UNIT 3 : INDIAN CAPITAL MARKET

UNIT STRUCTURE

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3.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

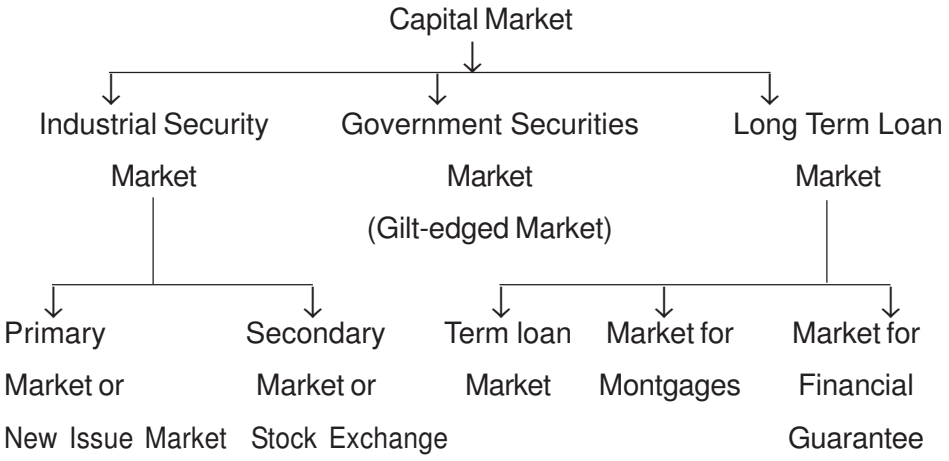
- discuss the meaning of Capital Market
- explain the structure of capital market
- explain the instrument and intermediaries of Capital Market

3.2 INTRODUCTION

The corporate bodies require funds for different projects in different times. They raise their funds depending on the preference of the investors and the regulatory framework. The business need two types of finance viz short term finance and long term finance. The capital market meets the long term requirements of fund. Through this unit, you will be able to know about the meaning of capital market and its instrument. The unit also, discusses about the capital market intermediaries. Thus, you will able to understand through this unit, the meaning, instrument and capital market intermediaries.

3.3 MEANING AND STRUCTURE OF INDIAN CAPITAL MARKET

Capital market is the market where long-term funds are traded. Capital market deals with securities with long term maturity. Instruments like shares, debentures, bond etc. are issued in the capital market for raising long term capital. The Indian capital market has the following structure:



3.3.1 Industrial Securities Market

Industrial securities market deals with the securities such as equity shares, preference shares etc., issued by the corporate houses. This market can further be classified in to: a) New Issue Market or Primary Market and b) Secondary Market or Stock Exchanges.

New issue market is the market where the securities which are issued for the first time or come to the market for the first time are bought and sold. The players in the new issue market are merchant bankers, underwriters, registrars to the issue collecting and coordinating bankers etc.

Secondary market or stock exchanges is the place where buying and selling of existing or second hand securities (securities which are once sold in the new issue market) takes place. This market provides liquidity and transferability to the securities. At present there are 25 stock exchanges working throughout the country.

3.3.2 Government Securities Market

Government Securities Market also called Gilt-Edged securities market. In this market long term securities issued by the government are traded. These securities are issued by the central government, state government; semi-government authorities like city corporation, port trust etc. electricity board, all India and state level financial institution and public sector enterprises are traded.

3.3.3 Long term Loan Market

This is the market where development banks and commercial banks supply long term loan to the corporate houses. This market can further be classified in to :

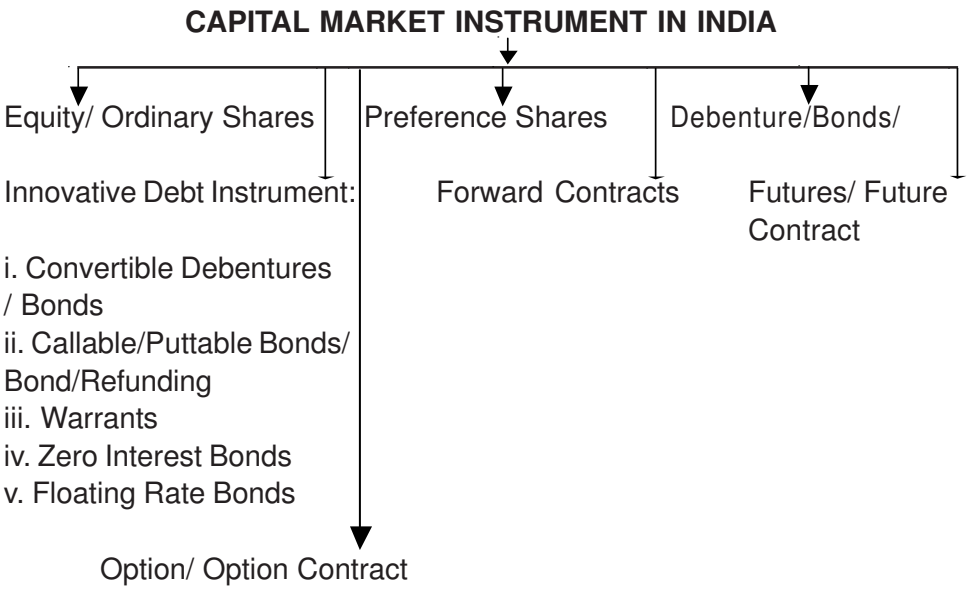
a) Term loan market

b) Mortgage market

c) Financial guarantee market.

3.4 CAPITAL MARKET INSTRUMENTS

The capital market instrument can be classified into three categories as pure, hybrid and derivatives. The pure instrument means equity shares, preference shares and debentures or bonds without mixing features. The hybrid instrument means combining of equity with bond, preference share and equity. Derivatives are nothing but contract which derive their values from the value of one or more of other assets i.e. financial instrument. Futures and options belong to the categories of derivatives.



a) **Equity or Ordinary Shares**: It represents the ownership capital. It is of several types:

Authorized equity share capital: The maximum amount of share capital that a company can raise is its authorized share capital.

Issued capital: It is that portion of the capital which is offered by the company to the investors.

Subscribed capital: It is the part of issued capital which is subscribed by the investors.

Paid-up capital: It is the capital that is paid by the shareholders.

The main features include limited liability, residual claim to income, right to control, pre-emptive rights.

b) **Preference Shares:** It has certain characters of equity share and debentures. It carries a fixed rate of interest. It has preferential right to get dividend in comparison to equity share. The preference shareholders can get cumulative dividends i.e. all unpaid dividend are payable. It does not carry any voting right. But, if the preference shares are not paid for more than two years with respect of cumulative shares, the preference shareholders entitled to vote.

c) **Debentures or Bonds or Notes**: The debenture holders are long term creditors. The debenture holders get fixed rate of interest and the principal amount repay at stipulated time. Three types of debentures

are found presently in India as:

i. Convertible debenture after 36 months,

ii. Optionally convertible debenture within 36 months,

iii. Compulsorily convertible with 18 months

d) **Innovative Debt or Instrument:** The debenture may be compulsory, optional or convertible. Call option gives the opportunity to the company to redeem the bonds prematurely. The firms issue such bonds and in favorable condition, they refund it.

A warrant gives the right to subscribe the equity shares at a certain period.

The zero coupon bonds do not carry any coupon rate and sold at discount from their maturity value.

The deep discount bond issued at discount over its face value far less than the yield to maturity.

Floating rate bonds are bonds whose interest rate are not fixed and it is the percentage point more than the benchmark rate. The benchmark rate is interest rate on treasury bills, bank rate, and maximum rate on term deposit.

e) **Forward Contracts:** It is the contract based on specified price to buy or sale at a specified future date of an asset. The buyer assumes a long position and agrees to buy at a specified future date at a specified price to buy and the other party gets short position to sell the asset on the same date at specified price. These are traded outside the stock exchange.

f) **Futures or Future Contracts**: It is an agreement between two parties to buy or sale an asset at a certain time in the future, at a certain price. It solves the different problems associated with the forward market. It reduces the counter party risk as seen in forward contract.

The future contracts are traded on an organized stock market whereas forward contract are traded on Over the Counter in nature. The future contracts are standardized contract which follow daily settlement. The forward contracts are customized contract terms and settlement done at the end of the period.

g) **Options or Option Contracts:** In forward contract and future contract, the parties committed themselves to do something whereas in case of option contract the parties get option the right to do something. The forward contract and future contract does involve any charge any cost. But the option contract requires an up front payment. The option contracts are of two types, call option and put option. In case of call option the holder get the right not obligation to buy an asset by a certain date for a certain price. In case of put option the holder gets the right not obligation to sell an asset by a certain date for a certain price.

3.5 CAPITAL MARKET INTERMEDIARIES

The financial markets have two components, the money market and the capital market. The capital market consists of two components, the securities market and other forms of lending and borrowing. The securities market which is divided again into two parts as primary market and secondary market.

The primary market deals with the sale of new securities. The following are the primary market intermediaries:

a. Merchant Banker or Lead Managers
b. Underwriter
c. Debenture Trustees
d. Registrars and Share Transfer Agents
e. Bankers to issue

The capital market intermediaries are vital link between investor, issuer and the regulator. Securities and Exchange Board of India Act, 1992 was made to protect, secure and promote the interest of the investors. It is responsible in constant monitoring for good government practices of the intermediaries.

The secondary market deals with the trading of securities initially offered. The following are the secondary market intermediaries:

a. Portfolio manager
b. Stock brokers
c. Sub-Brokers

d. Custodian

PRIMARY MARKET INTERMEDIARIES:

A. MERCHANT BANKER OR LEAD MANAGERS:

Merchant bankers are body corporate who are engaged in issue of securities. It acts as manager or advisor or consultant to issuing company. A merchant banker requires compulsory registration under the regulation 3 of SEBI (Merchant Bankers) Regulations, 1992. These activities mainly includes determining the composition of capital structure, compliance with procedural formalities, appointment of registration, listing of securities, arrangement of underwriting, selection of brokers and bankers, publicity and advertisement agent , private placement of securities, advisory services, etc. The merchant bankers are responsible to make all efforts to protect the interest of investors. The merchant bankers has to exercise due diligence, high standards of integrity, dignity. The merchant bankers are also responsible in providing adequate information without misleading about the applicable regulations and guidelines. It is now mandatory for all public issues to be managed by merchant bankers functioning as the lead managers.

B. UNDERWRITER:

An underwriter may be an individual, broker, merchant banker, financial institution or banks. The underwriting is an agreement between the issuing company and the assuring party through an agreement to take up shares or debentures or other securities to a specified extent in case public subscription does not amount to the expected level. Thus, in case any short-fall, it has to be made good by underwriting arrangements by the underwriter as per the agreement.

The underwriter shall not derive any benefit from underwriting the issue other than commission as specified in the agreement. If an underwriter is being called upon to subscribe the shares of a company has to subscribe such securities within 45 days of receipt of such intimation as per to the agreement. The underwriter has to appoint a compliance officer who is responsible for compliance of the Act. The compliance officer is required to report to SEBI and is responsible for complying the notification, guidelines, instruction issued by SEBI.

C. DEBENTURE TRUSTEES:

The issuing company has to make proper arrangements and comply with the legal requirements for the investor. The company renders these services to the investors for a fee under an agreement executing as trust deed with the trustee who are generally banks and financial institution and file the same with the Registrar of Companies. The main duties of debenture trustees are mainly possession of trust property in accordance with the trust deed, taking periodical report from the body corporate, enforce security of interest, protection of the debenture holders, inspect books of account, inform SEBI if any breach of trust deed etc.

Every debenture trustees is required to appoint a compliance officer. He is responsible for monitoring the compliance of the Act, rules and regulations. He is responsible for redressal of investor grievances.

D. REGISTRARS AND SHARE TRANSFER AGENTS:

The Registrars and Share Transfer Agents are very important intermediaries in mobilizing new capital, maintaining records, deciding the basis of allotment etc for the investors. They are very useful in case of share transfer, sale, as it helps in liquidity to the investors of their investment. They also provide this service to the existing companies. But this responsibility decreases as depository system comes into play. But unless and until the old system is completely eliminated and the shareholding totally switch over to dematerialized system, the share transfer agents will have to play their role.

The 'Registrar to an issue 'means, any person that appointed by the company or group of individuals carry out such activities on its behalf i.e. collecting applications, maintain records, determine the basic for allotment of securities, finalizing the list from the same, process and dispatch of allotment letters etc.

The 'Share Transfer Agents' means, any person who maintain records of holder of securities on behalf of any body corporate. They deal all matters connected with it, like redemption, transfer of securities etc. It may be the department of a body corporate performing the activities at any time the total number of holders of its securities issued exceed one lakh.

The Registrars and Share Transfer Agents shall have to maintain high standards of integrity, due diligence, adequate care, in the conduct of its business. They have to make reasonable effort to avoid misrepresentation, conflict and disclosure of its interest. They are also responsible in maintaining the continuity the data and records.

E. BANKERS TO ISSUE:

The Chapter I of SEBI (Bankers to an Issue) Regulations, 1994, deals with Banker to an issue. The Banker to an issue means a schedule bank carrying on all or any of the following activities:

A. Acceptance of application and application monies.

B. Acceptance of allotment or call monies.

C. Refund of application monies.

D. Payment of dividend or interest warrant.

The banks may render different function like, mobilizing of capital, issuing of securities, collection of application for securities etc. The banks are responsible in maintaining the records and furnish prompt information. But the company has to an agreement with the banks. Under Regulation 12, the banker to an issue has to maintain the date, name amount of monies refund, dividend and interest warrant paid; time, number of application received to the investor.



CHECK YOUR PROGRESS

Q 1: Mention three primary market intermediaries.

i) .....

ii) .....

iii) .....

SECONDARY MARKET INTERMEDIARIES:

A. PORTFOLIO MANAGER:

The word 'portfolio' means the total holdings of securities belonging to any person and the portfolio manager is the person who under an arrangement with the client, advises or directs the management and administration of such portfolio of securities. The portfolio manager has to enter into an agreement on behalf of a client and it contains:

1. The investment objectives,
2. Area of investment,
3. Type of instrument,
4. Custody of securities,
5. Procedure of client's account etc.



Networth: It means the aggregate value of paid-up equity capital plus free reserved which is aggregate value of loose and differed expenditure not written off.

Registration of portfolio manager:

a) The applicant is a body corporate and have infrastructure like adequate office space,

b) The principal officer of the applicant has professional qualification like law, finance, accountancy, management from a recognized university.

c) It has the capital requirement. The portfolio manager must have capital requirement of not less than networth of fifty lakhs rupees.

d) The grant of certificate to the applicant is in the interest of investors.

e) The applicant has minimum of two persons having at least five years of experience as portfolio manager or stock broker etc.

The portfolio manager act in a fiduciary capacity with regard to the clients funds under the provision of Reserve Bank of India, 1934. He shall pledge or give loan on securities on behalf of the client depending on the written permission of the client. He can not earn any direct or indirect benefits out of the clients fund or securities. The portfolio manager has to maintain high standard of integrity, fairness, due diligence. But he should not make any statement to any act, practice, unfair competition. The portfolio manager is responsible to appoint a compliance officer responsible for monitoring the compliance of the Act.

B. STOCK BROKERS AND SUB-BROKERS:

Stock brokers are members of recognized stock exchanges who

buy and sell or otherwise deal in securities. For a broker to deal in securities on a recognized stock exchange, it is obligatory that he should be registered as a stock broker with SEBI. The stock broker facilitates transaction of securities in the secondary market. The stock broker has to enter into an agreement with his client before buying and selling of securities. One must have a client account with a registered broker or sub- broker to buy or sell of securities and has to do the transaction through such broker or sub-broker. Broker or sub-broker charges brokerage commission for facilitating transaction.

The sub-brokers act as agent on behalf of the stock broker. The sub-brokers assist the investor in buying and selling the securities. Both broker and the sub-brokers hold a certificate of registration granted by SEBI. Both broker and the sub-brokers has to follow disciplinary proceedings under the rules, bye-laws etc. The SEBI observe before granting the certificate of Registration, about the applicant's eligibility to be admitted as a member of a stock exchange or not. The SEBI also take into account the availability of necessary infrastructure like adequate office space etc. Where an application does not fulfill the requirement may be rejected by SEBI and communicated within 30 days to the concerned stock exchange and to the applicant stating the grounds of refusals. But, SEBI can also reconsider an application.

The sub-broker has to forward an application in Form-B accompanied with letter in Form-C from a stock broker to a recognized stock exchange with whom he is to be affiliated as a member. But the applicant is eligible for registration like:

A) Incase of an individual, he should not less than 21 years of age, has not convicted of any offence and fit and proper. He should pass at least 12th standard or equivalent examination.

B) In case of body corporate or partnership firm, the directors or partners may comply with the requirements as stated by SEBI.

The sub-broker has the maintain different obligations like payment of fees as per Schedule III, agreement with the stock broker, abode the code of Conduct of Schedule II, all rules and regulation of stock exchange etc. Under Regulation 17 and 18, the sub-broker has to maintain the books of account.

Every broker has to appoint compliance officer who shall be responsible for monitoring the compliance of the act, rules, regulation etc issued by SEBI.

C. CUSTODIAN:

Custodian of securities means any person who provides custodial services in relation to securities of a client or safe keeping of gold or gold related instrument. They operate their function through opining custodial account. It is an account of a client maintained by a custodian of securities in respect of securities. Any person proposes to carry such business as custodian of securities has to make an application to SEBI for grant of a certificate for registration. The applicant fulfils the capital requirement specified under regulation 7(1), a net worth of a minimum of rupees fifty cores. The applicant must have necessary infrastructures and follow all rules and regulation approved under any law for the time being in force relating to securities, gold or gold related instrument. The applicant should be competent person and the grant of certificate is in the interest of investor. Custodian has the duty to inspected their affairs through the inspecting officer such as books, securities etc.



CHECK YOUR PROGRESS

Q 2: Mention three secondary market intermediaries.

i) .....

ii) .....

iii) .....



3.6 LET US SUM UP

In this unit we have discussed the following aspects -

- The word 'portfolio' means the total holdings of securities belonging to any person and the portfolio manager is the person who under an

arrangement with the client, advises or directs the management and administration of such portfolio of securities.

- The capital market instrument can be classified into three categories as pure, hybrid and derivatives.
- Three types of debentures are found presently in India as convertible debenture after 36 months, optionally convertible debenture within 36 months and compulsorily convertible with 18 months
- The capital market consists of two components, the securities market and other forms of lending and borrowing.
- Merchant bankers are person who engaged in issue of securities. It acts as manager or advisor or consultant to issuing company.
- The underwriting is an agreement between the issuing company and the assuring party through an agreement to take up shares or debentures or other securities to a specified extent in case public subscription does not amount to the expected level.
- The stock broker has to enter into an agreement with his client before buying and selling of securities
- Security Exchange Board of India is the regulator of capital Market in India.



3.7 FURTHER READINGS

1) Batra G.S. (2002). Financial services and markets. New Delhi, Deep and Deep Publication Pvt. Ltd.

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3) Khan, M. Y. (2007). Indian Financial System. New Delhi. Tata McGraw Hill.

4) Pathak, Bharati V (2006). The Indian Financial System : Markets, institutions and services. New Delhi, Pearson Education Ltd.

5) Srivastava, R.M. (2009). Management of Indian financial institutions. New Delhi, Himalaya Publishing House.



3.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The three primary market intermediaries are-

i. Merchant Banker or Lead Managers

ii. Underwriter

iii. Debenture Trustees

Ans to Q No 2: The three secondary market intermediaries are-

i. Portfolio manager

ii. Stock brokers and Sub-Brokers

iii. Custodian



3.9 MODEL QUESTIONS

Q 1: Discuss the role and obligation of portfolio manager.

Q 2: What is meant by merchant banker? Discuss its role as a primary market intermediary.

Q 3: What is meant by capital market? What are different primary market intermediary.

Q 4: Write short notes:

a. Custodian

b. Underwriter

c. Debenture Trustees

d. Registrars and Share Transfer Agents

e. Bankers to issue

f. Stock brokers and Sub-Brokers.

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