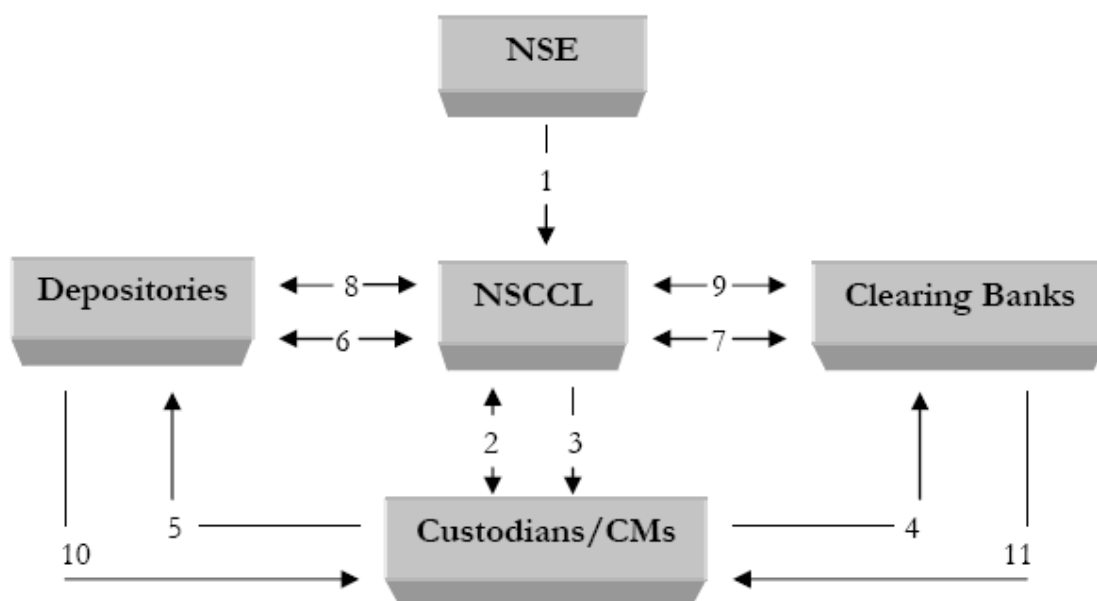


Fig.9.3 – Clearing Corporation Settlement Mechanism

(Source: bseindia.com)

The futures and the options contracts on the NSE have different settlement mechanisms.

Settlement of Nifty or individual futures contracts: For future contracts there is daily mark-to-market and final settlement price.

Daily Mark-to-Market Settlement: The positions in the futures contracts for each member is marked-to-market to the daily settlement price (available in the NSE Web site), of the futures contracts at the end of each trade day. The profits/ losses are computed as the difference between the trade price or the previous day's settlement price, as the case may be, and the current day's settlement price.

The clearing members (CM) who have suffered a loss are required to pay the mark-to-market loss amount to NSCCL, which is in turn passed on to the members who have made a profit. This is known as daily mark-to-market settlement.



Final Settlement

On the expiry of the futures contracts, NSCCL marks all positions of a CM to the final settlement price and the resulting profit / loss is settled in cash. The final settlement of the futures contracts is similar to the daily settlement process except for the method of computation of final settlement price. The final settlement profit / loss is computed as the difference between trade price or the previous day's settlement price, as the case may be, and the final settlement price of the relevant futures contract. Final settlement loss / profit amount is debited / credited on T+1 day (T= expiry day).

Settlement of index or individual option contracts: Index contracts can be exercised only on expiry whereas individual option contracts can be exercised any time before expiry.

Interim Exercise Settlement

This is applicable only for individual stock option contracts. Interim exercise settlement is effected for valid exercised option positions at in-the-money strike prices, at the close of the trading hours, on the day of exercise. Valid exercised option contracts are assigned to short positions in option contracts with the same series, on a random basis. The interim exercise settlement value is the difference between the strike price and the settlement price of the relevant option contract. Exercise settlement value is debited / credited to the relevant CMs clearing bank account on T+2 day (T= exercise date).

Final Exercise Settlement Final Exercise settlement is effected for option positions at in-the-money strike prices existing at the close of trading hours, on the expiration day of an option contract.

Long positions at in-the money strike prices are automatically assigned to short positions in option contracts with the same series, on a random basis. For index options contracts, exercise style is European style, while for options contracts on individual securities, exercise style is American style. Final Exercise is Automatic on expiry of the option contracts. Option contracts, which have been exercised, shall be assigned and allocated to Clearing Members at the client level. Final settlement loss/ profit amount for index option contracts is debited/ credited to the relevant CMs clearing bank account on T+1 day (T = expiry day). Final settlement loss/ profit amount for option contracts on Individual Securities is debited / credited to the relevant CMs clearing bank account on T+2 day (T = expiry day).

1.11 STOCK INDICES

Index

A measurement of the trend of share prices. It is not just an average of share prices, but weighted to reflect the number of shares outstanding for an individual scrip, but weighted to reflect the number of shares outstanding for an individual scrip. Thus, a 25% price fluctuation in a scrip with a small shareholding may have a much less impact on the market than a 3% fluctuation in a widely held scrip. The index thus gives an idea of the value change in share prices rather than just price change. The most widely known share price indices are the Dow Jones Industrial Average and Standard & Poor's 500 in New York, The Financial Times Stock Exchange 100



index or FT-SE 100 (called Footsie) in London, and the Economic Times, Financial Express, Business Standard, and the BSE indices in India.

BSE SENSEX Index

Bombay Stock Exchange Limited (BSE) in 1986 came out with a Stock Index that subsequently became the barometer of the Indian Stock Market. *SENSEX*, first compiled in 1986 was calculated on a “Market Capitalization-Weighted” methodology of 30 component stocks representing a sample of large, well-established and financially sound companies. One can identify the booms and bust of the Indian equity market through SENSEX. The base year of SENSEX is 1978-79. *SENSEX* is not only scientifically designed but also based on globally accepted construction and review methodology. The Index was initially calculated based on the “Full Market Capitalization” methodology but was shifted to the free-float methodology with effect from September 1, 2003. The “Free-float Market Capitalization” methodology of index construction is a widely followed index construction methodology on which majority of global equity benchmarks are based, regarded as an industry best practice globally. All major index providers like MSCI, FTSE, STOXX, S&P and Dow Jones use the Free-float methodology.

The general guidelines for selection of constituents in SENSEX are as follows:

1. **Listed History:** The scrip should have a listing history of at least 3 months at BSE. Exception may be considered if full market capitalisation of a newly listed company ranks among top 10 in the list of BSE universe. In case, a company is listed on account of merger / demerger / amalgamation, minimum listing history would not be required.
2. **Trading Frequency:** The scrip should have been traded on each and every trading day in the last three months. Exceptions can be made for extreme reasons like scrip suspension etc.
3. **Final Rank:** The scrip should figure in the top 100 companies listed by final rank. The final rank is arrived at by assigning 75% weightage to the rank on the basis of three-month average full market capitalisation and 25% weightage to the liquidity rank based on three-month average daily turnover & three-month average impact cost.
4. **Market Capitalization Weightage:** The weightage of each scrip in SENSEX based on three-month average free-float market capitalisation should be at least 0.5% of the Index.
5. **Industry Representation:** Scrip selection would generally take into account a balanced representation of the listed companies in the universe of BSE.
6. **Track Record:** In the opinion of the Committee, the company should have an acceptable track record.



BSE National Index or BSE 100 index works as broad-based index reflecting the stock market at national level. Initially Sense was compiled of only 30 most effective stocks of the market. Due to its limited effect, in 1989 BSE started BSE 100 index, compiled of 100 companies from “Specified” and the “Non-Specified” list of the five major stock exchanges, viz. Mumbai, Calcutta, Delhi, Ahmedabad and Madras. Year 1983-1984 was chosen as the base year due to the market stability that year.

‘BSE-200’ and the ‘DOLLEX-200’

The Exchange launched dollar-linked version of BSE-100 index i.e. Dollex-100 on May 22, 2006. With a view to provide a better representation of the increased number of companies listed, increased market capitalisation and the new industry groups, the Exchange constructed and launched on 27th May, 1994, two new index series viz., the ‘BSE-200’ and the ‘DOLLEX-200’ indices. Since then, BSE has come a long way in attuning itself to the varied needs of investors and market participants.

Other BSE Indices

In order to fulfill the need of the market participants for still broader, segment-specific and sector-specific indices, the Exchange has continuously been increasing the range of its indices. The launch of BSE-200 Index in 1994 was followed by the launch of BSE-500 Index and 5 sectoral indices in 1999. In 2001, BSE launched the BSE-PSU Index, DOLLEX-30 and the country’s first free-float based index - the BSE TECK Index. The Exchange shifted all its indices to a free-float methodology (except BSE PSU index) in a phased manner.

BSE-500 Index

Due to the changing pattern of the economy, Bombay Stock Exchange coined a new index as, BSE 500 comprising 500 scrips. The index represents about 93% of the total market capitalizations, ideally said to represent the total market. Initially calculated on the basis of full market capitalization methodology, later on free float methodology replaced the full market capitalization. BSE 500 was launched on August 16 2005. Year 1999 is selected as the base year because of its proximity to the current period and the base value is 1000.

BSE-Midcap

Bse midcap index was introduced by BSE to make sure the unbiased movement of the market. Midcap index track the performance of the companies with relatively small market capitalization. As the companies listed in BSE 500 index represents the 93% of total market capitalization. With Mid- Cap index it was easy to represent the mid cap companies listed on the stock exchange. It was also based on the free float methodology. Base year chosen is 2002-2003 and the base index value is 1000 for each indices.

BSE – Small Cap

BSE Small Cap Index was introduced to track the performance of the small cap companies listed on the stock exchange. Bse Small indices truly helped the investing community as they capture the movement of the mid and small segments of the market. Base year is 2002-2003 and the base index value is 1000.



BSE TECK

As Information Technology, Media, & Telecom sectors are emerging as the major dominating sectors of the economy, BSE introduced the TECK index. It serves as a quality benchmark for the investment community in these knowledge based sectors. BSE TECK index is composed of 21 quality stocks from the IT, Media and Telecom sectors. The base date chosen is April 2, 2001 and the base value for BSE TECK Index is 1000 points.

BSE Auto Index

In August 2004 BSE launched a new Sector Series (90/FF) indices comprising BSE Auto Index, BSE BANKEX, BSE Capital Goods Index, BSE Consumer Durables Index, BSE FMCG Index, BSE Health care Index, BSE IT Index, BSE Metal Index, BSE Oil & Gas Index, BSE Mid Cap Index, BSE Small Cap Index. BSE Auto Index comprises all the major auto stocks in the BSE 500 Index.

BSE Bankex Index

Bankex was launched by BSE to track the performance of the leading banking sectors as bank stocks are emerging as a major segment of the stock market. The base date for BANKEX is 1st January 2002 and base value for BANKEX is 1000 points. Bankex Index includes 12 selected major stocks which represent total 90% market capitalization of all the banking sector stocks listed on the BSE.

BSE CG

Consumer goods index is a part of the BSE sectoral Indices. To track the performance of companies dealing with the consumer goods it was necessary to list them in a new index named CG Index. CG Index comprises the companies occupying 90% market capitalization in the field of consumer goods.

BSE CD

Products whose life expectancy is at least three years are known as consumer durable. BSE classified the 90% market capitalization stocks in the field of consumer durable in the Sector Series (90/FF). Stocks are constructed and maintained as per the global best practices.

BSE FMCG

Products that shows a sudden shelf turnover, at comparatively low cost are classified as Fast Moving Consumer Goods. Eatables, soft drinks, and cleaning materials falls in FMCG category. Examples of FMCG brands are Coca-Cola, Kleenex and Mars. FMCG Index monitors the performance of the major brands in the FMCG category. Stocks having a minimum of 90% trading frequency in preceding six months are eligible to be included in the FMCG Index.



BSE HC

Health Care and Pharma sector are emerging as strong effectors on the economy of India. BSE launched a new Health Care Index, monitoring the health care sector performance individually. On August 23, 2004 five sectoral Indices viz BSE IT, BSE FMCG, BSE Capital Goods, BSE Consumer Durables and BSE Health care were shifted to Free-Float methodology and joined the Sector Series (90/FF). 90% coverage in health care sector is given from the universe of BSE-500 index constituents. Top stock performers in the health care sector are listed in the BSE Health Care Index.

BSE IT

Keeping track of the changing trends in Indian Economy, BSE launched new sectoral index named IT Index. Stocks capturing 90% market capitalization from the IT sector are listed on the IT Index. Indices are calculated and displayed on the BOLT system on the real time basis. Like all the similar indices 1998-99 is chosen as the base year, and the base value was fixed at 1000 points in order to keep the index comparable with other similar indices.

BSE Metal Index was launched on August 23, 2004. Metal stocks performing well in the economy are indexed in the BSE metal index.

BSE Oil and Gas Index – Oil and Gas sector is gaining its own weightage in the economy. The stocks from oil and gas sectors have lot to effect on the stock market movement. Oil and Gas index was launched effective August 23, 2004 as part of the new series “90/FF”. The index covers 90% of the sectoral market capitalization and is based on the Free-Float methodology.

NSE Indices:

S&P CNX Nifty - is a well diversified 50 stock index accounting for 21 sectors of the economy. It is used for a variety of purposes such as benchmarking fund portfolios, index based derivatives and index funds. S&P CNX Nifty is owned and managed by India Index Services and Products Ltd. (IISL), which is a joint venture between NSE and CRISIL. IISL is India's first specialised company focused upon the index as a core product. IISL have a consulting and licensing agreement with Standard & Poor's (S&P), who are world leaders in index services.

Other NSE Indices are:

S&P CNX Nifty ; CNX Nifty Junior ; CNX 100; S&P CNX 500; CNX Midcap; Nifty Midcap 50; S&P CNX Defty; CNX Midcap 200

SENSEX Calculation Methodology

SENSEX is calculated using the “Free-float Market Capitalization” methodology. As per this methodology, the level of index at any point of time reflects the Free-float market value of 30 component stocks relative to a base period. The market capitalization of a company is determined by multiplying the price of its stock by the number of shares issued by the company. This market capitalization is further multiplied by the free-float factor to determine the free-float market capitalization.

The base period of SENSEX is 1978-79 and the base value is 100 index points. This is often indicated by the notation 1978-79=100. The calculation of SENSEX involves dividing the Free-float market capitalization of 30 companies in the Index by a number called the Index Divisor. The Divisor is the only link to the original base period value of the SENSEX. It keeps the Index comparable over time and is the adjustment point for all Index adjustments arising out of corporate actions, replacement of scrips etc. During market hours, prices of the index scrips, at which latest trades are executed, are used by the trading system to calculate SENSEX every 15 seconds and disseminated in real time.

Methods of Computing Indices:

Indices are the barometer of the Indian Stock Market. They are the Representative of market movements. It helps to identify the booms and bust of the Indian equity market through SENSEX.

The methods of computing Indices are:

1. Market Value Weighted Index

2. Price Weighted Index

Base Market Capitalisation Adjustment: The formula for adjusting the Base Market Capitalisation is as follows:

$$\text{New Base Market Capitalization} = \frac{\text{Old Base Market Capitalization} \times \text{New Market Capitalisation}}{\text{Old Market Capitalization}}$$

Example : suppose a company issues right shares which increases the market capitalisation of the shares of that company by say, Rs.100 crores. The existing Base Market Capitalisation (Old Base Market Capitalisation), say, is Rs.2450 crores and the aggregate market capitalisation of all the shares included in the index before the right issue is made is, say Rs.4781 crores. The “New Base Market Capitalisation “ will then be equal to Rs.2501.24 crores.

$$\frac{2450 \times (4781+100)}{4781} = \text{Rs.2501.24 crores}$$

- i) **Market value-weighted index** is an index whose components are weighted according to the total market value of their outstanding shares. Also called a **capitalization-weighted index**. The impact of a component’s price change is proportional to the issue’s overall market value, which is the share price times the number of shares outstanding.
- ii) **Price-weighted index** is a stock market index where each constituent makes up a fraction of the index that is proportional to its price. For a stock market index this implies that stocks are included in proportions based on their quoted prices.



Apart from these two we have equal –weighted index also.

Clearing Mechanism

A Clearing Member's open position calculation is arrived by aggregating the open position of all the Trading Members (TM) and all custodial participants clearing through him. A TM's open position in turn includes his proprietary open position and clients' open positions.

- a. **Proprietary / Clients' Open Position :** While entering orders on the trading system, TMs are required to identify them as proprietary (if they are own trades) or client (if entered on behalf of clients) through 'Pro / Cli' indicator provided in the order entry screen. The proprietary positions are calculated on net basis (buy - sell) and client positions are calculated on gross of net positions of each client i.e., a buy trade is off-set by a sell trade and a sell trade is off-set by a buy trade.
- b. **Open Position:** Open position for the proprietary position are calculated separately from client position.

Types of Clearing Members

- Trading Member Clearing Member (TM-CM): A Clearing Member who is also a TM. Such CMs may clear and settle their own proprietary trades, their clients' trades as well as trades of other TM's
- Professional Clearing Member (PCM): A CM who is not a TM. Typically banks or custodians could become a PCM and clear and settle for TM's.
- Self Clearing Member (SCM): A Clearing Member who is also a TM. Such CMs may clear and settle only their own proprietary trades and their clients' trades but cannot clear and settle trades of other TM's.
- Clearing Member Eligibility Norms : Net worth of atleast Rs.300 lakhs. The net worth requirement for a CM who clears and settles only deals executed by him is Rs. 100 lakhs. Deposit of Rs. 50 lakhs to NSCCL which forms the Base Minimum Capital (BMC) of the CM. Additional incremental deposits of Rs.10 lakhs to NSCCL for each additional TM in case the CM undertakes to clear and settle deals for other TMs.

Clearing Banks

NSCCL has empanelled 8 clearing banks namely Canara Bank, HDFC Bank, Global Trust Bank, IndusInd Bank, ICICI Bank, UTI Bank, Centurion Bank, Bank of India, IDBI Bank and Standard Chartered Bank.

Every Clearing Member is required to maintain and operate a clearing account with any one of the empanelled clearing banks at the designated clearing bank branches. The clearing account is to be used exclusively for clearing & settlement operations.

Settlement Schedule

Product	Settlement	Schedule
Futures Contracts on Index & Individual Securities	Daily Mark-to-Market Settlement	Pay-in : T+1 working day at or after 11.30 a.m. Payout : T+1 working day at or after 12.00 p.m. (T is trade day)
Futures Contracts on Index & Individual Securities	Final Settlement	Pay-in : T+1 working day at or after 11.30 a.m. Payout : T+1 working day at or after 12.00 p.m. (T is expiration day of contract)
Interest Rate Futures Contracts	Daily Mark-to-Market Settlement	Pay-in : T+1 working day on or after 11.30 a.m. Payout : T+1 working day on or after 12.00 p.m. (T is trading day)
Interest Rate Futures Contracts	Final Settlement	Pay-in : T+1 working day on or after 11.30 a.m. Payout : T+1 working day on or after 12.00 p.m. (T is expiration day)
Options Contracts on Index & Individual Securities	Premium Settlement	Pay-in : T+1 working day at or after 11.30 a.m. Payout : T+1 working day at or after 12.00 p.m. (T is trade day)
Options Contracts on Index	Exercise & Final Settlement	Pay-in : T+1 working day at or after 11.30 a.m. Payout : T+1 working day at or after 12.00 p.m. (T is expiration day of contract)
Options Contract on Individual Securities	Interim Exercise Settlement	Pay-in : T+2 working day at or after 11.30 a.m. Payout : T+2 working day at or after 12.00 p.m. (T is exercise day)
Options Contract on Individual Securities	Exercise & Final Settlement	Pay-in : T+2 working day at or after 11.30 a.m. Payout : T+2 working day at or after 12.00 p.m. (T is expiration day)


Settlement Price

Product	Settlement	Settlement Price
Futures Contracts on Index or Individual Security	Daily Settlement	Closing price of the futures contracts on the trading day. (The closing price is the last half hour weighted average price of the contract).
Unexpired illiquid futures contracts	Daily Settlement	Theoretical Price computed as per formula $F = S * e^{rt}$
Futures Contracts on Index or Individual Securities	Final Settlement	Closing price of the relevant underlying index / security in the Capital Market segment of NSE, on the last trading day of the futures contracts. (The closing price of the underlying index / security is its last half an hour weighted average value / price in the Capital Market segment of NSE)
Options Contracts on Individual Securities	Interim Exercise Settlement	Closing price of such underlying security on the day of exercise of the options contract. (The closing price of the underlying security is its last half an hour weighted average price in the Capital Market Segment of NSE).
Options Contracts on Index and Individual Securities	Final Exercise Settlement	Closing price of such underlying security (or index) on the last trading day of the options contract. (The closing price of the underlying security (or index) is its last half an hour weighted average price in the Capital Market Segment of NSE).



National Stock Exchanges (NSE) - Derivatives Segment Clearing & Settlement - Settlement Mechanism

Settlement of futures contracts on index and individual securities - Daily Mark-to-Market Settlement

The positions in the futures contracts for each member is marked-to-market to the daily settlement price of the futures contracts at the end of each trade day.

The profits/ losses are computed as the difference between the trade price or the previous day's settlement price, as the case may be, and the current day's settlement price. The CMs who have suffered a loss are required to pay the mark-to-market loss amount to NSCCL which is in turn passed on to the members who have made a profit. This is known as daily mark-to-market settlement.

National Stock Exchanges (NSE)- Derivatives Segment - Clearing & Settlement Settlement Mechanism - Interest Rate Derivatives: Settlement Procedure & Settlement Price

Daily Mark to Market Settlement and Final settlement for Interest Rate Futures Contract

Daily Mark to Market settlement and Final Mark to Market settlement in respect of admitted deals in Interest Rate Futures Contracts shall be cash settled by debiting/ crediting of the clearing accounts of Clearing Members with the respective Clearing Bank.

All positions (brought forward, created during the day, closed out during the day) of a F&O Clearing Member in Futures Contracts, at the close of trading hours on a day, shall be marked to market at the Daily Settlement Price (for Daily Mark to Market Settlement) and settled.

All positions (brought forward, created during the day, closed out during the day) of a F&O Clearing Member in Futures Contracts, at the close of trading hours on the last trading day, shall be marked to market at Final Settlement Price (for Final Settlement) and settled.

Daily Settlement Price shall be the closing price of the relevant Futures contract for the Trading day.

Final settlement price for an Interest rate Futures Contract shall be based on the value of the notional bond determined using the zero coupon yield curve computed by National Stock Exchange or by any other agency as may be nominated in this regard.

Open positions in a Futures contract shall cease to exist after its expiration day.

Daily Settlement Price

Daily settlement price for an Interest Rate Futures Contract shall be the closing price of such Interest Rate Futures Contract on the trading day. The closing price for an interest rate futures contract shall be calculated on the basis of the last half an hour weighted average price of such interest rate futures contract. In absence of trading in the last half an hour, the theoretical price would be taken or such other price as may be decided by the relevant authority from time to time.



Theoretical daily settlement price for unexpired futures contracts, shall be the futures prices computed using the (price of the notional bond) spot prices arrived at from the applicable ZCYC Curve. The ZCYC shall be computed by the Exchange or by any other agency as may be nominated in this regard from the prices of Government securities traded on the Exchange or reported on the Negotiated Dealing System of RBI or both taking trades of same day settlement(i.e. $t = 0$).

In respect of zero coupon notional bond, the price of the bond shall be the present value of the principal payment discounted using discrete discounting for the specified period at the respective zero coupon yield. In respect of the notional T-bill, the settlement price shall be 100 minus the annualized yield for the specified period computed using the zero coupon yield curve. In respect of coupon bearing notional bond, the present value shall be obtained as the sum of present value of the principal payment discounted at the relevant zero coupon yield and the present values of the coupons obtained by discounting each notional coupon payment at the relevant zero coupon yield for that maturity. For this purpose the notional coupon payment date shall be half yearly and commencing from the date of expiry of the relevant futures contract.

For computation of futures prices from the price of the notional bond (spot prices) thus arrived, the rate of interest may be the relevant MIBOR rate or such other rate as may be specified from time to time.

Final Settlement Price for mark to market settlement of interest rate futures contracts

Final settlement price for an Interest rate Futures Contract on zero coupon notional bond and coupon bearing bond shall be based on the price of the notional bond determined using the zero coupon yield curve computed as explained above. In respect of notional T-bill it shall be 100 minus the annualised yield for the specified period computed using the zero coupon yield curve.

Settlement value in respect of notional T-bill

Since the T-bills are priced at 100 minus the relevant annualised yield, the settlement value shall be arrived at using the relevant multiplier factor. Currently it shall be $91/365$

Settlement Schedule

Product	Settlement	Schedule
Interest Rate Futures Contracts	Daily Mark-to-Market Settlement	Pay-in : T+1 working day on or after 11.30 a.m. Payout : T+1 working day on or after 12.00 p.m. (T is trading day)
Interest Rate Futures Co	Final Settlement	Pay-in : T+1 working day on or after 11.30 a.m. Payout : T+1 working day on or after 12.00 p.m. (T is expiration day)

Settlement of Custodial Participant (CP) Deals

NSCCL provides a facility to entities like institutions to execute trades through any TM, which may be cleared and settled by their own CM. Such entities are called Custodial Participants (CP).

To avail of this facility, a CP is required to register with NSCCL through his CM, which allots them a unique CP code. The CP and the CM are required to enter into an agreement as per specified format.

Thereafter, all trades executed by such CP through any TM are required to have the CP code in the relevant field on the F&O trading system at the time of order entry. Such trades executed on behalf of a CP are required to be confirmed by their CM (and not the CM of the TM through whom the trade was executed), within the time specified by NSE, using the confirmation facility provided by NSCCL to the CMs in the F&O segment.

Till such time the trade is confirmed by the CM of the CP, the same is considered as a trade of the TM and the responsibility of settlement of such trade vests with the CM of the TM. Once the trades have been confirmed by the CM of the CP, they form part of the obligations of the CM of the CP and they shall be responsible for all obligations arising out of such trades including the payment of margins and settlement of obligations.



Key Words

- Primary market
- Secondary market
- National Network
- Trading System
- OTCEI
- Demutualization of Stock Exchanges
- Money market
- Call Money Market
- Commercial Paper
- Certificates of deposit
- Bills Rediscounting
- Call / Notice Money Market
- Repurchase Agreements (Repos)
- Inter Bank Participation
- Bank deposits
- Term Money
- Public issues
- Offer for sale
- Placement
- Rights issues
- Green Shoe Option
- e-IPO
- QIBs
- Rights Issues
- Bought Out Deal
- Book Buiding

- Depositories
- Buy Back of shares
- CAPM
- Stock Indices
- Forward Contract
- Futures Contract
- Clearing Mechanism

Summary

In this chapter author tried to explain the Operations of Indian Stock Market and purpose of stock market. The Stock Market helps in the capital formation of the country. It maintains active trading It increases liquidity of assets, It also helps in price recovery process and short coming of stock exchanges Scarcity of floating stocks: Financial institutions, banks and insurance companies own 80 percent of the equity capital in the private sector. Speculation: 85 percent of the transactions on the NSE and BSE are speculative in nature. Reasons for Transactions on Secondary Market. The Securities which are traded in the secondary market may be classified as follows. Primary Vs. Secondary Market Stock Market in India Apart from the above you will understand the Role and Stock Exchange Functions, Membership, organization and Management, Trading System, Stock Market Information System, Principle Weaknesses of Indian Stock Market, Directions to reform the functioning of stock exchanges, Listing of securities, National Stock Exchange of India Ltd, Over The Counter Exchange of India (OTCEI), Inter-connected Stock Exchange of India, Demutualisation of Stock Exchanges Money market, Importance of money market, Features of a Developed Money Market, State Government / Public Sector / Municipality Issued, Certificate of Deposit, Call Money Market, Inter-Bank Participation Certificate, Bills Rediscounting Other Money Market Instruments, Money Laundering are explained.

Bought out deal, as the very name suggests is a type of wholesale of equities by a company. A company allots shares in full or in lots to a sponsors at a price negotiated between the company and the sponsor(s).

The principal function of a depository is to dematerialise securities and enable their transactions in book-entry form. Dematerialisation of securities occurs when securities, issued in physical form, are destroyed and an equivalent number of securities are credited into the beneficiary owner's account.

A **treasury stock** or **reacquired stock** is stock which is bought back by the issuing company, reducing the amount of outstanding stock on the open market ("open market" including insiders' holdings).

Stock repurchases are often used as a tax-efficient method to put cash into shareholders' hands, rather than pay dividends. Sometimes, companies do this when they feel that their stock is



undervalued on the open market. Other times, companies do this to provide a “bonus” to incentive compensation plans for employees. Rather than receive cash, recipients receive an asset that might appreciate in value faster than cash saved in a bank account.

CAPM explains the behaviour of security prices and provides a mechanism whereby investors could assess the impact of a proposed security investment on the overall portfolio risk and return. CAPM suggests that the prices of securities are determined in such a way that the risk premium or excess return are proportional to systematic risk, which is indicated by the beta coefficient.

Stock market or securities market is a market where securities issued by firms in the form of shares, bonds and debentures can be bought and sold freely. It consists of primary market and secondary market.

In a forward contract, two parties agree to do a trade at some future date, at a stated price and quantity. No money changes hands at the time the deal is signed. For example, a wheat farmer may wish to contract to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such transaction would take place through a forward market.

The futures contract is traded on a futures exchange as a standardised contract, subject to the rules and regulations of the exchange. It is the standardisation of the futures contract facilitates the secondary market trading. The futures contract relates to a given quantity of the underlying asset and only whole contracts can be traded, and trading of fractional contracts are not allowed in futures contracting.

Forward contracts are private bilateral contracts and have well established commercial usage. Future contracts are standardised tradable contracts fixed in terms of size, contract date and all other features.

Once you have bought or sold shares, the transaction is complete only when you have got the shares you purchased, or received money for the shares you sold. This is called settlement in stock market parlance. The stock exchanges have a complex mechanism in place to ensure that every trade is properly matched, and shares are received or delivered properly. In case of a shortfall of securities, an auction is resorted to close out the difference. The mechanism through which all parties to a transaction get their receivables i.e. either funds or shares is known as ‘clearing and settlement’ or simply ‘settlement’

Short questions

1. Explain briefly the operations of Indian stock market
1. What are the needs for a stock market in the country like India?
2. Write on Primary vs. Secondary market
3. Explain Stock market in India and Role and stock exchange functions
4. Write on Membership, organization and management of Stock exchanges

5. What are the principle weaknesses of Indian stock market?
6. What are the major directions to reform the functioning of stock exchanges?
7. What do you mean by Listing of securities. Explain?
8. Explain CAPM
9. Write in detail on the Issue mechanism of Primary market
10. Explain Briefly the clearing mechanism of the stock market.
11. Distinguish between Forward contract and Future contract
12. Write a note on buy back of shares
13. Write a short note on
 - Depositories
 - Private placement of shares
 - National stock exchange of India ltd
 - Over the counter exchange of India (OTCE)
 - Inter-connected stock exchange of India
 - Demutualization of stock exchanges
 - Money market
 - Importance of money market
 - Features of a developed money market
 - State government / public sector / municipality issued
 - Certificate of deposit
 - Call money market
 - Repurchase agreements (repos)
 - Inter-bank participation certificate
 - Bills rediscounting
 - Other money market instruments
 - Money laundering