MANGALAYATAN
U N I V E R S I T Y

Learn Today to Lead Tomorrow

Commodity and Stock Market

MGO-2103

Edited By

Dr. Siddarth Jain

DIRECTORATE OF DISTANCE AND ONLINE EDUCATION

MANGALAYATAN
UNIVERSITY

Contents

Unit 1: Capital Market 1-50

1.0 Learning Objectives 1
1.1 Introduction 1
1.2 Capital Market 2
1.3 Financial Markets 6
1.4 Major role and importance of Capital Market 11
1.5 Types of Capital Market 12
1.6 Secondary Market (Stock Exchange) 17
1.7 Capital Markets In India 18
1.8 Book Building 23
1.9 Listing of Securities 29
1.10 Issue Of Securities 37
1.11 Concept of Buy back 38

Unit 2: Stock Exchange 51-84

2.0 Learning Objectives 51
2.1 Introduction 51
2.2 Organisation And Structure Of Stock exchange 53
2.3 Online Trading 62
2.4 Major Stock Exchanges In India 64
2.5 Securities And Exchange Board Of India (Sebi) 68
2.6 SEBI's powers in relation to stock exchanges 72
2.7 Derivatives 73
2.8 Types Of Derivatives 79

Unit 3: Trading in Stock Market 85-130

3.0 Learning Objectives 85
3.1 Introduction 85
3.2 Stock Market 86
3.3 Stock Exchange 95

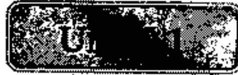
3.4	The Trading procedure	103
3.5	Depositories	104
3.6	Operators At Stock Exchange	110
3.7	National Security Depository Limited (NSDL)	117
3.8	Central Depository Services Limited	123
3.9	Dematerialisation	124

Unit 4: Commodities Market **131-162**

4.0	Learning Objectives	131
4.1	Introduction	131
4.2	Commodities Market	133
4.3	Transactions in Commodity Market	140
4.4	Participants in Commodity Derivative market	143
4.5	Types of Commodity Derivatives	145
4.6	Efficiency in Commodity future markets	147
4.7	Governing Body	151
4.8	Major Commodity exchanges in India	154
4.9	Commodity Exchange - A Reference to the Indian scenario	157

Unit 5: Trading in Commodities Market **163-184**

5.0	Learning Objectives	163
5.1	Introduction	163
5.3	Commodity Market In India	168
5.3	Trading in Commodity Market	170
5.4.	Types of Commodity Markets	171
5.5	Examples of Commodities Markets	171
5.6	Meaning of Forward Market Commission (Fmc)	172
5.7	The Role of Forward Markets Commission In Indian Commodity Markets	173
5.8	System of Regulation of Forward/Futures Trading	174
5.9	Regulatory Frame Work of Commodity Markets In India	175
5.10	Trading and Settlement in Commodity Market	179
5.11	Margins for Trading in Commodity Derivatives	181
5.12	Challenges faced by Commodity Markets	182



CAPITAL MARKETS

Structure

1.0 Learning Objectives
1.1 Introduction
1.2 Capital Market
1.3 Financial Markets
1.4 Major Role and Importance of Capital Market
1.5 Types of Capital Market
1.6 Secondary Market (Stock Exchange)
1.7 Capital Markets In India
1.8 Book Building
1.9 Listing of Securities
1.10 Issue of Securities
1.11 Concept of Buy back
Summary
Key Words
Review Questions
Further Readings

1.0 LEARNING OBJECTIVES

After reading this chapter students will be able to:

- Understand the basic concepts of apital market.
- Understand the role of Capital market in India .
- Understand the concept of listing and Issue of securities
- Understand the concept of Book Building .
- Understand the concept of Buy-Back of shares

Notes

1.1 INTRODUCTION

You all know that a business needs finance from the time an entrepreneur makes the decision to start it. It needs finance both for working capital requirements such as payments for raw materials and salaries to its employees, and fixed capital expenditure such as the purchase of machinery or building or to expand its production capacity. The above example gives a fair picture of how companies need to raise funds from the capital markets. Idea Cellular decided to enter the Indian capital market for its needs of expansion.

In this chapter you will study concepts like private placement, Initial public Offer (IPO) and capital markets which you come across in the example of Idea Cellular.

Business can raise these funds fromvarious sources and in different ways through financial markets.

This unit provides a brief description of the mechanism through which finances are mobilised by a business organisation for both short term and long term requirements. It also explains the institutional structure and the regulatory measures for different financial markets.

Concept of Capital Market

A business is a part of an economic system that consists of two main sectors – households which save funds and business firms which invest these funds. A financial market helps to link the savers and the investors by mobilizing funds between them. In doing so it performs what is known as an allocative function. It allocates or directs funds available for investment into their most productive investment opportunity.

When the allocative function is performed well, two consequences follow:

- The rate of return offered to households would be higher
- Scarce resources are allocated to those firms which have the highest productivity for the economy.

There are two major alternative mechanisms through which allocation of funds can be done: via banks or via financial markets. Households can deposit their surplus funds with banks, who in turn could lend these funds to business firms.

Alternately, households can buy the shares and debentures offered by a business using financial markets. The process by which allocation of funds is done is called financial intermediation.

Banks and financial markets are competing intermediaries in the financial system, and give households a choice of where they want to place their savings.

1.2 CAPITAL MARKET

The term capital market refers to facilities and institutional arrangements through which long-term funds, both debt and equity are raised and invested. It consists of a series of channels through which savings of the community are made available for industrial and commercial enterprises and for the public in general.

It directs these savingsinto their most productive use leading to growth and development of the economy. The capital market consists of development banks, commercial banks and stock exchanges.

Notes

An ideal capital market is one where finance is available at reasonable cost. The process of economic development is facilitated by the existence of a well functioning capital market. In fact, development of the financial system is seen as a necessary condition for economic growth. It is essential that financial institutions are sufficiently developed and that market operations are free, fair, competitive and transparent. The capital market should also be efficient in respect of the information that it delivers, minimise transaction costs and allocate capital most productively.

Definition

Financial system is a complex well integrated set of sub system of financial institutions, market, instruments and services which facilitates the transfer and allocation of funds efficiently and effectively System helps to mobilize the surplus funds and utilizing in productive manner. A capital market can be either a primary market or a secondary market. In a primary market, new stock or bond issues are sold to investors, often via a mechanism known as underwriting.

The main entities seeking to raise long-term funds on the primary capital markets are governments (which may be municipal, local or national) and business enterprises (companies). Governments issue only bonds, whereas companies often issue both equity and bonds.

The main entities purchasing the bonds or stock include pension funds, hedge funds, sovereign wealth funds, and less commonly wealthy individuals and investment banks trading on their own behalf. In the secondary market, existing securities are sold and bought among investors or traders, usually on an exchange, over-the-counter, or elsewhere.

The existence of secondary markets increases the willingness of investors in primary markets, as they know they are likely to be able to swiftly cash out their investments if the need arises.

A second important division falls between the stock markets (for equity securities, also known as shares, where investors acquire ownership of companies) and the bond markets (where investors become creditors).

Methods of Floatation

There are various methods of floating new issues in the primary market :

1. **Offer through Prospectus:** Offer through prospectus is the most popular method of raising funds by public companies in the primary market. This involves inviting subscription from the public through issue of prospectus. A prospectus makes a direct appeal to investors to raise capital, through an advertisement in newspapers and magazines. The issues may be underwritten and also are required to be listed on at least one stock exchange. The contents of the prospectus have to be in accordance with the provisions of the Companies Act and SEBI disclosure and investor protection guidelines.

2. **Offer for Sale:** Under this method securities are not issued directly to the public but are offered for sale through intermediaries like issuing houses or stock brokers. In this case, a company sells securities enbloc at an agreed price to brokers who, in turn, resell them to the investing public.

3. Private Placement: Private placement is the allotment of securities by a company to institutional investors and some selected individuals. It helps to raise capital more quickly than a public issue. Access to the primary market can be expensive on account of various mandatory and nonmandatory expenses.

   Some companies, therefore, cannot afford a public issue and choose to use private placement.

Notes

4. Rights Issue: This is a privilege given to existing shareholders to subscribe to a new issue of shares according to the terms and conditions of the company. The shareholders are offered the 'right' to buy new shares in proportion to the number of shares they already possess.
5. e-IPOs: A company proposing to issue capital to the public through the on-line system of the stock exchange has to enter into an agreement with the stock exchange. This is called an Initial Public Offer (IPO). SEBI registered brokers have to be appointed for the purpose of accepting applications and placing orders with the company. The issuer company should also appoint a registrar to the issue having electronic connectivity with the exchange. The issuer company can apply for listing of its securities on any exchange other than the exchange through which it has offered its securities. The lead manager coordinates all the activities amongst intermediaries connected with the issue.

Components

- Financial Instruments
- Financial Markets
- Financial Institutions
- Financial Services
- Regulatory Authority

Financial Instruments

Financial instruments are assets that can be traded, or they can also be seen as packages of capital that may be traded. Most types of financial instruments provide efficient flow and transfer of capital all throughout the world's investors. These assets can be cash, a contractual right to deliver or receive cash or another type of financial instrument, or evidence of one's ownership of an entity.

Key features:

- A financial instrument is a real or virtual document representing a legal agreement involving any kind of monetary value.
- Financial instruments may be divided into two types: cash instruments and derivative instruments.
- Financial instruments may also be divided according to an asset class, which depends on whether they are debt-based or equity-based.
- Foreign exchange instruments comprise a third, unique type of financial instrument.

Understanding Financial Instruments

- Financial instruments can be real or virtual documents representing a legal agreement involving any kind of monetary value.
- Equity-based financial instruments represent ownership of an asset. Debt-based financial instruments represent a loan made by an investor to the owner of the asset.
- Foreign exchange instruments comprise a third, unique type of financial instrument. Different subcategories of each instrument type exist, such as preferred share equity and common share equity.
- International Accounting Standards (IAS) defines financial instruments as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity."

Notes

Types of Financial Instruments

Financial instruments may be divided into two types: cash instruments and derivative instruments.

1. **Cash Instruments**

   The values of cash instruments are directly influenced and determined by the markets. These can be securities that are easily transferable.

   Cash instruments may also be deposits and loans agreed upon by borrowers and lenders.

2. **Derivative Instruments**

   The value and characteristics of derivative instruments are based on the vehicle's underlying components, such as assets, interest rates, or indices.

   An equity options contract, for example, is a derivative because it derives its value from the underlying stock. The option gives the right, but not the obligation, to buy or sell the stock at a specified price and by a certain date.

   As the price of the stock rises and falls, so too does the value of the option although not necessarily by the same percentage.

   There can be over-the-counter (OTC) derivatives or exchange-traded derivatives. OTC is a market or process whereby securities–that are not listed on formal exchanges–are priced and traded.

Types of Asset Classes of Financial Instruments

Financial instruments may also be divided according to an asset class, which depends on whether they are debt-based or equity-based.

Debt-Based Financial Instruments

- Short-term debt-based financial instruments last for one year or less. Securities of this kind come in the form of T-bills and commercial paper. Cash of this kind can be deposits and certificates of deposit (CDs).
- Exchange-traded derivatives under short-term, debt-based financial instruments can be short-term interest rate futures. OTC derivatives are forward rate agreements.
- Long-term debt-based financial instruments last for more than a year. Under securities, these are bonds. Cash equivalents are loans. Exchange-traded derivatives are bond futures and options on bond futures. OTC derivatives are interest rate swaps, interest rate caps and floors, interest rate options, and exotic derivatives.

Equity-Based Financial Instruments

Securities under equity-based financial instruments are stocks. Exchange-traded derivatives in this category include stock options and equity futures. The OTC derivatives are stock options and exotic derivatives.

Financial Markets

A financial market is a market in which people trade financial securities and derivatives at low transaction costs. Some of the securities include stocks and bonds, raw materials and precious metals, which are known in the financial markets as commodities.

Notes

Financial Institutions

- Financial institutions, otherwise known as banking institutions, are corporations that provide services as intermediaries of financial markets.

1. Central Banks.
2. Retail and Commercial Banks.
3. Internet Banks.
4. Credit Unions.
5. Savings and Loan Associations.
6. Investment Banks and Companies.
7. Brokerage Firms.
8. Insurance Companies.

Financial Services

Financial services are the economic services provided by the finance industry, which encompasses a broad range of businesses that manage money, including credit unions, banks, credit-card companies, insurance companies, accountancy companies, consumer-finance companies, stock brokerages, investment funds, individual managers, and some government-sponsored enterprises.

The term "financial services" became more prevalent in the United States partly as a result of the Gramm-Leach-Bliley Act of the late 1990s, which enabled different types of companies operating in the U.S. financial services industry at that time to merge.[3]

Companies usually have two distinct approaches to this new type of business. One approach would be a bank which simply buys an insurance company or an investment bank, keeps the original brands of the acquired firm, and adds the acquisition to its holding company simply to diversify its earnings. Outside the U.S. (e.g. Japan), non-financial services companies are permitted within the holding company.

In this scenario, each company still looks independent, and has its own customers, etc. In the other style, a bank would simply create its own insurance division or brokerage division and attempt to sell those products to its own existing customers, with incentives for combining all things with one company.

Regulatory Authority

The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act 1992 and is the principal regulator for Stock Exchanges in India. SEBI's primary functions include protecting investor interests, promoting and regulating the Indian securities markets.

1.3 FINANCIAL MARKETS

Financial market is a place or mechanism which facilitates the transfer of resources from one entity to another.

Role

1. Transfer of resources: FM facilitates the transfer of resources from one person to another.
2. Productivity usage: Financial markets allow for the productive use of the funds in

financialsystem thus enhancing the income and gross national production.

3. Growth in income: Financial markets allow lenders earn Interest and Divided on their surplus investable funds thus contributing to the growth in their income.
4. Capital formation: A channel through which savings low to aid capita formation of a country.
5. Price discovery: FM allow for the determination of the price of the traded financial assets through the interactions of different set of participants.

Function of Financial Markets

1. Facilitate creation and allocation of credit and liquidity
2. Serves as intermediaries
3. Assist process of economic growth
4. Caters financial needs

1. Financial markets play an important role in the allocation of scarce resources in an economy by erforming the following four important functions facilitates the transfer of savings from savers to investors. It gives savers the choice of different investments and thus helps to channelise surplus funds into the most productive use.
2. Facilitating Price Discovery: You all know that the forces of demand and supply help to establish a price for a commodity or service in the market. In the financial market, the households are suppliers of funds and business firms represent the demand. The interaction between them helps to establish a price for the financial asset which is being traded in that particular market.
3. **Providing Liquidity to Financial Assets:** Financial markets facilitate easy purchase and sale of financial assets. In doing so they provide liquidity to financial assets, so that they can be easily converted into cash whenever required. Holders of assets can readily sell their financial assets through the mechanism of the financial market.
4. **Reducing the Cost of Transactions:** Financial markets provide valuable information about securities being traded in the market. It helps to save time, effort and money that both buyers and sellers of a financial asset would have to otherwise spend to try and find each other. The financial market is thus, a common platform where buyers and sellers can meet for fulfillment of their individual needs.

   Financial markets are classified on the basis of the maturity of financial instruments traded in them. Instruments with a maturity of less than one year are traded in the money market. Instruments with longer maturity are traded in the capital market.

Types of Financial Markets

I. Money Market

Money market is collective name given to the various firms and institutions that deal in various grades of near money. The money market is a market for short term funds which deals in monetary assets whose period of maturity is upto one year.

These assets are close substitutes for money. It is a market where low risk, unsecured and short term debt instruments that are highly liquid are issued and actively traded everyday. It has no physical location, but is an activity conducted over the telephone and through the internet. It

Notes

enables the raising of short-term funds for meeting the temporary shortages of cash and obligations and the temporary deployment of excess funds for earning returns. The major participants in the market are the Reserve Bank of India (RBI), Commercial Banks, Non-Banking Finance Companies, State Governments, Large Corporate Houses and Mutual Funds.

Characteristics of money market (MM)

1. Concerned with borrowing and lending of short term funds only.
2. Source of working capital finance.
3. Dealings are done on negotiations and effect their financial transactions through telephone, telegram ,mail or any other means of communication
4. Market. Is composed of several specialised sub markets such as
   - call money market
   - Treasurybill market
   - Discount market
   - collateral loan market
5. Various instruments of MM. areCall money (inter bank loan),Certificate of deposits(time deposit)Treasury bill of the Govt., trade bills ,commercial papers promissory notes by reputing companies.
6. Dealers in Money Market are;-
   - Central Bank
   - Commercial Bank
   - Discount houses
   - Bill brokers
   - Insurance companies
   - Financial corporations

Functions of money market

(1) It provides an outlet to commercial banks for the employment of their shout term funds.

(2) It offers a channel to non-banking financial institutions such as Co's, financial houses etc. for the investment of their short term funds.

(3) It provides short term funds to industrialists to meet their requirements of working capital.

(4) It helps the Govt to raise the necessary short-term funds through the issue of treasury bills or

short-term loans.

(5) It serves as a medium through which the central back of a country can exercise its control over the creation of credit

Money Market Instruments

1. **Treasury Bill:** A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than one year. They are also known as Zero Coupon Bonds issued by the Reserve Bank of India on behalf of the Central Government to meet its short-term requirement of funds.

   Treasury bills are issued in the form of a promissory note. They are highly liquid and have assured yield and negligible risk of default. They are issued at a price which is lower than their face value and repaid at par. The difference between the price at which the treasury bills are issued and their redemption value is the interest receivable on them and is called discount. Treasury bills are available for a minimum amount of Rs 25,000 and in multiples thereof.

   Example: Suppose an investor purchases a 91 days Treasury bill with a face value of Rs. 1,00,000 for Rs. 96,000. By holding the bill until the maturity date, the investor receives Rs. 1,00,000. The difference of Rs. 4,000 between the proceeds received at maturity and the amount paid to purchase the bill represents the interest received by him.

2. **Commercial Paper:** Commercial paper is a short-term unsecured promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is issued by large and creditworthy companies to raise short-term funds at lower rates of interest than market rates.

   It usually has a maturity period of 15 days to one year. The issuance of commercial paper is an alternative to bank borrowing for large companies that are generally considered to be financially strong. It is sold at a discount and redeemed at par. The original purpose of commercial paper was to provide short-terms funds for seasonal and working capital needs. For example, companies use this instrument for purposes such as bridge financing.

   Example: Suppose a company needs long-term finance to buy some machinery. In order to raise the long term funds in the capital market the company will have to incur floatation costs (costs associated with floating of an issue are brokerage, commission, printing of applications and advertising etc.).

   Funds raised through commercial paper are used to meet the floatation costs. This is known as Bridge Financing.

3. **Call Money:** Call money is short term finance repayable on demand, with a maturity period of one day to fifteen days, used for inter-bank transactions. Commercial banks have to maintain a minimum cash balance known as cash reserve ratio. The Reserve Bank of India changes the cash reserve ratio from time to time which in turn affects the amount of funds available to be given as loans by commercial banks.

   Call money is a method by which banks borrow from each other to be able to maintain the cash reserve ratio. The interest rate paid on call money loans is known as the call rate. It is a highly volatile rate that varies from day-to-day and sometimes even from hour-to-hour. There is an inverse relationship between call rates and other short-term money market instruments such as certificates of deposit and commercial paper. A rise in call money rates makes other sources of finance such as commercial paper and certificates of deposit cheaper in comparison for banks raise funds from these sources.

4. **Certificate of Deposit:** Certificates of deposit (CD) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions. They can be issued to individuals, corporations and companies during periods of tight liquidity when the deposit growth of banks is slow but the demand for credit is high. They help to mobilise a large amount of money for short periods.

Notes

5. **Commercial Bill:** A commercial bill is a bill of exchange used to finance the working capital requirements of business firms. It is a short-term, negotiable, self-liquidating instrument which is used to finance the credit sales of firms. When goods are sold on credit, the buyer becomes liable to make payment on a specific date in future.

   The seller could wait till the specified date or make use of a bill of exchange. The seller (drawer) of the goods draws the bill and the buyer (drawee) accepts it. On being accepted, the bill becomes a marketable instrument and is called a trade bill. These bills can be discounted with a bank if the seller needs funds before the bill matures. When a trade bill is accepted by a commercial bank it is known as a commercial bill.

II. Capital Markets

Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions. They helps channelise surplus funds from savers to institutions which then invest them into productive use.

Generally, this market trades mostly in long-term securities. Capital market consists of primary markets and secondary markets. Primary markets deal with trade of new issues of stocks and other securities, whereas secondary market deals with the exchange of existing or previously-issued securities. Another important division in the capital market is made on the basis of the nature of security traded, i.e. stock market and bond market.

It is an organized market in which both individuals and business entities buy and sell debt and equity securities. It is designed to be an efficient way to enter into purchase and sale transactions. This market is a key source of funds for an entity whose securities are permitted by a regulatory authority to be traded, since it can readily sell its debt obligations and equity to investors. Governments also use capital markets to raise funds, typically through the issuance of long-term bonds. Governments do not issue shares, and so cannot issue equity securities.

A capital market is intended to be for the issuance and trading of long-term securities. When a publicly held company sells its securities in the capital markets, this is referred to as primary market activity. The subsequent trading of company securities between investors is known as secondary market activity. Short-term securities are traded elsewhere, such as in the money market.

Examples of highly organized capital markets are the New York Stock Exchange, American Stock Exchange, London Stock Exchange, and NASDAQ. Securities can also be traded "over the counter," rather than on an organized exchange. These securities are usually issued by entities whose business fundamentals (such as revenue, capitalization, and profitability) do not meet the minimum standards of a formal exchange, which forces investors to use other avenues to trade the securities.

Capital markets are highly interconnected, so a disturbance in a capital market on the other side of the globe will likely impact trading in markets located in other countries.

The Securities and Exchange Commission (SEC) is an example of a federal-level agency that regulates the reporting of information by any entity that wishes to issue securities in a capital market, or have its securities traded in a capital market.

Features

- The capital market deals in ordinary stock are shares and debentures of corporations, and bonds and securities of governments.
- The funds which flow into the capital market come from individuals who have savings to

Notes

invest, the merchant banks, the commercial banks and non-bank financial intermediaries, such as insurance companies, finance houses, unit trusts, investment trusts, venture capital, leasing finance, mutual funds, building societies, etc.

- Further, there are the issuing houses which do not provide capital but underwrite the shares and debentures of companies and help in selling their new issues of shares and debentures.
- The demand for funds comes from joint stock companies for working and fixed capital assets and inventories and from local, state and central governments, improvement trusts, port trusts, etc. to finance a variety of expenditures and assets.
- The capital market functions through the stock exchange market. A stock exchange is a market which facilitates buying and selling of shares, stocks, bonds, securities and debentures.
- It is not only a market for old securities and shares but also for new issues shares and securities. In fact, the capital market is related to the supply and demand for new capital, and the stock exchange facilitates such transactions.

1.4 MAJOR ROLE AND IMPORTANCE OF CAPITAL MARKET

The capital market has a crucial significance to capital formation. For a speedy economic development, the adequate capital formation is necessary. The significance of capital market in economic development is explained below:

Mobilization Of Savings And Acceleration Of Capital Formation

In developing countries like India, the importance of capital market is self-evident. In this market, various types of securities help to mobilize savings from various sectors of the population. The twin features of reasonable return and liquidity in stock exchange are definite incentives to the people to invest in securities. This accelerates the capital formation in the country.

Raising Long-Term Capital

The existence of a stock exchange enables companies to raise permanent capital. The investors cannot commit their funds for a permanent period but companies require funds permanently. The stock exchange resolves this dash of interests by offering an opportunity to investors to buy or sell their securities, while permanent capital with the company remains unaffected.

Helps to promote Industrial Growth

The stock exchange is a central market through which resources are transferred to the industrial sector of the economy. The existence of such an institution encourages people to invest in productive channels. Thus it stimulates industrial growth and economic development of the country by mobilizing funds for investment in the corporate securities.

Ready And Continuous Market

The stock exchange provides a central convenient place where buyers and sellers can easily purchase and sell securities. Easy marketability makes an investment in securities more liquid as compared to other assets.

Notes

Technical Support

An important shortage faced by entrepreneurs in developing countries is technical assistance. By offering advisory services relating to the preparation of feasibility reports, identifying growth potential and training entrepreneurs in project management, the financial intermediaries in capital market play an important role.

A Reliable Guide To Performance

The capital market serves as a reliable guide to the performance and financial position of corporate, and thereby promotes efficiency.

Proper Channelization Of Funds

The prevailing market price of a security and relative yield are the guiding factors for the people to channelize their funds in a particular company. This ensures effective utilization of funds in the public interest.

Provision Of Variety Of Services:

The financial institutions functioning in the capital market provide a variety of services such as a grant of long-term and medium-term loans to entrepreneurs, provision of underwriting facilities, assistance in the promotion of companies, participation in equity capital, giving expert advice etc.

Development Of Backward Areas

Capital Markets provide funds for projects in backward areas. This facilitates economic development of backward areas. Long-term funds are also provided for development projects in backward and rural areas.

Foreign Capital

Capital markets make possible to generate foreign capital. Indian firms are able to generate capital funds from overseas markets by way of bonds and other securities.

The government has liberalized Foreign Direct Investment (FDI) in the country. This not only brings in the foreign capital but also foreign technology which is important for economic development of the country.

Easy Liquidity

With the help of secondary market, investors can sell off their holdings and convert them into liquid cash. Commercial banks also allow investors to withdraw their deposits, as and when they are in need of funds.

1.5 TYPES OF CAPITAL MARKET

The Capital Market can be divided into two parts:

a. Primary Market

b. Secondary Market

A. Primary Market

The primary market is also known as the new issues market. It deals with new securities being issued for the first time. The essential function of a primary market is to facilitate the transfer of investible funds from savers to entrepreneurs seeking to establish new enterprises or to expand existing ones through the issue of securities for the first time.

The investors in this market are banks, financial institutions, insurance companies, mutual funds and individuals. A company can raise capital through the primary market in the form of equity shares, preference shares, debentures, loans and deposits. Funds raised may be for setting up new projects, expansion, diversification, modernisation of existing projects, mergers and takeovers etc

Methods of Floatation

There are various methods of floating new issues in the primary market :

1. **Offer through Prospectus:** Offer through prospectus is the most popular method of raising funds by public companies in the primary market.

   This involves inviting subscription from the public through issue of prospectus. A prospectus makes a direct appeal to investors to raise capital, through an advertisement in newspapers and magazines. The issues may be underwritten and also are required to be listed on at least one stock exchange.

   The contents of the prospectus have to be in accordance with the provisions of the Companies Act and SEBI disclosure and investor protection guidelines.

2. **Offer for Sale:** Under this method securities are not issued directly to the public but are offered for sale through intermediaries like issuing houses or stock brokers. In this case, a company sells securities enbloc at an agreed price to brokers who, in turn, resell them to the investing public.

3. **Private Placement:** Private placement is the allotment of securities by a company to institutional investors and some selected individuals. It helps to raise capital more quickly than a public issue. Access to the primary market can be expensive on account of various mandatory and nonmandatory expenses. Some companies, therefore, cannot afford a public issue and choose to use private placement.

4. **Rights Issue:** This is a privilege given to existing shareholders to subscribe to a new issue of shares according to the terms and conditions of the company. The shareholders are offered the 'right' to buy new shares in proportion to the number of shares they already possess.

5. **e-IPOs:** A company proposing to issue capital to the public through the on-line system of the stock exchange has to enter into an agreement with the stock exchange. This is called an Initial Public Offer (IPO). SEBI registered brokers have to be appointed for the purpose of accepting applications and placing orders with the company. The issuer company should also appoint a registrar to the issue having electronic connectivity with the exchange. The issuer company can apply for listing of its securities on any exchange other than the exchange through which it has offered its securities. The lead manager coordinates all the activities amongst intermediaries connected with the issue.

Notes

Distinction between Capital Market and Money Market

The major points of distinction between the two markets are as follows:

(i) **Participants:** The participants in the capital market are financial institutions, banks, corporate entities, foreign investors and ordinary retail investors from members of the public. Participation in the money market is by and large undertaken by institutional participants such as the RBI, banks, financial institutions and finance companies.

Individual investors although permitted to transact in the secondary money market, do not normally do so.

(ii) **Instruments:** The main instruments traded in the capital market are - equity shares, debentures, bonds, preference shares etc. The main instruments traded in the money market are short term debt instruments such as T-bills, trade bills reports, commercial paper and certificates of deposit.

(iii) **Investment Outlay:** Investment in the capital market i.e. securities does not necessarily require a huge financial outlay. The value of units of securities is generally low i.e. Rs 10, Rs 100 and so is the case with minimum trading lot of shares which is kept small i.e. 5, 50, 100 or so. This helps individuals with small savings to subscribe to these securities.

In the money market, transactions entail huge sums of money as the instruments are quite expensive.

(iv) **Duration:** The capital market deals in medium and long term securities such as equity shares and debentures. Money market instruments have a maximum tenure of one year, and may even be issued for a single day.

(v) **Liquidity:** Capital market securities are considered liquid investments because they are marketable on the stock exchanges. However, a share may not be actively traded, i.e. it may not easily find a buyer.

Money market instruments on the other hand, enjoy a higher degree of liquidity as there is formal arrangement for this. The Discount Finance House of India (DFHI) has been established for the specific objective of providing a ready market for money market instruments.

(vi) **Safety:** Capital market instruments are riskier both with respect to returns and principal repayment. Issuing companies may fail to perform as per projections and promoters may defraud investors. But the money market is generally much safer with a minimum risk of default.

This is due to the shorter duration of investing and also to financial soundness of the issuers, which primarily are the government, banks and highly rated companies.

(vii) **Expected return:** The investment in capital markets generally yield a higher return for investors than the money markets. The possibility of earnings is higher if the securities are held for a longer duration. First, there is the scope of earning capital gains in equity share. Second, in the long run, the prosperity of a company is shared by shareholders by way of high dividends and bonus issues.

Some of the functions of primary market are as follows :

a. Origination: Origination is referred to as examine, evaluate, and process new project proposals in the primary market. It begins prior to an issue is present in the market. It is done with the help of commercial bankers.

b. Underwriting: For ensuring the success of new issue there is a need for underwriting firms. These are the ones who guarantee minimum subscription. In case, the issue remains unsold the underwriters have to buy. But if the issues are completely subscribed then there will be no liability left for them.

c. Distribution: For the success of issue, brokers and dealers are given job distribution who directly contact with investors.

New issue mechanism

- A company can rise finance by issuing E.g. Shares in different forms.
- IPO (initial Public Offerings)
- FPO (Follow Up offer) Right issue.
- Pvt Placements.
- PreferentialAllotments.
- Bought out deals (offer for sale).
- Book Building

Method of Floatation of Securities in Primary Market

The securities may be issued in primary market by the following methods:

1. Public Issue through Prospectus:

- Under this method company issues a prospectus to inform and attract general public. In prospectus company provides details about the purpose for which funds are being raised, past financial performance of the company, background and future prospects of company.
- The information in the prospectus helps the public to know about the risk and earning potential of the company and accordingly they decide whether to invest or not in that company Through IPO company can approach large number of persons and can approach public at large. Sometimes companies involve intermediaries such as bankers, brokers and underwriters to raise capital from general public.
- IPO Initial Public Offer :A initial public offering is process of issuing share to the public for the first time by a company

Procedure Regarding New Issues

1. **Issue of Prospectus** - A company, which intends to raise finance from the public through new issues, must be familiar to public .. This can be done by issuing a prospectus. The prospectus is any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public, inviting offers from the public for the subscription or purchase of shares or debentures of a company.
2. **Application** - When a company issues the prospectus, the investors/public may apply for the shares offered by the company. These application forms may be obtained from the brokers, bankers or lead managers, who assist the company in the issue of new shares. The application may be in the name of individuals or companies. The applicant usually pays an amount called 'application money' along with the application

Notes

3. **Application for listing of securities -** A company can create a favorable impression in the minds of the investors about its financial soundness, marketability of its shares etc., by getting its securities listed in stock exchange. The prospectus for new issues should include details regarding submission of application form for listing of its securities in recognized stock exchanges.
4. **Allotment of shares -** On closing the subscription list, the company can allot shares to the applicants. After allotment of shares, the allottees become the shareholders of the company.
5. **Allotment / Regret letter -** After the allotment of shares, the allotment letters or share certificates be sent to the allottees within a reasonable time, say, two months from the date of closing of subscription list. Letters of regret along with refund orders must be sent to nonallotees

Advantages of going public

- Access to capital - basic purpose for going public is to have larger access to capital for long term long term
- Stock holder diversification-founders can diversify their holdingsand thereby reduce the risk of portfolio.
- Investor's recognition.
- Liquidity to promoters-
- Reputation of the company-when company go for public it enhances the image ad reputation of the company
- Signals from Markets.it provides useful information about the market to managers

Disadvantages

- Dilution of control- when shares are issued to public it leads to dilution of proportionate ownership in the firm
- Loss of flexibility.-company will lose it flexibility in decision making process since they are accountable to public
- Disclosure- company requires to disclose the information to investors
- Accountability-company should be responsible and accountable to public in management activities as they are the owners of the company

Offer for Sale:

Under this method new securities are offered to general public but not directly by the company but by an intermediary who buys whole lot of securities from the company. Generally the intermediaries are the firms of brokers.

So sale of securities takes place in two steps: first when the company issues securities to the intermediary at face value and second when intermediaries issue securities to general public at higher price to earn profit.

Under this method company is saved from the formalities and complexities of issuing securities directly to public.

Private Placement:

Under this method the securities are sold by the company to an intermediary at a fixed price and in second step intermediaries sell these securities not to general public but to selected clients at

Notes

higher price. The issuing company issues prospectus to give details about its objectives, future prospects so that reputed clients prefer to buy the security from intermediary. Under this method the intermediaries issue securities to selected clients such as UTI, LIC, General Insurance, etc.

The private placement method is a cost saving method as company is saved from the expenses of underwriter fees, manager fees, agents' commission, listing of company's name in stock exchange etc. Small and new companies prefer private placement as they cannot afford to raise from public issue.

Right Issue (For Existing Companies):

This is the issue of new shares to existing shareholders. It is called right issue because it is the pre-emptive right of shareholders that company must offer them the new issue before subscribing to outsiders. Each shareholder has the right to subscribe to the new shares in the proportion of shares he already holds. A right issue is mandatory for companies under Companies' Act 1956.

The stock exchange does not allow the existing companies to go for new issue without giving pre-emptive rights to existing shareholders because if new issue is directly issued to new subscribers then the existing equity shareholders may lose their share in capital and control of company i.e., it would water their equity. To stop this the pre-emptive or right issue is compulsory for existing company.

e-IPOs, (electronic Initial Public Offer):

It is the new method of issuing securities through on line system of stock exchange. In this company has to appoint registered brokers for the purpose of accepting applications and placing orders. The company issuing security has to apply for listing of its securities on any exchange other than the exchange it has offered its securities earlier. The manager coordinates the activities through various intermediaries connected with the issue.

1.6 SECONDARY MARKET (STOCK EXCHANGE)

The secondary market is also known as the stock market or stock exchange. It is a market for the purchase and sale of existing securities. It helps existing investors to disinvest and fresh investors to enter the market.

It also provides liquidity and marketability to existing securities. It also contributes to economic growth by channelising funds towards the most productive investments through the process of disinvestment and reinvestment.

Securities are traded, cleared and settled within the regulatory framework prescribed by SEBI. Advances in information technology have made trading through stock exchanges accessible from anywhere in the country through trading terminals.

Along with the growth of the primary market in the country, the secondary market has also grown significantly during the last ten years.

- The secondary market on the other hand is the market for old and already issued securities. It is the market for the sale and purchase of previously issued or second hand securities.
- The secondary capital market is composed of industrial security market or the stock exchange in which industrial securities are bought and sold and the gilt-edged market in which the government and semi-government securities are traded. It is known as stock exchange or stock market. Here the securities are bought and sold by the investors.
- In secondary market securities are not directly issued by the company to investors. The

Notes

securities are sold by existing investors to other investors.

- Sometimes the investor is in need of cash and another investor wants to buy the shares of the company as he could not get directly from company. Then both the investors can meet in secondary market and exchange securities for cash through intermediary called broker.
- In secondary market companies get no additional capital as securities are bought and sold between investors only so directly there is no capital formation but secondary market indirectly contributes in capital formation by providing liquidity to securities of the company.
- If there is no secondary market then investors could get back their investment only after redemption period is over or when company gets dissolved which means investment will be blocked for a long period of time but with the presence of secondary market, the investors can convert their securities into cash whenever they want and it also gives chance to investors to make profit as securities are bought and sold at market price which is generally more than the original price of the securities.
- This liquidity offered by secondary market encourages even those investors to invest in securities who want to invest for small period of time as there is option of selling securities at their convenience.

Some of the functions of secondary market are as follows:

1. Regular information about the value of security
2. Offers liquidity to the investors for their assets
3. Continuous and active trading
4. Provide a Market Place

1.7 CAPITAL MARKETS IN INDIA

India has a fair share of the world economy and hence the capital markets or the share markets of India form a considerable portion of the world economy. The capital market is vital to the financial system. The capital Markets are of two main types. The Primary markets and the secondary markets. In a primary market, companies, governments or public sector institutions can raise funds through bond issues.

Also, Corporations can sell new stock through an initial public offering (IPO) and raise money through that. Thus in the primary market, the party directly buys shares of a company. The process of selling new shares to investors is called underwriting.

In the Secondary Markets, the stocks, shares, and bonds etc. are bought and sold by the customers. Examples of the secondary capital markets include the stock exchanges like NSE, BSE etc. In these markets, using the technology of the current time, the shares, and bonds etc. are sold and purchased by parties or people.

Classification

The capital market in India includes the following institutions (i.e., supply of funds tor capital markets comes largely from these);

(i) Commercial Banks;

(ii) Insurance Companies (LIC and GIC);

(iii) Specialised financial institutions like IFCI, IDBI, ICICI, SIDCS, SFCS, UTI etc.;

(iv) Provident Fund Societies;

(v) Merchant Banking Agencies;

(vi) Credit Guarantee Corporations.

Individuals who invest directly on their own in securities are also suppliers of fund to the capital market.

Thus, like all the markets the capital market is also composed of those who demand funds (borrowers) and those who supply funds (lenders). An ideal capital market at tempts to provide adequate capital at reasonable rate of return for any business, or industrial proposition which offers a prospective high yield to make borrowing worthwhile.

The Indian capital market is divided into gilt-edged market and the industrial securities market. The gilt-edged market refers to the market for government and semi-government securities, backed by the RBI. The securities traded in this market are stable in value and are much sought after by banks and other institutions.

The industrial securities market refers to the market for shares and debentures of old and new companies. This market is further divided into the new issues market and old capital market meaning the stock exchange.

The new issue market refers to the raising of new capital in the form of shares and debentures, whereas the old capital market deals with securities already issued by companies.

Broad Constituents in the Indian Capital Markets

Fund Raisers

Fund Raisers are companies that raise funds from domestic and foreign sources, both public and private. The following sources help companies raise funds.

Large Organisation grow by doing innovations and by raising the capital to finance expansion. Corporations have five primary methods which are used to raise funds in capital market.

- Issue of bonds : Bond is an amount of money which has to be given at a certain date or dates in future. Bondholders receive interest payments at fixed rate and specific dates. Corporate issues bonds because interest rates which must pay investors are lower than rates of borrowing and holders can sell bonds to someone else before they due.
- Issue of preferred stock : company choose this to raise capital. If a company have financial trouble the buyers of shares gets special status. If profits are limited then owners will be paid the dividend after bondholders receive the interest payments.
- Sell of common stock : if financial condition of the company is good then it can raise the capital issue the common stock. Bank helps the companies to do the investment and issue stock. Investors' gets interested if the company pays large dividends and offers steady income. Value of shares increases if investor expects the corporate earning to rise.
- Borrowing: companies used to raise short term capital by getting the loans from banks or other sources. After good market run the profits which the company gets can be used to finance their operating by retaining their earnings.

Fund Providers

Fund Providers are the entities that invest in the capital markets. These can be categorized as domestic and foreign investors, institutional and retail investors. The list includes subscribers to primary market issues, investors who buy in the secondary market, traders, speculators, FIIs/

Notes

sub-accounts, mutual funds, venture capital funds, NRIs, ADR/GDR investors, etc.

Intermediaries

Intermediaries are service providers in the market, including stock brokers, sub-brokers, financiers, merchant bankers, underwriters, depository participants, registrar and transfer agents, FIIs/ sub-accounts, mutual Funds, venture capital funds, portfolio managers, custodians, etc.

Organizations

Organizations include various entities such as MCX-SX, BSE, NSE, other regional stock exchanges, and the two depositories National Securities Depository Limited (NSDL) and Central Securities Depository Limited (CSDL).

Market Regulators

Market Regulators include the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), and the Department of Company Affairs (DCA).

Growth of Indian Capital Market

Indian Capital Market before Independence

Indian capital market was hardly existent in the pre-independence times. Agriculture was the mainstay of economy but there was hardly any long term lending to agricultural sector.

Similarly the growth of industrial securities market was very much hampered since there were very few companies and the number of securities traded in the stock exchanges was even smaller.

Indian capital market was dominated by gilt-edged market for government and semi-government securities. Individual investors were very few in numbers and that too were limited to the affluent classes in the urban and rural areas.

Last but not the least, there were no specialised intermediaries and agencies to mobilise the savings of the public and channelise them to investment.

Indian Capital Market after Independence

Since independence, the Indian capital market has made widespread growth in all the areas as reflected by increased volume of savings and investments.

In 1951, the number of joint stock companies (which is a very important indicator of the growth of capital market) was 28,500 both public limited and private limited companies with a

Notes

paid up capital of Rs. 775 crore, which in 1990 stood at 50,000 companies with a paid up capital of Rs. 20,000 crore.

The rate of growth of investment has been phenomenal in recent years, in keeping with the accelerated tempo of development of the Indian economy under the impetus of the five year plans.

Factors Influencing Capital Market:

The firm trend in the market is basically affected by two important factors:

- operations of the institutional investors in the market; and
- the excellent results flowing in from the corporate sector.

New Financial Intermediaries in Capital Market

Since 1988 financial sector in India has been undergoing a process of structural transformation.

Some important new financial intermediaries introduced in Indian capital market are:

1. Merchant Banking:

Merchant bankers are financial intermediaries between entrepreneurs and investors. Merchant banks may be subsidiaries of commercial banks or may have been set up by private financial service companies or may have been set up by firms and individuals engaged in financial up by firms and individuals engaged in financial advisory business.

Merchant banks in India manage and underwrite new issues, undertake syndication of credit, advice corporate clients on fund raising and other financial aspects.

Since 1993, merchant banking has been statutorily brought under the regulatory framework of the Securities Exchange Board of India (SEBI) to ensure greater transparency in the operation of merchant bankers and make them accountable. The RBI supervises those merchant banks which were subsidiaries, or are affiliates of commercial banks.

2. Leasing and Hire-Purchase Companies:

Leasing has proved a popular financing method for acquiring plant and machinery specially or small and medium sized enterprises. The growth of leasing companies has been due to advantages of speed, informality and flexibility to suit individual needs.

The Narasimhan Committee has recognised the importance of leasing and hire-purchase companies in financial intermediation process and has recommended that:

1. a minimum capital requirement should be stipulated;
2. prudential norms and guidelines in respect of conduct of business should be laid down; and
3. supervision should be based on periodic returns by a unified supervisory authority.

3. Mutual Funds:

- It refers to the pooling of savings by a number of investors-small, medium and large. The corpus of fund thus collected becomes sizeable which is managed by a team of investment specialists backed by critical evaluation and supportive data.
- A mutual fund makes up for the lack of investor's knowledge and awareness. It attempts to optimise high return, high safety and high liquidity trade off for maximum of investor's benefit.
- It thus aims at providing easy accessibility of media including stock market in country to one and all, especially small investors in rural and urban areas.

Notes

- Mutual funds are most important among the newer capital market institutions. Several public sector banks and financial institutions set up mutual funds on a tax exempt basis virtually on same footing as the Unit Trust of India (UTI) and have been able to attract strong investor support and have shown significant progress.
- Government has now decided to throw open the field to private sector and joint sector mutual funds.
- At present Securities and Exchange Board of India (SEBI) has authority to lay down guidelines and to supervise and regulate working of mutual funds.
- The guidelines issued by the SEBI in January 1991, are related in advertisements and disclosure and reporting requirements etc.
- The investors have to be informed about the status of their investments in equity, debentures, government securities etc.
- The Narasimhan Committee has made the following recommendations regarding mutual funds:
  - (i) creation of an appropriate regulatory framework to promote sound, orderly and competitive growth of mutual fund business:
  - (ii) creation of proper legal framework to govern the establishments and operation of mutual funds (the UTI is governed by a special statute), and
  - (iii) equality of treatment between various mutual funds including the UTI in the area of tax concessions.

4. Global Depository Receipts (GDR):

Since 1992, the Government of India has allowed foreign investment in the Indian securities through the issue of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs). Initially the Euro-issue proceeds were to be utilised for approved end uses within a period of one year from the date of issue.

Since there was continued accumulation of foreign exchange reserves with RBI and there were long gestation periods of new investment the government required the issuing companies to retain the Euro-issue proceeds abroad and repatriate only as and when expenditure for the approved end uses were incurred.

5. Venture Capital Companies (VCC):

- The aim of venture capital companies is to give financial support to new ideas and to introduction and adaptation of new technologies.
- They are of a great importance to technocrat entrepreneurs who have technical competence and expertise but lack venture capital.
- Financial institutions generally insist on greater contribution to the investment financing, in which technocrat entrepreneurs can depend on venture capital companies.
- Venture capital financing involves high risk.
- According to the Narasimhan Committee the guidelines for setting up of venture capital companies are too restrictive and unrealistic and have impeded their growth. The committee has recommended a review and amendment of guidelines.
- Knowing the high risk involved in venture capital financing, the committee has recommended a reduction in tax on capital gains made by these companies and equality of tax treatment between venture capital companies and mutual funds.

Notes

6. Other New Financial Intermediaries:

Besides the above given institutions, the government has established a number of new financial intermediaries to serve the increasing financial needs of commerce and industry is the area of venture Capital, credit rating and leasing etc.

- Technology Development and Information Company of India (TDICI) Ltd., a technology venture finance company, which sanctions project finance to new technology venture since 1989.
- Risk Capital and Technology Finance Corporation (RCTFC) Ltd., which provides risk capital to new entrepreneurs and offers technology finance to technology-oriented ventures since 1988.
- Infrastructure Leasing and Financial Services (IL&FS) Ltd., set up in 1988 focuses on leasing of equipment for infrastructure development.
- The credit rating agencies namely credit rating information services of India (CRISIS) Ltd., setup in 1988; Investment and Credit Rating Agency (ICRA) setup in 1991, and Credit Analysis and Research (CARE) Ltd., setup in 1993 provide credit rating services to the corporate sector.
- Credit rating promotes investors interests by providing them information on assessed comparative risk of investment in the listed securities of different companies. It also helps companies to raise funds more easily and at relatively cheaper rate if their credit rating is high.
- Stock Holding Corporation of India (SHCIL) Ltd., setup in 1988, with the objective of introducing a book entry system for transfer of shares and other type of scrips thereby avoiding the voluminous paper work involved and thus reducing delays in transfers.

1.8 BOOK BUILDING

Every business organisation needs funds for its business activities. It can raise funds either externally or through internal sources. When the companies want to go for the external sources, they use various means for the same. Two of the most popular means to raise money are Initial Public Offer (IPO) and Follow on Public Offer (FPO).

During the IPO or FPO, the company offers its shares to the public either at fixed price or offers a price range, so that the investors can decide on the right price.

The method of offering shares by providing a price range is called book building method. This method provides an opportunity to the market to discover price for the securities which are on offer.

Book building is the process by which an underwriter attempts to determine the price at which an initial public offering (IPO) will be offered. An underwriter, normally an investment bank, builds a book by inviting institutional investors (such as fund managers and others) to submit bids for the number of shares and the price(s) they would be willing to pay for them.

Key points:

- Book building is the process by which an underwriter attempts to determine the price at which an initial public offering (IPO) will be offered.
- The process of price discovery involves generating and recording investor demand for shares before arriving at an issue price.

Notes

- Book building is the de facto mechanism by which companies price their IPOs and is highly recommended by all the major stock exchanges as the most efficient way to price securities.

Understanding Book Building

Book building has surpassed the 'fixed pricing' method, where the price is set prior to investor participation, to become the de facto mechanism by which companies price their IPOs.

The process of price discovery involves generating and recording investor demand for shares before arriving at an issue price that will satisfy both the company offering the IPO and the market. It is highly recommended by all the major stock exchanges as the most efficient way to price securities.

The book building process comprises these steps:

- The issuing company hires an investment bank to act as an underwriter who is tasked with determining the price range the security can be sold for and drafting a prospectus to send out to the institutional investing community.
- The investment bank invites investors, normally large scale buyers and fund managers, to submit bids on the number of shares that they are interested in buying and the prices that they would be willing to pay.
- The book is 'built' by listing and evaluating the aggregated demand for the issue from the submitted bids. The underwriter analyzes the information and uses a weighted average to arrive at the final price for the security, which is termed the cutoff price.
- The underwriter has to, for the sake of transparency, publicize the details of all the bids that were submitted.
- Shares are allocated to the accepted bidders.
- Even if the information collected during the book building process suggests a particular price point is best, that does not guarantee a large number of actual purchases once the IPO is open to buyers. Further, it is not a requirement that the IPO be offered at that price suggested during the analysis.

Accelerated Book Building

An accelerated book-build is often used when a company is in immediate need of financing, in which case, debt financing is out of the question. This can be the case when a firm is looking to make an offer to acquire another firm.

Basically, when a company is unable to obtain additional financing for a short-term project or acquisition due to its high debt obligations, it can use an accelerated book-build to obtain quick financing from the equity market.

With an accelerated book build, the offer period is open for only one or two days and with little to no marketing. In other words, the time between pricing and issuance is 48 hours or less. A book build that is accelerated is frequently implemented overnight, with the issuing company contacting a number of investment banks that can serve as underwriters on the evening prior to the intended placement.

The issuer solicits bids in an auction-type process and awards the underwriting contract to the bank that commits to the highest backstop price. The underwriter submits the proposal with the price range to institutional investors. In effect, placement with investors happens overnight with the security pricing occurring most often within 24 to 48 hours.

Notes

IPO Pricing Risk

With any IPO, there is a risk of the stock being overpriced or undervalued when the initial price is set. If it is overpriced, it may discourage investor interest if they are not certain that the company's price corresponds with its actual value. This reaction within the marketplace can cause the price to fall further, lowering the value of shares that have already been secured.

In cases where a stock is undervalued, it is considered to be a missed opportunity on the part of the issuing company as it could have generated more funds than were acquired as part of the IPO.

Compete Risk Free with $100,000 in Virtual Cash

Put your trading skills to the test with our FREE Stock Simulator. Compete with thousands of Investopedia traders and trade your way to the top!

Submit trades in a virtual environment before you start risking your own money. Practice trading strategies so that when you're ready to enter the real market, you've had the practice you need.

Definition

SEBI guidelines, 1995 defines book building as "*A process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document.*

Book Building may be defined as a process used by companies raising capital through Public Offerings-both Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer.

The process is directed towards both the institutional investors as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process.

Book Building vs. Fixed Price Method:

The main difference between the book building method and the fixed price method is that in the former, the issue price to not decided initially. The investors have to bid for the shares within the price range given. The issue price is fixed on the basis of demand and supply of the shares.

On the other hand, in the fixed price method, the price is decided right at the start. Investors cannot choose the price.

They have to buy the shares at the price decided by the company. In the book building method, the demand is known every day during the offer period, but in fixed price method, the demand is known only after the issue closes.

Book Building in India:

The introduction of book-building in India was done in 1995 following the recommendations of an expert committee appointed by SEBI under Y.H. Malegam. The committee recommended and SEBI accepted in November 1995 that the book-building route should be open to issuer companies,

Notes

subject to certain terms and conditions. In January 2000, SEBI came out with a compendium of guidelines, circulars and instructions to merchant bankers relating to issue of capital, including those on the book-building mechanism.

Book Building Process:

The principal intermediaries involved in a book building process are the companies, Book Running Lead Manager (BRLM) and syndicate members are the intermediaries registered with SEBI and eligible to act as underwriters.

Syndicate members are appointed by the BRLM. The book building process is undertaken basically to determine investor appetite for a share at a particular price. It is undertaken before making a public offer and it helps determine the issue price and the number of shares to be issued.

Process of Book Building

A Book Building process involves following steps :

The following are the important points in book building process:

1. The Issuer who is planning an offer nominates lead merchant banker(s) as 'book runners'.
2. The Issuer specifies the number of securities to be issued and the price band for the bids.
3. The Issuer also appoints syndicate members with whom orders are to be placed by the investors.
4. The syndicate members put the orders into an 'electronic book'. This process is called 'bidding' and is similar to open auction.
5. The book normally remains open for a period of 5 days.
6. Bids have to be entered within the specified price band.
7. Bids can be revised by the bidders before the book closes.
8. On the close of the book building period, the book runners evaluate the bids on the basis of the demand at various price levels.
9. The book runners and the Issuer decide the final price at which the securities shall be issued.
10. Generally, the number of shares is fixed; the issue size gets frozen based on the final price per share.
11. Allocation of securities is made to the successful bidders. The rest bidders get refund orders.

Types of Book Building Process

The Companies in India are bound to follow to the SEBI's guidelines for book building offers in the following manner:

- 75 percent Book-Building Process: Under this process 25 percent of the issue is to be sold at a fixed price and the balance of 75 percent through the Book Building process.
- Offer to public through Book building process: The process specifies that an issuer company may make an issue of securities to the public through prospectus in the following manner:

    100% of the net offer to the public through book building process, or

    75% of the net offer to the public through book building process and 25% of the net

offer to the public at the price determined through book building process.

- Pure Auction as an Additional Book building Mechanism: SEBI has decided to introduce an additional method of book building, to start with, for FPOs, in which the issuer would decide on a floor price and may mention the floor price in the red herring prospectus.
- If the floor price is not mentioned in the red herring prospectus, the issuer shall announce the floor price at least one working day before opening of the bid in all the newspapers in which the pre-issue advertisement was released.

For Instance,

Coffee Day Enterprises Ltd, the holding company of the CCD chain, plans to raise 1,150 crore through an initial public offering (IPO). The public issue is open 14-16 October. The price band is 316-328 per share. The final price at which the shares will get listed on the stock exchange will be fixed based fully on the book building process. Now , Let's take a look at how share prices are determined based on the book building process.

How is the Price Fixed?

All the applications received till the last dates are analyzed and a final offer price, known as the cut¬off price is arrived at. The final price is the equilibrium price or the highest price at which all the shares on offer can be sold smoothly. If the price quoted by an investor is less than the final price, he will not get allotment.

If price quoted by an investor is higher than the final price, the amount in excess of the final price is refunded if he gets allotment.

If the allotment is not made, full money is refunded within 15 days after the final allotment is made. If the investor does not get money or allotment in a month's time, he can demand interest at 15 per cent per annum on the money due.

Example

In this method, the company doesn't fix up a particular price for the shares, but instead gives a price range, e.g., Rs. 80 to 100. When bidding for the shares, investors have to decide at which price they would like to bid for the shares, e.g., Rs. 80, Rs. 90 or Rs. 100. They can bid for the shares at any price within this range. Based on the demand and supply of the shares, the final price is fixed.

The lowest price (Rs. 80) is known as the floor price and the highest price (Rs. 100) is known as cap price. The price at which the shares are allotted is known as cut off price. The entire process begins with the selection of the lead manager, an investment banker whose job is to bring the issue to the public.

Both the lead manager and the issuing company fix the price range and the issue size. Next, syndicate members are hired to obtain bids from the investors. Normally, the issue is kept open for 5 days. Once the offer period is over, the lead manager and issuing company fix the price at which the shares are sold to the investors.

If the issue price is less than the cap price, the investors who bid at the cap price will get a refund and those who bid at the floor price will end up paying the additional money. For example, if the cut off in the above example is fixed at Rs. 90, those who bid at Rs. 80, will have to pay Rs. 10 per share and those who bid at Rs. 100, will end up getting the refund of Rs. 10 per share. Once each investor pays the actual issue price, the share are allotted.

Notes

Book Building vs. Reserve Book Building:

While book building is used to raise capital for the company's business operations, reverse book building is used for buyback of shares from the market. Reverse book building is also a price discovery method, in which the bids are taken from the current investors and the final price is decided on the last day of the offer. Normally the price fixed in reverse book building exceeds the market price.

Advantages of Book Building:

Book building helps in evaluating the intrinsic worth of the instrument being offered and the company's credibility in the eyes of public. The entire exercise is done on a wholesale basis.

- Price of instrument is determined in a more realistic way on the commitments made by the prospective investors to the issue.
- The prime objective of book building process is to determine the highest market price for shares and securities and demand level from highest quality investors in order to adjust pricing and allocation decision.
- Book building is a process of fixing price for an issue on feedback from potential investors on how they are willing to bid to pick up issues and instruments.
- The process of book building is advantageous to the issuer company as the pricing of issue would be more realistic as the final price is decided about 11 to 12 days before the opening of the issue. Book building also offers access to capital more quickly than the public issue.
- As the issue is pre-sold, there would be no uncertainties relating to the fate of the issue involved.
- The Issuer company saves advertising and brokerage commissions.
- Issuers can choose investors by quality.
- Investors have a voice in the pricing of issues. They have a greater certainty of being allotted what they demand. Investors need not lockup huge amounts of capital with the Issuer as they pay at the end of the process.
- The issue price is market-determined. As it is a distant possibility that the market price of the shares would fall lower than the issue price. Hence, the investor is less likely to suffer from erosion of his investment on listing.
- Optimal demand based pricing is possible.
- Efficient capital raising with improved issue procedures, leading to a reduction in issue costs, paper work and lead times.
- Flexibility to increase/decrease price and/or size of offering the issues is possible.
- Transparency of allocations is made.
- Upgraded information flow of issues, lead managers, syndicate members and investors is made possible.
- Book-building process inspires investors confidence leading to a larger investor universe.
- Book-building process creates a liquid and buoyant after market.
- As the syndicate members will get firm allocation, the investors to that extent are assured of allotment.
- Immediate allotment and listing of placement portion of securities.

Notes

Limitations of Book Building:

The book-building system has various limitations, some of these limitations are summarized as follows:

- Book building is appropriate for mega issues only. In the case of small issues, the companies can adjust the attributes of the offer according to the preferences of the potential investors. It may not be possible in big issues, since the risk-return preference of the investors cannot be estimated easily.
- The issuer company should be fundamentally strong and well known to the investors.
- The book building system works very efficiently in matured market conditions. In such circumstances, the investors are aware of various parameters affecting the market price of the securities. But, such conditions are not commonly found in practice.
- There is a possibility of price rigging on listing as promoters may try to bailout syndicate members.

1.9 LISTING OF SECURITIES

Listing means the admission of securities of a company to trading on a stock exchange. Listing is not compulsory under the Companies Act. It becomes necessary when a public limited company desires to issue shares or debentures to the public. When securities are listed in a stock exchange, the company has to comply with the requirements of the exchange. Let us know about listing of securities.

1. It provides liquidity to investments. Security holders can convert their securities into cash by selling them as and when they require.
2. Shares are traded in an open auction market where buyers and sellers meet. It enables an investor to get the best possible price for his securities.
3. Ease of entering into either buy or sell transactions.
4. Transactions are conducted in an open and transparent manner subject to a well defined code of conduct. Therefore investors are assured of fair dealings.
5. Listing safeguards investors interests. It is because listed companies have to provide clear and timely information to the stock exchanges regarding dividends, bonus shares, new issues of capital, plans for mergers, acquisitions, expansion or diversification of business. This enables investors to take informed decisions.
6. Listed securities enable investors to apply for loans by providing them as collateral security.
7. Investors are able to know the price changes through the price quotations provided by the stock exchanges in case of listed securities.
8. Listing of shares in stock exchanges provides investors facilities for transfer, registration of rights, fair and equitable allotment.
9. Share holders are provided due notice with regard to book closure dates, and they can take investment decisions accordingly.

Advantages of listing to companies

1. Listed securities are preferred by the investors as they have better liquidity.
2. Listing provides wide publicity to the companies since their name is mentioned in stock

Notes

market reports, analysis in newspapers, magazines, TV news channels. This increases the market for the securities. As Hasting has observed,

"A listed security will receive more attention from investment advisory services than an unlisted one."

3. Listing provides a company better visibility and improves its image and reputation.
4. It makes future financing easier and cheaper in case of expansion or diversification of the business.
5. Growth and stability in the market through broadening and diversification of its shareholding.
6. Listing attracts interest of institutional investors of the country as well as foreign institutional investors.
7. Listing enables a company to know its market value and this information is useful in case of mergers and acquisitions, to arrive at the purchase consideration, exchange ratios etc.
8. By complying with the listing requirements, the operations of the company become more transparent and investor friendly. It further enhances the reputation of the company.

Disadvantages of listing Securities

Listing is not without its limitations. The following are the limitations of listing:

1. Listing might enable speculators to drive up or drive down prices at their will. The violent fluctuations in share prices affect genuine investors.
2. In case of excessive speculation, share prices might not reflect its fundamentals. The stock markets may fail to be the true economic barometer of an economy's performance.
3. In case of bear markets share prices might be hammered down, and the standing of a company might be lowered in the eyes of the investors, shareholders, bankers, creditors, employees etc.
4. Listing of securities may induce the management and the top level employees to indulge in 'insider trading' by getting access to important information. Such actions adversely affect the common security holders.
5. The management might enter into an agreement with brokers to artificially increase prices before a fresh issue and benefit from that. Common public might be induced to buy shares in such companies, ultimately the prices would crash and the common investors would be left with worthless stock of securities.
6. Listing requires disclosing important sensitive information to stock exchanges such as plans for expansion, diversification, selling of certain businesses, acquisition of certain brands or companies etc. Such information might be used by the competitors to gain advantage.
7. Outsiders might acquire substantial shares in the company and threaten to take over the company or they might demand hefty compensation to sell their shares.
8. Stock exchanges in India still suffer from shortcomings. Listed securities might be utilized by scamsters to indulge in scams.

Objectives of Listing

The major objectives of listing are

1. To provide ready marketability and liquidity of a company's securities.
2. To provide free negotiability to stocks.
3. To protect shareholders and investors interests.
4. To provide a mechanism for effective control and supervision of trading.

Types of Listing of Securities

1. Initial listing: Here, the shares of the company are listed for the first time on a stock exchange.
2. Listing for public Issue: When a company which has listed its shares on a stock exchange comes out with a public issue.
3. Listing for Rights Issue: When the company which has already listed its shares in the stock exchange issues securities to the existing shareholders on rights basis.
4. Listing of Bonus shares: When a listed company in a stock exchange is capitalizing its profit by issuing bonus shares to the existing shareholders.
5. Listing for merger or amalgamation: When the amalgamated company issues new shares to the shareholders of amalgamated company, such shares are listed

Listing requirements

A company which desires to list its shares in a stock exchange has to comply with the following requirements:

1. Permission for listing should have been provided for in the Memorandum of Association and Articles of Association.
2. The company should have issued for public subscription at least the minimum prescribed percentage of its share capital (49 percent).
3. The prospectus should contain necessary information with regard to the opening of subscription list, receipt of share application etc.
4. Allotment of shares should be done in a fair and reasonable manner. In case of over subscription, the basis of allotment should be decided by the company in consultation with the recognized stock exchange where the shares are proposed to be listed.
5. The company must enter into a listing agreement with the stock exchange. The listing agreement contains the terms and conditions of listing. It also contains the disclosures that have to be made by the company on a continuous basis.

Minimum Public Offer

A company which desires to list its securities in a stock exchange, should offer at least sixty percent of its issued capital for public subscription.

Out of this sixty percent, a maximum of eleven percent in the aggregate may be reserved for the Central government, State government, their investment agencies and public financial institutions.

The public offer should be made through a prospectus and through newspaper advertisements. The promoters might choose to take up the remaining forty percent for themselves, or allot a part of it to their associates.

Notes

Fair allotment

Allotment of shares should be made in a fair and transparent manner. In case of over subscription, allotment should be made in an equitable manner in consultation with the stock exchange where the shares are proposed to be listed.

In case, the company proposes to list its shares in more than one exchange, the basis of allotment should be decided in consultation with the stock exchange which is located in the place in which the company's registered office is located.

Listing Procedure

The following are the steps to be followed in listing of a company's securities in a stock exchange:

1. The promoters should first decide on the stock exchange or exchanges where they want the shares to be listed.
2. They should contact the authorities to the respective stock exchange/ exchanges where they propose to list.
3. They should discuss with the stock exchange authorities the requirements and eligibility for listing.
4. The proposed Memorandum of Association, Articles of Association and Prospectus should be submitted for necessary examination to the stock exchange authorities
5. The company then finalizes the Memorandum, Articles and Prospectus
6. Securities are issued and allotted.
7. The company enters into a listing agreement by paying the prescribed fees and submitting the necessary documents and particulars.
8. Shares are then and are available for trading.

Advantages of Listing on Stock Exchange:

(a) Information about the company is available in detail.

(b) Information provides awareness about the work of the organization. This increases trading activity of purchase and sale of shares of the company.

(c) Continuous dealing of the security raises its value in the securities market.

(d) It provides convenience of sale of security. This lends liquidity to the shares.

(e) There is safety in dealing as it is registered with SEBI.

(f) It ensures creditworthiness.

(g) The act of listing of shares creates a favourable impression on the investor.

(h) Listing gives collateral value in making loans and advances from banks who prefers quoted securities.

(i) It widens the market of the security.

Thus, listing benefits both the investor as well as the company. Listing on stock exchange is done only when the company follows the statutory rules laid down under the Securities Exchange Board of India (SEBI).

Rules for Listing of Securities:

The following statutory rules have been laid down for the listing of securities under the SEBI.

A company requiring a quotation for its shares (i.e., desiring its securities to be listed) must apply in the prescribed form supported by the documentary evidence given below:

Documents to be attached:

(i) Copies of Memorandum and Articles of Association, Prospectus or Statement in lieu of Prospectus, Directors' Reports, Balance Sheets, and Agreement with Underwriters etc.

(ii) Specimen copies of Share and Debenture Certificates, Letter of Allotment, Acceptance, Renunciation etc.

(iii) Particulars regarding its capital structure.

(iv) A statement showing the distribution of shares.

(v) Particulars of dividends and cash bonuses during the last ten years.

(vi) Particulars of shares or debentures for which permission to deal is applied for.

(vii) A brief history of the company's activities since its incorporation.

Criteria for Listing of Securities:

The Stock Exchange has to direct special attention to the following particulars while scrutinizing the application:

i. Articles:

(a) Whether the Articles contain the following provisions:

(i) A common form of transfer shall be used.

(ii) Fully paid shares will be free from lien.

(iii) Calls paid in advance may carry interest, but shall not confer a right to dividend.

(iv) Unclaimed dividends shall not be forfeited before the claim becomes time barred.

(v) Option to call on shares shall be given only after sanction by the general meeting.

(b) Whether at least 49% of each class of securities issued was offered to the public for subscription through newspapers for not less than three days.

(c) Whether the company is of a fair size, has a broad based capital structure and there is sufficient public interest in its securities.

ii. Listing of Agreement:

- After scrutiny of the application, the stock exchange authorities may, if they are satisfied, call upon the company to execute a listing agreement which contains the obligations and restrictions which listing will entail. This agreement contains 39 clauses with a number of sub-clauses.
- These cover various aspects of the issue of letters of allotment, share certificates, transfer of shares, information to be given to the stock exchanges regarding closure of register of

Notes

members for the purpose of payment of dividend, issue of bonus and right shares and convertible debentures, holding of meetings of the board of directors for recommendation or declaration of dividend or issue of right or bonus shares or convertible debentures, submission of copies of directors' report, annual accounts and other notices, resolutions and so on to the shareholders.

- The basic purpose behind making these provisions in the listing agreement is to keep the shareholders and investors informed about the various activities which are likely to affect the share prices of such companies so that equal opportunity is provided to all concerned for buying or selling of the securities. On the basis of these details, investors are able to make investment decisions based on correct information.
- The stock exchange enlisting the securities of a company for the purpose of trading insists that all applicants for shares will be treated with equal fairness in the matter of allotment. In fact, in the event of over-subscription, the stock exchange will advise the company regarding the basis for allotment of shares. It will try to ensure that applicants for large blocks of shares are not given under the preference over the other.

A company whose securities are listed with a stock exchange must keep the stock exchange fully informed about matters affecting the company, e.g.,

(i) To notify the stock exchange promptly of the date of the Board Meeting at which dividend will be declared;

(ii) To forward immediately to the stock exchange copies of its annual audited accounts after they are issued;

(iii) To notify the stock exchange of any material change in the general nature or character of the company's business;

(iv) To notify the stock exchange of any change in the company's capital; and

(v) To notify the stock exchange (even before shareholders) of the issue of any new shares (right shares or otherwise) as the issue of any privileges or bonus to members.

The company must also undertake:

(a) Not to commit a breach of any condition on the basis of which listing has been obtained;

(b) To notify the exchange of any occasion which will result in the redemption, cancellation or retirement of any listed securities;

(c) Avoid as far as possible the establishment of a false market for the company's shares;

(d) To intimate the stock exchange of any other information necessary to enable the shareholders to appraise the company's position.

According to Section 73 of the Companies Act, 1976, if a company indicate in its prospectus that an application has been made or will be made to a recognized stock exchange for admitting the company's shares or debentures to dealings therein, such permission must be applied for within a stipulated period to time.

The Securities Contracts (Regulation) Act, 1956, gives the Central Government power to compel an incorporated company to get its securities with a recognized stock exchange in accordance with the rules and regulations prescribed for the purpose.

If a recognized exchange refuses to list the securities of a company, the company can file an appeal against such a decision with the government. The Act empowers the government to set aside or change the decision after giving proper opportunity to both the parties to explain their position in this regard.

iii. Guidelines for Listing Securities:

- To ensure the effective working of the recognized stock exchange in the public interest, Government framed Securities Contracts (Regulation) Rules, 1957. From time-to-time, these Rules have been revised whenever it has been necessary to do so depending on the environmental requirements through guidelines issued by the government in this regard.
- In November 1982, certain administrative guidelines governing the listing of securities on recognized stock exchanges, in relaxation of Rule-19 (2) (b) if these Rules were issued. These guidelines broadly cover the following:
- ***Established Non-FERA Companies:***

According to the Act, 'Non-FERA Companies' mean

- those companies which are incorporated in India at least ten years prior to the date of applying for the listing regulation; or companies which have a profit earning record for a continuous period of at least five years prior to the date of the listing application; and
- in which foreign equity does not exceed 40 per cent.

The rule provides that in relation to these non-FERA companies, public offer should ordinarily be at least 49% of the issued capital of the company. But in certain cases, where there is already a considerable public shareholding in the company, a further reduction in the public offer may also be considered if the following conditions are satisfied:

(i) The shares are held by persons not connected with the management, their associates and associate companies.

(ii) The shares have remained widely distributed, without undue concentration of large holdings in the hands of the shareholders on record (or their predecessors in title) for a period of at least 3 years prior to the date of the listing application.

(iii) The number of such shareholders is at least 20 for every Rs. 1 lakh of capital held by them.

iv. Other Established or New Non-FERA Companies:

In respect of:

(a) Other established Non-FERA companies, that is, companies incorporated in India within ten years of the date of the listing application and in which foreign equity does not exceed 40 per cent, and

(b) New companies without any foreign equity participation, the provisions of Rule 19 (2) (b) of the Securities Contracts (Regulation) Rules will apply. In other words, the public offer should be at least 60 per cent of the issued capital of the company in such cases.

Subscriptions by the Central Government, State Government and their agencies and public financial institutions will be counted as a part of the public offer up to a maximum extent of 11 per cent of the issued capital of the company.

v. Existing FERA Companies:

In respect of existing companies having more than 40 per cent foreign equity and undergoing the process of Indianisation under the Foreign Exchange (Regulation) Act, 1973, the public offer should be balance of the issued capital after deduction of the permissible level of foreign equity and the holding of existing Indian shareholders.

However, in no case should the public offer be less than 20 per cent of the issued capital of the company.

Notes

New Companies with Foreign Equity Participation:

In respect of new companies with approved foreign equity participation, the public offer should be the balance of the issued capital after deduction of the capital subscribed by the foreign participants and the Indian promoters.

The following conditions should, however, be fulfilled:

(i) The public offer should in no case be less than 33 per cent of the issued capital of the company.

(ii) The share of the Indian promoters should not be more than 40 per cent of the issued capital of the company.

vi. New Companies with Non-Resident Indian Equity Participation:

Where non-residents of Indian nationally or origin of overseas companies, partnership firms, trusts, societies and other corporate bodies, owned predominant ownership is that at least 60 per cent of the ownership of these entitles should be with non-residents of Indian nationality or origin (the criterion for determining such predominant ownership is that at least 60 per cent of the ownership of these entities should be with non-residents of Indian nationality or origin) are themselves the promoters of the company after deduction of the capital subscribed by them.

However, public offer in such a case should not be less than 26% of the issued capital of the company.

- If the non-resident Indian equity is 74 per cent, the public offer should be 26 percent of the issued capital of the company.
- If the non-resident Indian equity is 40 per cent, the public offer should be 60 per cent of the issued capital of the company. [There is no relaxation of Rule 19(2) (b) in this case].
- If the non-resident Indian equity is 30 per cent, the public offer need not exceed 60 per cent and the balance of 10 per cent can be allotted to friends, relatives and associates of the promoters. [Here again, there is no relaxation of Rule 19(2) (b)].

vii. Joint Sector Companies:

In a Joint sector company, the principal promoter will be a State Government and/or its agencies and the co- promoter will be a private party. The shareholding of the State Government and/or its agencies will not ordinarily be less than that of the co-promoter.

- In such cases, the public offer should be the balance of the issued capital of the company after deduction of the capital subscribed by the promoters and the co-promoters subject to the condition that the public offer should not normally be less than 33-1/3 per cent of the issued capital of the company.
- To illustrate, if the State Government and/or its agencies take up 26 per cent and the co-promoter takes up 25 per cent of the issued capital of the company, the balance of 49 per cent should be offered to the public.

viii Offer for the Sale of Existing Issued Capital:

Companies can have their shares listed on recognized Stock Exchange by arranging for an offer for sale of their existing issued capital. Such an offer for sale can be combined with a fresh issue of

Notes

capital also. The extent of public offer in these cases should be in conformity with the provisions detailed above.

In addition, the following conditions should also be fulfilled:

(i) The net worth (i.e., existing paid up equity capital plus free reserves, excluding reserves created out of revaluation of fixed assets) of the company should not be less than its existing paid up capital and the company should not have incurred a loss in each of the three years preceding the listing application.

(ii) The offer should result in a wide distribution of shares among the general public without undue concentration of large holdings, and the number of public shareholders should be at least 20 for every Rs. 1 lakh of the public offer.

(iii) If the share is offered at a price above its par value, the price should have been approved by the Central Government.

(iv) The offer should set out all material particulars relating to the company and the shares offered to the public. It must be in a form approved by the Stock Exchange concerned and must comply with all conditions pertaining to public advertisement, opening and closing of subscription lists, payment of application money, disposal of applications, basis of allotment, etc., as are applicable to a company offering fresh shares for public subscription in accordance with the listing regulations and instructions issued by the government from time-to-time.

1.10 ISSUE OF SECURITIES

An issue is one process of offering securities in order to raise funds from investors. Companies may issue bonds or stocks to investors as a method of financing the business.

The term "issue" also refers to a series of stocks or bonds that have been offered to the public and typically relates to the set of instruments that were released under one offering.

- An issue is an offering of new securities to investors in hopes of raising capital.
- Issues of bonds can be made as long as there is investor appetite for the company's debt. That appetite is influenced by the company's ability to actually make the payments.
- Additional issues of shares of stock can lead to dilution, which investors tend to frown upon, but the shares do not require interest payments.

Understanding Issues

The issuance of securities can take many forms. Companies may have a new issue, in which they release a security for the first time, or a seasoned issue, in which an established firm offers additional shares. In general, an issue tends to refer to a particular offering.

For example, if a company sells a group of 10-year bonds to the public, that set of bonds will be referred to as a single issue.

- If a company needs capital to stay in business, it has options to secure funding through selling stocks or issuing bonds. In a secondary stock offering, the board of directors (BOD) votes to issue more shares and increase the number of shares available in the market for trading. The proceeds from selling additional shares to the public go directly to the company.

Notes

- Likewise, if a business wants to move existing debt and create new debt at the same time, it might decide to issue bonds. The company borrows money from investors and repays it with interest. The interest is a tax-deductible expense that reduces the corporation's cost of borrowing.

Factors in Issuing Stocks or Bonds

Companies need to consider business goals when deciding whether to sell stock or to issue bonds. Issuing stocks or bonds in order to raise capital for projects to change the capital structure of a firm which is comprised of debt and equity. How weighted a company's structure is in either debt or capital determines the cost of capital for the company. The cost of issuing debt is the interest rate that the issuing company has to periodically pay its investors and lenders. The cost of issuing equity is dividend payments. Finding a good balance between both types of securities can help a firm avoid paying a high cost of capital.

Money from equity investment does not need to be repaid, nor do dividends associated with shares need to be paid as interest does with bonds. Since each issue of stock changes an investor's ownership in the company, there is a limit to how much stock a company can issue as dilution becomes a problem.

However, corporations can issue bonds as long as investors are willing to act as lenders. Because companies can pay bondholders a lower interest rate and retain greater control over funding, issuing bonds is less expensive than borrowing from a bank. Bonds do not change the ownership or operation of a company that is owned while selling stock does.

Record-keeping is simpler with bondholders, as all bonds with the same issuance earn the same interest rate and have the same maturity date. Bond offerings are also more flexible than stock issuance.

Stock and Bond Underwriting

Companies issuing stocks and bonds may use investment banks to facilitate the process. For example, if a company decides to sell bonds, the investment bank determines the value and riskiness of the corporation, then determines the prices, and finally underwrites and sells the bonds to the public. Investment banks might also underwrite stocks or other securities for an initial public offering (IPO) or secondary public offering. Book runners may be assigned to larger accounts.

1.11 CONCEPT OF BUY BACK

A buyback, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available on the open market. Companies buy back shares for a number of reasons, such as to increase the value of remaining shares available by reducing the supply or to prevent other shareholders from taking a controlling stake.

Key Points

- A buyback is when a corporation purchases its own shares in the stock market.
- A repurchase reduces the number of shares outstanding, thereby inflating (positive) earnings per share and, often, the value of the stock.
- A share repurchase can demonstrate to investors that the business has sufficient cash set aside for emergencies and a low probability of economic troubles.

Understanding Buy Back

Buy-back of shares is a method of financial engineering. It can be described as a procedure which enables a company to go back to the holders of its shares and offer to purchase the shares held by them.

- Buy-back helps a company by giving a better use for its funds than reinvesting these funds in the same business at below average rates or going in for unnecessary diversification or buying growth through costly acquisitions.
- When a company has substantial cash resources, it may like to buy its own shares from the market particularly when the prevailing rate of its shares in the market is much lower than the book value or what the company perceives to be its true value.
- This mode of purchase is also called 'Shares Repurchase'. A company can utilize its reserves to buy-back equity shares for the purpose of extinguishing these or treasure operations. The former option results in re¬duction of the paid up capital, and consequently higher earnings and book value per share. Naturally, the market price of equity goes up.
- The reduction in share capital strengthens the promoter's control and enhances the equity value for shareholders. In the latter option, companies buy their shares from open market and keep these as 'treasury stock'.
- This enables the promoters to strengthen their control over the shares bought back, without any investment of their own. In case of treasure operations, there is a diversion of company's funds to buy shares and reduction in the value of equity for the shareholders.
- The main aim of shares repurchase might be reduce the number of shares in circula¬tion in order to improve the share price, or simply to return to the shareholders resources no longer needed by the company.
- The shares repurchase may be by way of purchase from the open market or by general tender offer to all shareholders made by the company to repurchase a fixed amount of its securities at pre-stated price.
- A buyback allows companies to invest in themselves. Reducing the number of shares outstanding on the market increases the proportion of shares owned by investors. A company may feel its shares are undervalued and do a buyback to provide investors with a return.
- And because the company is bullish on its current operations, a buyback also boosts the proportion of earnings that a share is allocated. This will raise the stock price if the same price-to-earnings (P/E) ratio is maintained.
- The share repurchase reduces the number of existing shares, making each worth a greater percentage of the corporation. The stock's earnings per share (EPS) thus increases while the price-to-earnings ratio (P/E) decreases or the stock price increases.
- A share repurchase demonstrates to investors that the business has sufficient cash set aside for emergencies and a low probability of economic troubles.
- Another reason for a buyback is for compensation purposes. Companies often award their employees and management with stock rewards and stock options.
- To offer rewards and options, companies buy back shares and issue them to employees and management. This helps avoid the dilution of existing shareholders.
- Because share buybacks are carried out using a firm's retained earnings, the net economic effect to investors would be the same as if those retained earnings were paid out as shareholder dividends.

Notes

- Buybacks are carried out in two ways: Shareholders might be presented with a tender offer, where they have the option to submit, or tender, all or a portion of their shares within a given time frame at a premium to the current market price. This premium compensates investors for tendering their shares rather than holding onto them.
- Companies buy back shares on the open market over an extended period of time and may even have an outlined share repurchase program that purchases shares at certain times or at regular intervals.
- A company can fund its buyback by taking on debt, with cash on hand, or with its cash flow from operations.
- An expanded share buyback is an increase in a company's existing share repurchase plan. An expanded share buyback accelerates a company's share repurchase plan and leads to a faster contraction of its share float.
- The market impact of an expanded share buyback depends on its magnitude. A large, expanded buyback is likely to cause the share price to rise.
- The buyback ratio considers the buyback dollars spent over the past year, divided by its market capitalization at the beginning of the buyback period.
- The buyback ratio enables a comparison of the potential impact of repurchases across different companies.
- It is also a good indicator of a company's ability to return value to its shareholders since companies that engage in regular buybacks have historically outperformed the broad market.

Example of a Buyback

A company's stock price has underperformed its competitor's stock even though it has had a solid year financially. To reward investors and provide a return to them, the company announces a share buyback program to repurchase 10% of its outstanding shares at the current market price.

The company had $1 million in earnings and 1 million outstanding shares before the buyback, equating to earnings per share (EPS) of $1. Trading at a $20 per share stock price, its P/E ratio is 20. With all else being equal, 100,000 shares would be repurchased and the new EPS would be $1.11, or $1 million in earnings spread out over 900,000 shares. To keep the same P/E ratio of 20, shares would need to trade up 11% to $22.22.

Reasons for Buy-Back:

There are reasons why a company would opt for buy-back:

1. To improve shareholder value, since buy-back provides a means for utilizing the companies surplus funds which have unattractive alternative investment options, and since a reduction in the capital base arising from buy-back would generally results in higher earnings per share (EPS).
2. It is used as a defense mechanism, in an environment where the threat of corporate takeovers has become real. Buy-back provides a safeguard against hostile take-over by increasing promoter's holdings.
3. It would enable corporate to shrink their equity base thereby injecting much needed flexibility.

4. It improves the intrinsic value of the shares by virtue of the reduced level of floating stock.
5. It would enable corporate to make use of the buy-back shares for subsequent use in the process of mergers and acquisitions without enlarging their capital base.
6. Buy-back of shares is used as a method of financial engineering.
7. It is used for signaling the effects of buy-back on the share price.

Financing Aspects of Buy-Back:

Finance is the nerve centre for the business activities and success is more depending on the better and efficient management of funds and finance. In order to buy-back of shares and securities in large numbers, the company needs huge amounts of capital and funds which may be mobilized through one or more of the sources viz.

1. Internal sources
2. Sufficient cash position
3. Selling of temporary investment with the least possible loss
4. Raising of working capital needs
5. Raising cash by issuing fixed deposits
6. Raising by issue of debentures and loan bonds
7. Cash credit from commercial banks
8. Overdraft from commercial banks etc.

Advantages of Buy Back

The benefits derived from share repurchase program are as follows:

1. Firms whose profitability was below their industry average enjoy greater share price growth after shares are repurchased than firms whose profitability was above their industry average.
2. Firms whose sales growth was below their industry average enjoy greater share price growth after shares are repurchased than firms whose sales growth was above their industry average.
3. Profitable and growth firms that repurchase shares provide a clear indication to the investors about the strengths of the company.
4. Repurchasing firms with debt ratios below but sales growth rates above their industry average experience substantially higher share price growth after repurchasing than firms with debt ratios above but sales growth below their industry average.
5. Repurchasing firms with profitability and debt ratios below their industry average demonstrate higher share price growth after repurchasing than firms with profitability and debt ratios above their industry average.

Some of the most important advantages of buyback of shares are as follows:

1. Companies possessing large free reserves base and are willing to use funds to purchase or acquire shares and other securities under the buyback scheme, can use their funds in a wise and effective manner.

Notes

2. As share buy backs change the capital structure of the firm, sometimes share buy backs are undertaken as a counter-measure against re-issue of shares (which are made compulsorily to discharge the existing obligations) to maintain a balance, to the extent possible, in the capital structure. In other words, share repurchases are undertaken to provide shares for retirement programmes (e.g. conversion of convertible debentures, bonds etc.), exercise of stock option scheme, bonuses or other re-issue purposes.
3. Announced share repurchase programmes signal management's positive information about the future prospects of the firm. If the management possesses favourable information, well known to themselves but not known to the market, it can distribute cash to shareholders with the anticipation that the company expects future cash flows to increase and thus as per management's present calculations, the firm is undervalued.
4. Buy back of shares and securities helps the promoters to formulate an effective defensive strategy against hostile takeover bids.
5. Share buy backs are undertaken to increase the stake of the promoters and sometimes with the ultimate object of buying out completely the entire shareholdings of the non- promoter shareholders or at least to the extent which enables the promoters holding to cross 90% and delist the company.
6. A company cannot buy back its shares more than once in a year but there is no restriction to adopt repeated buy back deals year after year. This also paves the way of the promoters to reach their targets quickly to increase their share and more control in the companies.
7. Buyback of shares and securities results in lower capital base, enhances post-buyback earning per share and appreciates considerably the price-earnings ratio.
8. Buyback of shares & securities is allowed under section 77B, if the liquidity position of the company is good. Companies which have defaulted in repayment of deposits, redemption of debentures or preference shares or repayment of term loans or interest payable thereon, from banks and financial institutions are not allowed buyback shares. It is a good check on the companies with unhealthy liquidity position.
9. After buyback of shares the companies will have the advantage of servicing a reduced capital base with higher dividend yield.

Limitations of Buy Back:

The shares repurchase is criticized for the following reasons:

1. This could enable unscrupulous promoters to use company's money to raise their personal stakes.
2. It opens up possibilities for share price manipulation.
3. It could divert away the company's funds from productive investments.

Legal Provision as to Buy-Back:

Buy-back enables the company to go back to its shareholders and offers to purchase from them the share they held. With the introduction of sections 77A, 77A A and 77B in the Companies Act, 1956 through the Companies (Amendment) Act, 1999, now the companies allowed buy-back shares.

They buy-back of shares are also subject to the SEBI (Buy-back of Securities) Regulations, 1998. The said legal provisions are summarized as follows:

Notes

1. The Sources of funds for buy-back of shares or other specified securities of a company are:

(a) Free reserves or

(b) Securities premium account or

(c) The proceeds of issue of any shares or other specified securities.

2. No buy-back should be made out of the proceeds of an earlier issue of same kind of shares or same kind of other specified securities.

3. Explanation to section 372A of the Act provides that 'reserves' as per the last audited Balance sheet of the company are to be taken as free reserves. The amounts credited after the close of financial year to free reserves and the securities premium account should not be utilized for buy-back.

4. The company may buy-back its own shares or other specified securities in any of the following manner:

- From the existing security holders on a proportionate basis, or
- From the open market, or
- From odd lots, or
- By purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

5. A company may buy-back its shares or other specified securities to the extend 10% of its total paid-up equity capital and free reserves by passing only a Board resolution.

6. If buy-back is beyond 10%, it must be approved by shareholders resolution. In any case, buy-back of equity shares by a company cannot exceed 25% of its total paid-up equity capital in that financial year.

7. Where the companies buy-back its own shares, it shall extinguish and physically destroy the securities so bought back within seven days of the last date of completion of buy-back.

8. A company can issue bonus shares at any time after the buy-back of shares.

- Regulation 19(l)(a) of the SEBI (Buy-back of Securities) Regulations, 1998, a company shall not issue any specified securities including by way of bonus till the date of closure of the offers for buy-back made under the regulations.
- Section 77(8) prohibits further issue of shares (including allotment of further shares) under clause (a) of sub-section (1) of section 81 for a period of six months except by way of bonus shares.

9. A company can buy-back its shares every year but subject to the satisfaction of other conditions such as debt-equity ratio, limits of buy-back stipulated in section 77A etc. Promoters can participate under tender offer or buy-back through book building subject to full disclosures being made in the letter of offer.

10. A company cannot buy-back equity shares from the promoter or person in control of the company if the buy-back is through stock exchange.

11. Passing of resolution by a company does not create any obligation on the company to buy-back its securities. Buy-back becomes irrevocable only when the letter of offer is filed with the appropriate authority or public announcement of the offer to buy-back is made.

12. The company should pay the consideration only by way of cash/ cheque /bank draft.

13. The cost of buy-back of securities should be taken as an expense and charged to the Profit and Loss Account.

Notes

14. Listed companies are required to intimate the stoke exchange of general meeting and resolution passed thereof.

15. The buy-back shares of a private limited company are subject to the compliance of Private Limited Company (Buy-back of Securities) Rules, 1999.

    A listed company is required to open an escrow account which is to be used as a security for the purpose of making payment in respect of buy-back of shares. The company should deposit in an escrow account opened with a scheduled commercial bank on or before the opening of the offer for buy-back of securities, such sum as specified below:

16. Where the estimated consideration payable for buy-back does not exceed Rs. 100 cores, 25% of the consideration payable.

17. In case the consideration payable for buy-back exceed Rs. 100 crores, 25% up to Rs. 100 crores and 10% of the balance.

18. The companies are required to maintain a 'Register of Securities Bought back' which should contain the prescribed information. .

19. The company is required to extinguish and physically destroy the security certificates bought back in the presence of the Registers or Merchant Banker or Statutory Auditor within seven days from the date of acceptance of securities. Mere stamping 'cancelled is not sufficient.

20. The securities offered for buy back, if already dematerialized, should be extinguished and destroyed in the manner specified under SEBI (Depositories and Participants) Regulations, 1996 and the bye-laws framed thereunder.

21. Where a company purchases its own shares out of free reserves, then a sum equal to the nominal value of the shares so purchased shall be transferred to the 'Capital Redemption Reserve' and details of such transfer shall be disclosed in the Balance sheet.

22. Disclosure are required to be made in Directors Report as to reasons for failure of buy-back, if shares are not bought back within 12 months from date of Board or Shareholders resolution.

23. A company should not keep the offer for buy-back open for a period exceeding 30 days.

Profit or Loss Prior to Incorporation:

- A company may acquire another business from a date prior to its incorporation, normally from the beginning of the accounting year of the selling concern with to avoid preparation of final accounts up to the date of acquisition.
- For example, a company incorporated on May 1, 1984, may purchase a business with effect from January 1, 1984, the date on which the accounting year of the vendor starts.
- Suppose, the company closes its accounts on December 31 and prepares the Profit and Loss Account for the year ended December 31, 1984, any Profit earned by the company from January 1, 1984, to April 30, 1984 (i.e., Prior to incorporation) is known as profit prior to incorporation and treated as capital profit and transferred to the Capital Reserve Account.
- In the same manner any loss incurred prior to incorporation is treated as capital loss and debited to the Goodwill Account. The profit earned by the company after the date of its incorporation is its revenue profit and is available for dividend.
- A pertinent point to be noted is that even though a public company can earn revenue profits only after getting the Certificate of Commencement, for all practical purposes, the

date of incorporation is taken as the basis for the calculation of profit prior to incorporation.

Ascertainment of Profit or Loss Prior to Incorporation:

The following steps are taken to ascertain the profit earned prior to incorporation and after incorporation.

- A Trading Account for the full accounting period is prepared and Gross Profit is arrived at.
- Gross profit is apportioned between the two periods on the basis of the sales in the two periods.
- All fixed expenses such as rent, rates, salaries, insurance, audit fees, etc., are allocated on a time basis as these expenses are related to the time factor.
- Expenses which are directly related to sales, like discount allowed, bad debts, commission on sales, advertising etc., are allocated on the basis of the sales of each period.
- Certain expenses which are incurred by the company or incurred only in the post-incorporation period, e.g., preliminary expenses, debenture interest paid, directors' fees, etc., are charged as expenses of the post-incorporation period only.

SEBI Guidelines for Buyback for Shares

SEBI guidelines for buyback for shares are as follows:

- Notice of special resolution
- Buying from Members through Tender offer
- Buyback through Stock Exchange.

(a) Notice of special resolution:

The notice of special resolution to be passed by the members should contain explanatory statement giving details of the buy back deal as prescribed in Schedule I of SEBI Regulations.

(b) Buying from Members through Tender offer:

Under this method, the maximum price at which the company intends to buy back the shares should be indicated in the notice of the general meeting.

If the promoters intend to offer their shares for buy back, details should be given in the notice of the general meeting.

The company should make a public announcement in at least one English National Daily, One Hindi National Daily and One regional newspaper daily, all with wide circulation giving details prescribed in Scheduled II of SEBI Regulations.

The public announcement will mention the 'specified date' for the purpose of determining the names of shareholders to whom letters of offer shall be sent.

Draft offer letter giving prescribed details should be submitted to SEBI along-with prescribed fees, at least 21 days before dispatch of letters of offer to shareholders. Offer for buy back will remain open for minimum 15 days and maximum 30 days.

Letters of offer should be sent to the members well in advance so as to reach them before the opening date of the offer.

If the acceptances by the shareholders are more than the number of shares offered to them for repurchase, the actual buy back will be on proportionate basis. The company shall have to open and maintain an escrow account with prescribed amount as deposit.

Notes

Within 15 days of closure of offer for buy back, payment should be made or regret letters should be sent to the shareholders.

(c) **Buyback through Stock Exchange**

In case of buy back of shares through stock exchange route, special resolution of members should prescribe maximum price at which shares can be bought and the buy backs shall not be made from promoters or persons having control in the company.

Such persons will not deal in shares in stock exchanges when offer for buy back is open.

The company should appoint a merchant banker. Public announcement should be made at least 7 days prior to commencement of buy back.

A copy of public announcement is to be filed with SEBI along-with prescribed fee within 2 days of such announcement.

Companies buying back via stock exchange route must disclose purchases daily. Details of shares purchased every day should be informed to the stock exchanges. Payment will be made as per rules of trading in the stock exchanges.

Other Guidelines:

(a) The company will make true and full disclosure in the letter of offer and the public announcement.

(b) Bonus shares will not be announced when the buy- back offer is open.

(c) All payments will be made only by cash/cheque.

(d) Buy- back offer will not be withdrawn after public announcement.

(e) Locked-in-shares will not be bought back.

(f) The details regarding number of shares bought, price, total amount invested in buy back, details of shareholders from whom more than 1% of the total shares were bought and the consequent change in the capital structure.

SUMMARY

- Capital market consists of primary markets and secondary markets. Primary markets deal with trade of new issues of stocks and other securities, whereas secondary market deals with the exchange of existing or previously-issued securities.
- Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions. They helps channelise surplus funds from savers to institutions which then invest them into productive use.
- Generally, this market trades mostly in long-term securities. Capital market consists of primary markets and secondary markets. Primary markets deal with trade of new issues of stocks and other securities, whereas secondary market deals with the exchange of existing or previously-issued securities. Another important division in the capital market is made on the basis of the nature of security traded, i.e. stock market and bond market.
- It is an organized market in which both individuals and business entities buy and sell

Notes

debt and equity securities. It is designed to be an efficient way to enter into purchase and sale transactions. This market is a key source of funds for an entity whose securities are permitted by a regulatory authority to be traded, since it can readily sell its debt obligations and equity to investors. Governments also use capital markets to raise funds, typically through the issuance of long-term bonds. Governments do not issue shares, and so cannot issue equity securities.

- A capital market is intended to be for the issuance and trading of long-term securities. When a publicly held company sells its securities in the capital markets, this is referred to as primary market activity. The subsequent trading of company securities between investors is known as secondary market activity. Short-term securities are traded elsewhere, such as in the money market.
- Examples of highly organized capital markets are the New York Stock Exchange, American Stock Exchange, London Stock Exchange, and NASDAQ. Securities can also be traded "over the counter," rather than on an organized exchange. These securities are usually issued by entities whose business fundamentals (such as revenue, capitalization, and profitability) do not meet the minimum standards of a formal exchange, which forces investors to use other avenues to trade the securities.
- Capital markets are highly interconnected, so a disturbance in a capital market on the other side of the globe will likely impact trading in markets located in other countries.
- The Securities and Exchange Commission (SEC) is an example of a federal-level agency that regulates the reporting of information by any entity that wishes to issue securities in a capital market, or have its securities traded in a capital market.
- The primary market is also known as the new issues market. It deals with new securities being issued for the first time. The essential function of a primary market is to facilitate the transfer of investible funds from savers to entrepreneurs seeking to establish new enterprises or to expand existing ones through the issue of securities for the first time.
- The investors in this market are banks, financial institutions, insurance companies, mutual funds and individuals. A company can raise capital through the primary market in the form of equity shares, preference shares, debentures, loans and deposits. Funds raised may be for setting up new projects, expansion, diversification, modernisation of existing projects, mergers and takeovers etc
- The secondary market is also known as the stock market or stock exchange. It is a market for the purchase and sale of existing securities. It helps existing investors to disinvest and fresh investors to enter the market. It also provides liquidity and marketability to existing securities. It also contributes to economic growth by channelising funds towards the most productive investments through the process of disinvestment and reinvestment.
- Securities are traded, cleared and settled within the regulatory framework prescribed by SEBI. Advances in information technology have made trading through stock exchanges accessible from anywhere in the country through trading terminals.
- Along with the growth of the primary market in the country, the secondary market has also grown significantly during the last ten years.
- The secondary market on the other hand is the market for old and already issued securities. It is the market for the sale and purchase of previously issued or second hand securities.
- The secondary capital market is composed of industrial security market or the stock exchange in which industrial securities are bought and sold and the gilt- edged market in which the government and semi-government securities are traded . It is known as stock exchange or stock market. Here the securities are bought and sold by the investors.

Notes

- In secondary market securities are not directly issued by the company to investors. Th securities are sold by existing investors to other investors.
- Sometimes the investor is in need of cash and another investor wants to buy the shares o the company as he could not get directly from company. Then both the investors can mee in secondary market and exchange securities for cash through intermediary called broker
- In secondary market companies get no additional capital as securities are bought and sol between investors only so directly there is no capital formation but secondary marke indirectly contributes in capital formation by providing liquidity to securities of th company.
- It is an organized market in which both individuals and business entities buy and sell deb and equity securities. It is designed to be an efficient way to enter into purchase and sal transactions.
- This market is a key source of funds for an entity whose securities are permitted by a regulatory authority to be traded, since it can readily sell its debt obligations and equity to investors.
- Governments also use capital markets to raise funds, typically through the issuance o long-term bonds. Governments do not issue shares, and so cannot issue equity securities.
- India has a fair share of the world economy and hence the capital markets or the share markets of India form a considerable portion of the world economy. The capital market is vital to the financial system.
- The capital Markets are of two main types. The Primary markets and the secondary markets. In a primary market, companies, governments or public sector institutions can raise funds through bond issues.
- Also, Corporations can sell new stock through an initial public offering (IPO) and raise money through that. Thus in the primary market, the party directly buys shares of a company. The process of selling new shares to investors is called underwriting.
- The capital market functions through the stock exchange market. A stock exchange is a market which facilitates buying and selling of shares, stocks, bonds, securities and debentures.
- It is not only a market for old securities and shares but also for new issues shares and securities. In fact, the capital market is related to the supply and demand for new capital, and the stock exchange facilitates such transactions.
- Every business organisation needs funds for its business activities. It can raise funds either externally or through internal sources. When the companies want to go for the external sources, they use various means for the same.
- Two of the most popular means to raise money are Initial Public Offer (IPO) and Follow on Public Offer (FPO).
- During the IPO or FPO, the company offers its shares to the public either at fixed price or offers a price range, so that the investors can decide on the right price. The method of offering shares by providing a price range is called book building method.
- Buy-back of shares is a method of financial engineering. It can be described as a procedure which enables a company to go back to the holders of its shares and offer to purchase the shares held by them.
- Buy-back helps a company by giving a better use for its funds than reinvesting these funds in the same business at below average rates or going in for unnecessary diversification or buying growth through costly acquisitions.

Notes

KEY WORDS

- **Primary Market (New Issue Market):** Primary market is also known as new issue market. As in this market securities are sold for the first time, i.e., new securities are issued from the company.
- **e-IPOs, (electronic Initial Public Offer):** It is the new method of issuing securities through on line system of stock exchange. In this company has to appoint registered brokers for the purpose of accepting applications and placing orders.
- **Secondary Market (Stock Exchange):** The secondary market on the other hand is the market for old and already issued securities. It is the market for the sale and purchase of previously issued or second hand securities.
- **Fund Raisers:** Fund Raisers are companies that raise funds from domestic and foreign sources, both public and private. The following sources help companies raise funds.
- **Fund Providers:** Fund Providers are the entities that invest in the capital markets. These can be categorized as domestic and foreign investors, institutional and retail investors. The list includes subscribers to primary market issues, investors who buy in the secondary market, traders, speculators, FIIs/ sub-accounts, mutual funds, venture capital funds, NRIs, ADR/GDR investors, etc.
- **Intermediaries:** Intermediaries are service providers in the market, including stock brokers, sub-brokers, financiers, merchant bankers, underwriters, depository participants, registrar and transfer agents, FIIs/ sub-accounts, mutual Funds, venture capital funds, portfolio managers, custodians, etc.
- **Merchant bankers** are financial intermediaries between entrepreneurs and investors. Merchant banks may be subsidiaries of commercial banks or may have been set up by private financial service companies or may have been set up by firms and individuals engaged in financial up by firms and individuals engaged in financial advisory business.
- **Mutual Funds:** It refers to the pooling of savings by a number of investors-small, medium and large. The corpus of fund thus collected becomes sizeable which is managed by a team of investment specialists backed by critical evaluation and supportive data
- **A global depositary receipt (GDR):** is a bank certificate issued in more than one country for shares in a foreign company. GDRs list shares in two or more markets, most frequently the U.S. market and the Euromarkets, with one fungible security
- **Venture Capital Companies (VCC):** The aim of venture capital companies is to give financial support to new ideas and to introduction and adaptation of new technologies

REVIEW QUESTIONS

1. With reference to the capital markets of India, pick the incorrect statement from the following:

   A) Capital markets make possible to generate foreign capital.

Notes

B) Capital Markets provide funds for projects in backward areas.

C) The existence of a stock exchange enables companies to raise permanent capital.

D) Intermediaries include various entities such as MCX-SX, BSE, NSE, other regional stock exchanges.

2. What is meant by global depository receipts .
3. State the differences between Primary market and secondary market .
4. Write an explanatory note on role and importance of capital markets.
5. What are the benefits of Book Building?
6. Describe the Methods of Floatation of Securities in Primary Market.
7. Describe the process of Book building .
8. Describe Venture Capital Companies (VCC):
9. State the advantages and dis advantages of buy back of shares .
10. Zaveri Ltd. resolved to buy back 3,00,000 of its fully paid equity shares of Rs 10 each at Rs 12 per share. For the purpose, it issued 10,000 13% preference shares of Rs 100 each at par, the total sum being payable with applications.

    The company uses Rs 8,50,000 of its balance in Securities Premium Account apart from its adequate balance in General Reserve Account to fulfill the legal requirements regarding buy-back. Pass journal entries for all the transactions involved in the buy-back.

FURTHER READINGS

1. Mukund Sharma , H.R.Appanaiah Stock and Commodity Market-Himalayan Publication International Financial Management.
2. Dr.Preeti Singh ,Stock and Commodity Market- Himalayan Publication International Financial Management khan,Indian Financial System 6th edition ,Tata McGraw Hill
3. Garner, Carley. A Trader's First Book on Commodities. (New Jersey: FT Press, 2010): Futures Trading Act of 1921, Declared unconstitutional in Hill v. Wallace 259 U.S. 44 (1922), the Grain Futures Act of 1922 and Board of Trade of City of Chicago v. Olsen 262 U.S. 1 (1923).
4. Cronon, William. Pricing the Future: Grain. Nature's Metropolis: Chicago and the Great West. University of Chicago, 1991. pp.109-133.

UNIT 2

STOCK EXCHANGE

Notes

Structure

2.1 Introduction
2.2 Organisation and Structure of Stock exchange
2.3 Online Trading
2.4 Major Stock Exchanges in India
2.5 Securities and Exchange of Board of India [SEBI]
2.6 SEBI's Powers in Relation to Stock Exchanges
2.7 Derivatives
2.8 Types of Derivatives
Summary
Key Words
Review Questions
Further Readings

2.0 LEARNING OBJECTIVES

After reading this chapter students will be able to:

- Understand the meaning and function of Stock Exchanges .
- Know the types of Stock Exchanges .
- Understand the Procedure for dealing in stock exchange
- Know the SEBI's powers in relation to stock exchanges
- Know the various major stock exchanges in india
- Describe the concept of derivatives

2.1 INTRODUCTION

A stock exchange, securities exchange, or bourse is an exchange where stockbrokers and traders can buy and sell securities, such as shares of stock, bonds, and other financial instruments. Stock exchanges may also provide facilities for the issue and redemption of such securities and instruments and capital events including the payment of income and dividends. Securities traded

Notes

on a stock exchange include stock issued by listed companies, unit trusts, derivatives, pooled investment products and bonds.

Stock exchanges often function as "continuous auction" markets with buyers and sellers consummating transactions via open outcry at a central location such as the floor of the exchange or by using an electronic trading platform.

To be able to trade a security on a certain stock exchange, the security must be listed there. Usually, there is a central location at least for record keeping, but trade is increasingly less linked to a physical place, as modern markets use electronic communication networks, which give them advantages of increased speed and reduced cost of transactions.

Trade on an exchange is restricted to brokers who are members of the exchange. In recent years, various other trading venues, such as electronic communication networks, alternative trading systems and "dark pools" have taken much of the trading activity away from traditional stock exchanges.

Initial public offerings of stocks and bonds to investors is done in the primary market and subsequent trading is done in the secondary market. A stock exchange is often the most important component of a stock market. Supply and demand in stock markets are driven by various factors that, as in all free markets, affect the price of stocks (see stock valuation).

There is usually no obligation for stock to be issued through the stock exchange itself, nor must stock be subsequently traded on an exchange. Such trading may be off exchange or over-the-counter. This is the usual way that derivatives and bonds are traded.

Increasingly, stock exchanges are part of a global securities market. Stock exchanges also serve an economic function in providing liquidity to shareholders in providing an efficient means of disposing of shares.

Meaning of Stock Exchange

Stock market is organized market where securities are traded. It includes market for shares debentures etc. The stock exchange is an organised and centralised market for the purchase and sale of industrial and financial securities of all descriptions, viz., Stocks, Shares, Debentures etc.

It is a market for transactions in old securities. Practically, it is a place where the buyer of a security may find a seller who is ready to sell his holdings at a fair and reasonable price provided the security has been listed.

According to the Securities Contracts (Regulations) Act of 1956, a stock exchange 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'.

Stock Exchange market is a vital component of a stock market. It facilitates the transaction between traders of financial instruments and targeted buyers. A stock exchange in India adheres to a set of rules and regulations directed by Securities and Exchange Board of India or SEBI. The said authoritative body functions to protect the interest of investors and aims to promote the stock market of India.

A stock exchange is an important factor in the capital market. It is a secure place where trading is done in a systematic way. Here, the securities are bought and sold as per well-structured rules and regulations. Securities mentioned here includes debenture and share issued by a public company that is correctly listed at the stock exchange, debenture and bonds issued by the government bodies, municipal and public bodies.

Typically bonds are traded Over-the-Counter (OTC), but a few corporate bonds are sold in

Notes

a stock exchange. It can enforce rules and regulation on the brokers and firms that are enrolled with them.

In other words, a stock exchange is a forum where securities like bonds and stocks are purchased and traded. This can be both an online trading platform and offline (physical location).

History of Stock Exchange

History of Indian Stock Market: Indian stock market marks to be one of the oldest stock market in Asia. It dates back to the close of 18th century when the East India Company used to transact loan securities. In the 1830s, trading on corporate stocks and shares in Bank and Cotton presses took place in Bombay.

An informal group of 22 stockbrokers began trading under a banyan tree opposite the Town Hall of Bombay from the mid-1850s, each investing a (then) princely amount of Rupee . Further the brokers increased to 250. The informal group of stockbrokers organized themselves as the BSE was shifted to an old building near the Town Hall.

In 1928, the plot of land on which the BSE building now standswas acquired, and a building was constructed and occupied in 1930. PremchandRoychand was a leading stockbroker of that time, and he assisted in setting out traditions, conventions, and procedures for the trading of stocks at Bombay Stock Exchange and they are still being followed.

In 1956, the Government of India recognized the Bombay Stock Exchange as the first stock exchange in the country under the Securities Contracts (Regulation) Act. The most decisive period in the history of the BSE took place after 1992. In the aftermath of a major scandal with market manipulation involving a BSE member named Harshad Mehta, shook the stock market. Then government started National Stock Exchange (NSE), which created an electronic marketplace. NSE started trading on 4 November 1994. Stock Exchange provides a trading platform, where buyers and sellers can meet to transact in securities.

Concept of Stock Exchange

After the new issue or the original issue of securities is complete; securities become secondhand and are traded (i.e. bought and sold) at the floor of the stock exchange-through brokers and other intermediaries.

The literal meaning of stock exchange is an exchange of stock (or shares and other securities) between buyers and sellers.

Under the Securities Contract (Regulation) Act, 1956, the term stock exchange is defined "as an association, organisation or body of individuals- whether incorporated or not-established for the purpose of assisting, regulating and controlling the business in buying, selling and dealing in securities."

Stock exchange could be very simply defined as follows:

A stock exchange is an organized market, where second-hand securities that have been listed thereon, may be bought and sold, in a safe, quick and convenient manner.

2.2 ORGANISATION AND STRUCTURE OF STOCK EXCHANGE

The stock exchanges are the exclusive centres for trading of securities. At present, there are 23 operative stock exchanges in India. Most of the stock exchanges in the country are incorporated as

Notes

'Association of Persons' of Section 25 companies under the Companies Act. These are organised as 'mutuals' and are considered beneficial in terms of tax benefits and matters of compliance.

The trading members, who provide brooking services also own, control and manage the stock exchanges. They elect their representatives to regulate the functioning of the exchange, including their own activities.

Until recently, the area of operation/jurisdiction of an exchange was specified at the time of its recognition, which in effect precluded competition among the exchanges.

These are called regional exchanges. In order to provide an opportunity to investors to invest/ trade in the securities of local companies, it is mandatory for the companies, wishing to list their securities, to list on the regional stock exchange nearest to their registered office.

If they so wish, they can seek listing on other exchanges as well. Monopoly of the exchanges within their allocated area, regional aspirations of the people arid mandatory listing on the regional stock exchange resulted in multiplicity of exchanges.

As a result, at the end of March 2008, there were 19 stock exchanges registered with SEBI having a total of 8,517 registered brokers and 43,874 registered sub-brokers trading on them.

The stock exchanges need to be recognized under the Securities Contracts (Regulation) Act, 1956. There are 19 stock exchanges in India. The Securities and Exchange Board of India (SEBI), has approved and notified the Corporatisation and Demutualisation Scheme of 19 Stock Exchanges.

BSE has successfully completed the process of Demutualisation in terms of The BSE (Corporatisation and Demutualisation) Scheme, 2005 on May 16, 2007.

NSE since inception has adopted a demutualised structure and its model of demutualization compares well with the international models of demutualised stock exchanges as seen from.

Membership

The trading platform of a stock exchange is accessible only to trading members. They play a significant role in the secondary market by bringing together the buyers and the sellers.

The brokers give buy/sell orders either on their own account or on behalf of clients. As these buy and sell order matches, the trades are executed.

The exchange can admit a broker as its member only on the basis of the terms specified in the Securities Contracts (Regulation) Act, 1956, the SEBI Act 1992, the rules, circulars, notifications, guidelines, and the byelaws, rules and regulations of the concerned exchange. No stock broker or sub- broker is allowed to buy, sell or deal in securities, unless he or she holds a certificate of registration from the SEBI.

Fees/Eligibility Criteria

The stock exchanges however are free to stipulate stricter requirements than those stipulated by the SEBI. The minimum standards stipulated by NSE are in excess of those laid down by the SEBI. The admission of trading members is based on various criteria like capital adequacy, track record, education, and experience.

With effect from July 1, 2008 a processing fee of Rs. 11,2367 and an admission fee of Rs. 5,61,8007- is charged for taking up new membership.

Corporatisation: No of Brokers and Sub Brokers

The authorities have been encouraging corporatisation of the broking industry. As a result, a number of brokers-proprietor firms and partnership firms have converted themselves into corporates. As of end March 2008,4,190 brokers, accounting for nearly 44.1 7 % of total brokers have become corporate entities. Amongst those registered with NSE around 92.03 % of them were corporatised, followed by BSE with 81.08 % corporate brokers.

During 2007- 08, 218 new brokers were registered with SEBI, whereas 174 were membership cases of reconciliation/cancellation/surrender. As at end-March 2008, there were 44,074 sub-brokers registered with SEBI, as compared with 27,540 sub-brokers as at end of previous year. NSE and BSE together constituted 97.02% of the total sub-brokers.

Eligibility Criteria for members

1. He is not less than 21 years
2. He should be citizen of india
3. He has not been adjudged bankrupt
4. He has not compounded with creditors
5. He has not convicted for an offenceinvolving fraud and dishonesty he has not been expelled from any other stock exchange
6. The stock exchanges however are free to decide the fees
7. The minimum standards are laid down by the SEBI
8. The admission of trading members is based on various criteria like capital adequacy, track record, education, and experience
9. With effect from July 1, 2008 a processing fee of Rs. 11,2367 and an admission fee of Rs. 5,61,8007- is charged for taking up new membership

(c) Management:

The general administration of a stock exchange is administered by a committee of management and is called by different names in different exchanges.

The selected Executive Committee of different stock exchanges carries on management of their day-to-day activities through sub-committees such as Listing Committee, Defaulters' Committee, Arbitration Committee, etc.

(d) Nature of Transactions:

Two types of transactions – cash or forward – are made in a stock Transactions exchange. Cash transaction is one which reveals the delivery of securities within a short time which is settled by the payment of price.

This type of transaction is also known as investment transaction since it is based on bona fide intention of purchase and sale of securities.

On the contrary, a forward transaction is one which reveals forward delivery contracts and fixed settlement days. It is a speculative transaction and the settlement is made by the payment of price differences.

Notes

Members of London Stock Exchange:

The members of London Stock Exchange are divided into two classes: (i) Jobbers, and (ii) Brokers. Every member of the exchange has to express clearly whether he would act as a Jobber or as a Broker at the time of his admission. He, however, cannot change his position during the course of the year.

A Jobber is an independent dealer in securities, i.e., he deals in securities in his own account. He has no direct contact with the intending purchaser and seller.

In other words, a jobber can deal either with a broker or with another jobber. He cannot work on commission basis but can do so for profit which is known as turn in technical language. A Broker, on the other hand, is a Commission Agent who transacts business in securities on behalf of non- members. He has a direct contact with the intending purchaser and seller.

Therefore, a broker is a link between the general public and the jobber while a jobber is a dealer in his own right.

A jobber is a professional speculator who deals in a limited number of shares while a broker acts for a large number of his non-member clients dealing in a large number and variety of securities.

Books of Accounts Maintained for Stock Exchange:

The Books of Accounts which are to be maintained are

(a) Books of Original Entry: which Include:

- Journal;
- Day Books;
- Cash Book;
- Stamps and Fees;
- Tickets Payable and Receivable; and
- Contango Journal.

(b) Ledgers: which Include:

- General Ledger;
- Clients' Ledger;
- Jobbers' Ledger;
- Investment Ledger;
- Dividend and Rights

Organisation and Working of Stock Exchange:

Practically, the organisation and working of a stock exchange differs from exchange to exchange in technical details although the general pattern of all exchanges is almost the same.

Stock Exchange in India: Governing Body and Membership

1. **Governing Body:**

   The stock exchanges in India are managed by a governing board or executive committee or council of management.

Notes

The governing board consists of 16 members of the exchange elected on general election basis by the members of the exchange, three persons appointed by the Central Government as its representatives, one representative of the Reserve Bank of India appointed by the Central Government, three persons nominated as public representatives and a chairman or executive director.

The executive members alert from among themselves the president or chairman of the stock exchange. In day-to-day management, the governing board is assisted by a number of committees such as listing committee, arbitration committee, defaulters committee, admission committee, etc. The governing board is empowered to make rules and regulations in consultation with the Government and the members of the stock exchange.

2. **Membership:**

The members only enter into trading of stock exchange and carry on business. A non-member can buy or sell securities through a member. Every stock exchange has its own rules and regulations for the admission of members. Member of a stock exchange are allowed to appoint certain agents to do business on their behalf.

The non-members who can carry on business on the floor of a stock exchange on behalf of the members are of three types:

(a) Remisiers:

They are agents of full-fledged members of a stock exchange. They are appointed to secure business for the members. They cannot carry business on their own name. They are paid commission out of the brokerage collected by members on the business procured by the remisiers. They also known as half-commission men or sub-brokers.

(b) Authorised Clerks:

A member of the stock exchange can appoint authorised clerks or assistants to assist him. The authorised clerks are merely employees of the members, and cannot do business in their own name.

(c) Brokers and Jobbers:

A broker is a commission agent who buys and sells securities on behalf of non-members. He executes the order of his clients and earns commission from them.

A Jobber is an independent dealer in securities who buys and sells securities in his own name. He cannot enter into contract with non-members. He derives his income from the profit made through difference in prices.

Features of Stock Exchange:

Salient features of stock exchange are the following:

(i) **An organised Market for securities :**

Stock exchange is an organised market for dealing in securities. Stock exchange is a market, where securities of corporate bodies, government and semi-government bodies are bought and sold.

Every stock exchange has a management committee, which has all the rights related to management and control of exchange. All the transactions taking place in the stock ex-

Notes

change are done as per the prescribed procedure under the guidance of the management committee. Activities of a stock exchange are governed by a recognised code of conduct, apart from statutory regulations.

(ii) Deals in second hand securities :

It is basically a market for second-hand listed securities of companies viz., shares, debentures/ bonds and government securities. It deals with shares, debentures bonds and such securities already issued by the companies. In short it deals with existing or second hand securities and hence it is called secondary market.

(iii) Regulates trade in securities :

Stock exchange does not buy or sell any securities on its own account. It merely provides the necessary infrastructure and facilities for trade in securities to its members and brokers who trade in securities. It regulates the trade activities so as to ensure free and fair trade.

(iv) Allows dealings only in listed securities :

Only those securities are traded in the stock exchange which is listed there. After fulfilling certain terms and conditions, security gets listed on the stock exchange. In fact, stock exchanges maintain an official list of securities that could be purchased and sold on its floor. Securities which do not figure in the official list of stock exchange are called unlisted securities. Such unlisted securities cannot be traded in the stock exchange.

(v) Transactions effected only through members :

All transactions in securities at the stock market are effected through authorised members only. All the transactions in securities at the stock exchange are effected only through its authorised brokers and members. Outsiders or direct investors are not allowed to enter in the trading circles of the stock exchange. Investors have to buy or sell the securities at the stock exchange through the authorised brokers only.

(vi) Dealing only through Authorised Members:

Investors can sell and purchase securities in stock exchange only through the authorised members. Stock exchange is a specified market place where only the authorised members can go. Investor has to take their help to sell and purchase.

(vii) Necessary to Obey the Rules and Bye-laws:

While transacting in Stock Exchange, it is necessary to obey the rules and bye-laws determined by the Stock Exchange. Buying and selling transactions in securities at the stock exchange are governed by the rules and regulations of stock exchange as well as SEBI Guidelines. No deviation from the rules and guidelines is allowed in any case.

(viii) Specific location :

Stock exchange is a particular market place where authorised brokers come together daily (i.e. on working days) on the floor of market called trading circles and conduct trading activities. The prices of different securities traded are shown on electronic boards. After the working hours market is closed. All the working of stock exchanges is conducted and controlled through computers and electronic system.

(ix) Financial Barometers:

Stock exchanges are the financial barometers and development indicators of national economy of the country. Industrial growth and stability is reflected in the index of stock exchange.

Notes

Functions of the Stock Exchange

(i) Continuous and ready market for securities

Stock exchange provides a ready and continuous market for purchase and sale of securities. It provides ready outlet for buying and selling of securities. Stock exchange also acts as an outlet/counter for the sale of listed securities.

Stock exchange is a convenient meeting place for buyers and sellers of second-hand securities. Investors who have a preference for liquidity (i.e. cash) can sell their securities; and those who wish to invest in securities can buy the same. Since stock exchange ensures liquidity of investment; people are induced to buy securities.

(ii) Safe Market

Stock exchange is, perhaps, the safest market for having transactions in securities. A stock exchange functions according to a recognised code of conduct and is subject to strict statutory regulations. Since the establishment of SEBI (Securities and Exchange Board of India) in the year 1988, dealings in securities at stock exchanges have become further safer.

In the absence of stock exchange, investing public might be deceived or cheated by shrewd unscrupulous brokers.

(iii) Providing Liquidity and Marketability to Existing Securities

Stock exchange is a market place where previously issued securities are traded. Various types of securities are traded here on regular basis.

Whenever required, an investor can invest his money through this market into securities and can reconvert this investment into cash. Availability of ready market for sale and purchase of securities increases their marketability and enhances liquidity.

(iv) Pricing of Securities

A stock exchange provides platform to deal in securities. The forces of demand and supply work freely in the stock exchange. In this way, prices of securities are determined.

(v) Safety of Transactions

Stock exchanges are organised markets. It provides safety, security and equity (justice) in dealings as transactions are conducted as per well defined rules and regulations.

They fully protect the interest of investors. The managing body of the exchange keeps control on the members. Each stock exchange has its own laws and bye-laws. Fraudulent practices are also checked effectively. Due to various rules and regulations, stock exchange functions as the custodian of funds of genuine investors.

Each member of stock exchange has to follow them and if any member is found violating them, his membership is cancelled.

For instance, if any broker working in stock exchange charges more commission than stipulated from any investor or misleads him in any other way, then the management committee of the stock exchange can fine the broker and even his membership can be cancelled.

(vi) Contributes to Economic Growth

A stock exchange provides liquidity to securities. This gives the investor a double benefit-first, the benefit of the change in the market price of securities can be taken advantage of, and secondly, in case of need for money they can be sold at the existing market price at any time.

Notes

These advantages provided by the share market encourage the people to invest their money in securities. In this way, people's money gets invested in industries and economic development becomes possible.

(vii) Spreading Equity Cult

Share market collects every type of information (more particularly about their economic condition) in respect of the listed companies.

Generally, this information is published or in case of need anybody can get it from the stock exchange free of any cost. In this way, the stock exchange guides the investors by providing various types of information.

Consequently, the number of shareholders in companies is increasing continuously. Thus the stock exchanges are playing a vital role in ensuring wider share ownership.

(viii) Providing Scope for Speculation

When securities are purchased with a view to getting profit as a result of change in their market price, it is called speculation. It is allowed or permitted under the provisions of the relevant Act.

It is accepted that in order to provide liquidity to securities, some scope for speculation must be allowed. The share market provides this facility.

(ix) Evaluation of Securities

Stock exchange determines prices of various securities (in terms of their real worth) through the interplay of demand and supply forces. Prices at which transactions in securities take place are recorded and published, in the form of market quotations.

So, it is useful for the evaluation of industrial securities. Which enables the investors to know the true worth of their holdings at any time. Comparison of companies in the same industry is possible through stock exchange quotations (i.e price list).

Securities for which published quotations are readily available; become reliable securities for obtaining loans etc. against these.

Regulates company management Listed companies have to comply with rules and regulations of concerned stock exchange and work under the vigilance (i.e supervision) of stock exchange authorities.

(x) Facilitates public borrowing

Stock exchange serves as a platform for marketing Government securities. It enables government to raise public debt easily and quickly.

(xi) Provides clearing house facility

Stock exchange provides a clearing house facility to members. It settles the transactions among the members quickly and with ease. The members have to pay or receive only the net dues (balance amounts) because of the clearing house facility.

(xii) Facilitates healthy speculation

Healthy speculation, keeps the exchange active. Normal speculation is not dangerous but provides more business to the exchange. However, excessive speculation is undesirable as it is dangerous to investors & the growth of corporate sector.

(xiii) Capital Formation

- Agency of Capital Formation :Stock exchange is an agency of capital formation. It draws the savings of the man in the street into productive investment channels. Since stock exchange provides a safe and convenient market for liquidity and investment purposes; people are induced to save and invest in securities.Through stock exchange, savings of people which otherwise would have gone into destructive channels, are routed into productive channels.
- Encourages capital formation: Stock exchange accelerates the process of capital formation. It creates the habit of saving, investing and risk taking among the investing class and converts their savings into profitable investment. It acts as an instrument of capital formation. In addition, it also acts as a channel for right (safe and profitable) investment.

(xiv) Qualitative Industrial and Commercial Development

Stock exchange aids in the process of ensuring qualitative industrial and commercial development of the economy. This is so, because, through stock exchange people keep shifting their investment from inefficient companies (which do not pay good dividends) to efficient companies (which promise high returns on investment). This shifting process of investment is specially important for a country where savings are scarce.

(xv) Offers safety in corporate investment

An investor can invest his surplus money (i.e extra money) in the listed securities with reasonable safety. The risk in such investment is reduced considerably due to the supervision of stock exchange authorities on listed companies. Moreover, securities are listed only when the exchange authorities are satisfied as regards legality and solvency of company concerned. Such scrutiny (detailed checking) avoids listing, of securities of unsound companies (i.e. companies with bad financial status).

(xvi) Acting as a Barometer of the Company

(Barometer is something that shows the changes that are happening in an economic, social or political situation). Stock exchange is sensitive to economic, political and social conditions of the economy; as such conditions affect the prices of securities.

In fact, price trends at stock exchange reflect the economic climate of the country. "Stock exchanges are not merely the chief theatres of business transactions; they are also barometers which indicate the general conditions of the atmosphere of business in a country."- Alfred Marshall

(xvii) Control Over Company Managements

Stock exchange very directly exercises control over the managements of companies, whose securities are listed with it. In fact, those companies whose securities are listed with a stock exchange have to abide by the rules and regulations of the stock exchange.

(xviii) Storehouse of Business Information

Companies, whose securities are listed with the stock exchange, are required to furnish financial statements, annual reports and other reports to the stock exchange.

Many stock exchanges publish directories which provide data on the corporate sector. Such information is highly helpful to the government in economic planning. It is equally useful to managements of many business enterprises.

Procedure for dealing in stock exchange

i Selection of broker : Customer will select the broker from whom purchase or sale is to be made.

Notes

ii Placing the order : Client places order for the purchase or sale of security in stock exchange on behalf of client

iii Making the contract :On trading floor authorized brokers will express the intention to buy or sell the shares .traditionally it happened through out cry method and both the parties will agree in price.

iv Contract note : Buying and selling brokers will prepare contract notes after their mutual consent

v Settlement :Spot dealings are settled in full selling broker will transfer the share to buying broker in return of money

2.3 ONLINE TRADING

Online trading refers to facility provided to investor which eables him to buy and sell shares using internet trading platform.

In the recent times, trading on stocks has become as simple as shopping online. Investor can do that sitting in a coffee shop using a smart phone. All it needs is a good internet connection, subscription to 3-in-1 account, mobile banking application and sufficient funds in the bank account.

Fortunately, all the hectic paper work has come down to a single click or touch on the mobile screen. Many free and paid mobile and web applications and portals for trading are available on internet.

Stock trading can be financially rewarding if done in the right way. Investing in the stock market involves riding the various ups and downs of the market. Since the introduction of online trading in India, investing has become convenient. Stock market trading is a great alternative when it comes to long-term wealth creation. Although, it might take a while for you to hone your skills.

What is Online Trading

Online trading involves the trading of securities through an online platform. Online trading portals facilitate the trading of various financial instruments such as equities, mutual funds, and commodities. Angel Broking offers Angel Speed Pro – an online trading platform that helps investors and traders to buy/sell stocks and other financial instruments.

How to Trade Online

Open Demat and Trading Account:

To begin trading online you need to open an online trading account with an online broking firm. Angel Broking offers reliable Demat and trading accounts services with low maintenance cost and affordable brokerage. It is essential to choose a broker who is a registered member of all the stock exchanges and is certified by the SEBI.

Learn all the Stock Market Basics:

The stock market functions on the system of supply and demand. Learning to trade begins with gaining more knowledge about the share market investment. Keeping tabs on financial news and websites, listening to pod-casts and taking up investing courses are all excellent ways to become an efficient investor.

Practice with an Online Stock Simulator:

Online stock trading simulators are a great way to learn online trading. Since it is a simulator, the losses you make would not affect you, hence you can learn trade without any fear.

Notes

Draft a plan:

- While you trade, it is very important to think through your investment strategies. Decide in advance how much you are willing to invest in a particular company and set limits on the amount of loss you are willing to bear.
- If you bear all these points in mind, online share trading will be an easy and profitable task for you. Practice is the key to successful online trading.
- Stock trading is a long-term investment and requires patience and perseverance.
- It involves buying and selling of securities such as stocks, bonds, and other related financial instruments online. For this purpose, you will require a Demat account and a trading account.
- A Demat account acts as the common repository to store the purchased units of stocks whereas the trading account acts as the platform to buy and sell the share. A bank account is linked to the trading account to facilitate funding of trade.

The major benefit of online trading is that investor can seek the help of dedicated customer care in case of any clarifications or queries.

Get hands-on information about the online trading below:

Requirements for online trading

- Demat account- account where shares are kept in electronic form. Demat account can open through stock broker(depository participant)
- Trading account- it is opened with broker who provides trading account number for ding trading of shares
- Bank account- money transaction in each trading account will happen through bankaccount linked to each trading account

The advantages of online trading:

- You have the ability to manage your own stock portfolios
- You will have more control and flexibility over the types of transaction you choose to conduct
- The commission costs for trading are significantly less money than using the services of a professional broker
- You can get access to lower fee mutual fund investments
- Online brokerage firms tend to offer their clients a slew of tools included real-time Level 2 stock quotes, news, financial tools and graphs to help you do research
- Some online brokerages will provide their clients to free access to high quality research reports created by Standard and Poor and other predominate financial players
- Online account investors have access to their accounts 24/7 - although market hours (trading hours) are from 9:30am to 4pm
- As long as you have access to a computer and the internet, you can take steps to manage your finances wherever you may be.

Notes

Disadvantages of online trading

1) Investors, who are trading for the first time, go with the flow and get immersed in technology and actually temporarily forget that they are actually using their real money.
2) There is no relationship that of a mentor between a professional broker and an online trading account holder, thus leaving the investor on his own to make choices of the right shares.
3) Users who are not familiar with the ins and outs of the basics of brokerage software can make mistakes which can prove to be a costly affair.
4) An investor may sometimes incur huge losses slow internet speed and network outages.

Investment Methods

Investors can invest in a stock exchange of India through these two ways –

I. **Primary market** – This market creates securities and acts as a platform where firms float their new stock options and bonds for the general public to acquire. It is where companies enlist their shares for the first time.

II. **Secondary market** – The secondary market is also known as the stock market; it acts as a trading platform for investors. Here, investors trade in securities without involving the companies who issued them in the first place with the help of brokers. This market is further broken down into – auction market and dealer market.

2.4 MAJOR STOCK EXCHANGES IN INDIA

Being a vital part of the Indian stock market, a stock exchange in India tends to influence the country's financial sector to a great extent. Their collective performances happen to be a deciding factor of economic growth.

Also, all major types of stock exchanges are closely integrated with each other; if one major stock exchange falls, it will have a ripple effect on all other major exchanges across the globe.

For example, if the index of Bombay Stock Exchange falls, its effect will be felt across stock exchanges like New York Stock Exchange, Tokyo Stock Exchange, Shanghai Stock Exchange, etc. as well.

Bombay Stock Exchange (BSE)

The Bombay Stock Exchange (BSE) is the first and largest securities market in India and was established in 1875 as the Native Share and Stock Brokers' Association. Based in Mumbai, India, the BSE lists close to 6,000 companies and is one of the largest exchanges in the world, along with the New York Stock Exchange (NYSE), Nasdaq, London Stock Exchange Group, Japan Exchange Group, and Shanghai Stock Exchange.

The BSE has helped develop India's capital markets, including the retail debt market, and has helped grow the Indian corporate sector. The BSE is Asia's first stock exchange and also includes an equities trading platform for small-and-medium enterprises (SME).

BSE has diversified into providing other capital market services including clearing, settlement, and risk management.

BSE is a stock exchange located on Dalal Street, Mumbai, Maharashtra, India. It was was

Notes

established as "The Native Share & Stock Brokers' Association" in 1875. It is the11th largest stock exchange in the world by market capitalisation as on 31 December 2012.Established in 1875.

Over the past 137 years, BSE has facilitated the growth of the Indian corporate sector by providing it an efficient capital-raising platform.. More than 5000 companies are listed on BSE making it world's No. 1 exchange in terms of listed members.

The companies listed on BSE Ltd command a total market capitalization of USD Trillion 1.32 as of January 2013. BSE Ltd is world's fifth most active exchange in terms of number of transactions handled through its electronic trading system.

It is also one of the world's leading exchanges (3rd largest in December 2012) for Index options trading BSE also provides a host of other services to capital market participants including risk management, clearing, settlement, market data services and BSE provides trading facilities through BOLT (BSEOn-Line trading System) BSE's trading session starts from 9 am – 15.30 pm (Monday to Fri-day).

BSE provides depository services through its Central Depository Services Ltd. (CDSL) BSE's popular equity index - the S&P BSE SENSEX [Formerly SENSEX] - is India's most widely tracked stock market benchmark index.

Key poiints

- Established in 1875 as the Native Share and Stock Brokers' Association, the Bombay Stock Exchange (BSE) is Asia's first exchange and the largest securities market in India.
- The BSE has been instrumental in developing India's capital markets by providing an efficient platform for the Indian corporate sector to raise investment capital.
- The BSE is known for its electronic trading system that provides fast and efficient trade execution.
- The BSE enables investors to trade in equities, currencies, debt instruments, derivatives, and mutual funds.
- The BSE also provides other important capital market trading services such as risk management, clearing, settlement, and investor education.

How the Bombay Stock Exchange (BSE) Works

In 1995, the BSE switched from an open-floor to an electronic trading system. There are more than a dozen electronic exchanges in the U.S. alone with the New York Stock Exchange (NYSE) and Nasdaq being the most widely known.

Today, electronic trading systems dominate the financial industry overall, offering fewer errors, faster execution, and better efficiency than traditional open-outcry trading systems. Securities that the BSE lists include stocks, stock futures, stock options, index futures, index options, and weekly options.

The BSE's overall performance is measured by the Sensex, a benchmark index of 30 of the BSE's largest and most actively traded stocks covering 12 sectors. Debuting in 1986, the Sensex is India's oldest stock index. Also called the "BSE 30," the index broadly represents the composition of India's entire market.

Dalal Street

The Bombay Stock Exchange is located on Dalal Street in downtown Mumbai, India. In the 1850s, stockbrokers would conduct business under a banyan tree in front of the Mumbai town hall.

Notes

After a few decades of various meeting locations, Dalal Street was formally selected in 1874 as the location for the Native Share and Stock Brokers' Association, the forerunner organization that would eventually become the BSE.

Mumbai is now a major financial center in India and Dalal Street is home to a large number of banks, investment firms, and related financial service companies. The importance of Dalal Street to India is similar to that of Wall Street in the United States.

Indian investors and the press will cite the investment activity of Dalal Street and will use it as a figure of speech to represent the Indian financial industry.

The National Stock Exchange (NSE)

NSE islocated in Mumbai, India. National Stock Exchange (NSE) was established in the mid 1990s as a demutualized electronic exchange. NSE provides a modern, fully automated screenbased trading system, with over two lakh trading terminals, through which investors in every nook and corner of India can trade. NSE has played a critical role in reforming the Indian securities market and in bringing unparalleled transparency, efficiency and market integrity.

NSE has a market capitalisation of more than US$989 billion and 1,635 companies listed as on July 2013. Though a number of other exchanges exist, NSE and the Bombay Stock Exchange are the two most significant stock exchanges in India, and between them are responsible for the vast majority of share transactions.

NSE operates on the 'National Exchange for Automated Trading' (NEAT) system NSE's flagship index, the CNX NIFTY 50, is used extensively by investors in India and around the world to take exposure to the Indian equities market.

Ojectives of NSE:

(a) establishing a nationwide trading facility for all types of securities,

(b) ensuring equal access to all investors all over the country through an appropriate communication network,

(c) providing a fair, efficient and transparent securities market using electronic trading system,

(d) enabling shorter settlement cycles and book entry settlements and

(e), meeting the international benchmarks and standards.

Features of NSE :

1. NSE is a fully automated screen based trading environment, no trading floor like before times.
2. The market operates with all market participants stationed at their offices and making use of computer terminals for trading, collecting information etc.
3. The identity of the trading member is not disclosed on the NSE computer trading system.
4. The system provides complete transparency of trading operations .Investors can can see the prices, order quantity, what time the trade was executed etc on the screen.
5. The NSE trading system provides enormous flexibility to these members . When entering

an order ; he can place various conditions on the terms of the order like price, time, order size.

NIFTY

Nifty stands for National stock exchange fifty. It is a computed index from the performances of top stocks from different sectors listed on the NSE. It consists of 50 companies from 24 sectors.

The NIFTY 50 is a benchmark Indian stock market index that represents the weighted average of 50 of the largest Indian companies listed on the National Stock Exchange. It is one of the two main stock indices used in India, the other being the BSE SENSEX.

Nifty 50 is owned and managed by NSE Indices (previously known as India Index Services & Products Limited), which is a wholly owned subsidiary of the NSE Strategic Investment Corporation Limited. NSE Indices had a marketing and licensing agreement with Standard & Poor's for co-branding equity indices until 2013. The Nifty 50 index was launched on 22 April 1996, and is one of the many stock indices of Nifty.

The NIFTY 50 index has shaped up to be the largest single financial product in India, with an ecosystem consisting of exchange-traded funds (onshore and offshore), exchange-traded options at NSE, and futures and options abroad at the SGX. NIFTY 50 is the world's most actively traded contract. WFE, IOMA and FIA surveys endorse NSE's leadership position.

The NIFTY 50 index covers 14 sectors (as on 20 June 2020) of the Indian economy and offers investment managers exposure to the Indian market in one portfolio. Between 2008 & 2012, the NIFTY 50 index's share of NSE's market capitalisation fell from 65% to 29% due to the rise of sectoral indices like NIFTY Bank, NIFTY IT, NIFTY Pharma, NIFTY SERV SECTOR, NIFTY Next 50, etc.

The NIFTY 50 Index gives a weightage of 39.47% to financial services, 15.31% to Energy, 13.01% to IT, 12.38% to consumer goods, 6.11% to Automobiles and 0% to the agricultural sector.[11]

The NIFTY 50 index is a free float market capitalisation weighted index. The index was initially calculated on a full market capitalisation methodology. On 26 June 2009, the computation was changed to a free-float methodology.

The base period for the NIFTY 50 index is 3 November 1995, which marked the completion of one year of operations of the National Stock Exchange Equity Market Segment.

- It is weighted average of stock prices It is calculated real time by NSE system
- The size of index shows status of market.
- It gives overall picture of the performance of stocks that are listed in the NSE.
- It is used for benchmarking fund portfolios, index based derivatives and index funds.

'Over-The-Counter Exchange Of India - OTCEI'

The first electronic OTC stock exchange in India was established in 1990 to provide investors and companies with an additional way to trade and issue securities. An electronic stock exchange based in India that is comprised of small- and medium-sized firms looking to gain access to the capital markets. This was the first exchange in India to introduce market makers, which are firms that hold shares in companies and facilitate the trading of securities by buying and selling from other participants.

- It is the first exchange for small companies.
- It is the first screen based nationwide stock exchange in India.

Notes

- It was set up to access high-technology enterprising promoters in raising finance for new
- product development in a cost effective manner and to provide transparent and efficient trading system to the investors.

OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, theIndustrial Finance Corporation of India and others and is a recognized stock exchange under the SCR Act.

Here is a list of other stock exchanges in India

- India International Exchange or India INX
- Metropolitan Stock Exchange of India Ltd (was valid up to September 15th, 2019)
- NSE IFSC Ltd.

2.5 SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

Securities and Exchange Board of India (SEBI) was initially constituted on 12th April, 1988 as a non-statutory body through a resolution of the Government for dealing with all matters relating to the development and regulation of securities market and investor protection and to advices the Government on all these matters.

Later on SEBI became a statutory body under the Securities and Exchange Board of India Act, 1992.

- Under the Act, the SEBI shall consist of a chairman and five other members appointed by the Central government (two members representing the Ministries of Finance and Law, one member from the Reserve Bank of India and two other members).
- SJEBI was given statutory status and powers through an ordinance promulgated on January 30, 1992.
- The statutory powers and functions of SEBI were strengthened through the promulgation of the Securities Laws (Amendment) ordinance on January 25, 1995 which was subsequently replaced by an Act of parliament.
- In terms of this Act, SEBI has been vested with regulatory powers over corporates in the issuance of capital, the transfer of securities and other related matters. Besides, SEBI has also been empowered to impose monetary penalties on capital market intermediaries and other participants for a range of violation.

Reasons for Establishment of SEBI:

With the growth in the dealings of stock markets, lot of malpractices also started in stock markets such as price rigging, 'unofficial premium on new issue, and delay in delivery of shares, violation of rules and regulations of stock exchange and listing requirements.

Due to these malpractices the customers started losing confidence and faith in the stock exchange. So government of India decided to set up an agency or regulatory body known as Securities Exchange Board of India (SEBI)

Features of SEBI

1. The SEBI shall be a body corporate established under SEBI ACT, with perpetual succession and a common seal.

2. The head office of the board shall be at Mumbai. SEBI can have branch offices at other places in India.
3. The board shall consist of the following members.
    a. A chairman
    b. Two members from amongst the officials of the Ministries of the Central Government dealing with finance and law.
    c. One member from amongst the officials of the Reserve Bank of India.
    d. Two other members - Chairman and other members of the Board are appointed by the central Government.
4. The general superintendence, direction and management of the SEBI shall vest in the Board of members. Those members exercise all powers and do all acts and things which may be exercised by the Board (SEBI)
5. Central Government shall have the power to remove a member or the chairman appointed to the Board
6. Central government shall provide finance and also make appropriate grants to the Board.
7. Central government has power to issue direction to the board on the policy matters and shall supercede the board in the event of default by the Board.

Objectives of SEBI:

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

1. To regulate the activities of stock exchange.
2. To protect the rights of investors and ensuring safety to their investment.
3. To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.
4. To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

Functions of SEBI:

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

- Protective functions
- Developmental functions
- Regulatory functions.

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

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

Notes

(ii) It Prohibits Insider trading: Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities.

This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue.

This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.

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

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

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

(a) SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in midterm.

(b) SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.

(c) SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.

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

(i) SEBI promotes training of intermediaries of the securities market.

(ii) SEBI tries to promote activities of stock exchange by adopting flexible and adoptable approach in following way:

(a) SEBI has permitted internet trading through registered stock brokers.

(b) SEBI has made underwriting optional to reduce the cost of issue.

(c) Even initial public offer of primary market is permitted through stock exchange.

3. **Regulatory Functions:** These functions are performed by SEBI to regulate the business in stock exchange.

To regulate the activities of stock exchange following functions are performed:

(i) SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.

(ii) These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.

(iii) SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.

(iv) SEBI registers and regulates the working of mutual funds etc.

(v) SEBI regulates takeover of the companies.

(vi) SEBI conducts inquiries and audit of stock exchanges.

Organisation and Management:

SEBI is managed by six members—one chairman (nominated by Central Government), two members, (officers of Central Ministries), one member (from RBI) and remaining two members are nominated by Central Government. The office of SEBI is situated at Mumbai with its regional offices at Kolkata, Delhi and Chennai.

In 1988 the initial capital of SEBI was Rs. 7.5 crore which was provided by its promoters (IDBI, ICICI, and IECI). This amount was invested and with its interest amount, the day-to-day expenses of SEBI are managed.

All statutory power for regulating Indian Capital Market are vested with SEBI itself.

The Organisational Structure of SEBI:

1. SEBI is working as a corporate sector.
2. Its activities are divided into five departments. Each department is headed by an executive director.
3. The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.
4. SEBI has formed two advisory committees to deal with primary and secondary markets.
5. These committees consist of market players, investors associations and eminent persons.

Objectives of the two Committees are:

1. To advise SEBI to regulate intermediaries.
2. To advise SEBI on issue of securities in primary market.
3. To advise SEBI on disclosure requirements of companies.
4. To advise for changes in legal framework and to make stock exchange more transparent.
5. To advise on matters related to regulation and development of secondary stock exchange. These committees can only advise SEBI but they cannot force SEBI to take action on their advice.

SEBI Regulations:

SEBI has adopted a number of regulations and revolutionary steps to re-establish the credit of capital market, which includes the following:

1. ***Share Price and Premium Determination:***

   According to the latest directions of SEBI, Indian companies are now free to determine their share prices and premium on those shares. But determined price and premium amount will he equally applicable to all without any discrimination.

2. ***Control on Share Brokers:***

   Under the new rules every broker and sub-broker has to obtain registration with SEBI and any stock exchange in India.

Notes

3. ***Control on Utilizing 'Application Amount' having no Interest by Companies Releasing Public Issues:***

   At the instance of SEBI, Commercial banks introduced Stock Investment Scheme under which investor has to submit stock-invests, purchased from banks, with their shares application. If the investor is allotted shares/debentures, the required amount is transferred in concerned company's account by the bank issuing 'stock invest'.

   In other case (if share/debenture is not allotted), investor gets a predetermined interest rate on invested capital. This step of SEBI ensured interest earning to the investor until he got share/debenture allotment. It also ensures the refund of invested amount to the investor in case shares are not allotted.

4. ***Underwriters:***

   The minimum asset limit has been fixed to be Rs. 20 lakh to work as underwriter. Besides, SEBI has warned underwriters that their registration can be cancelled if any irregularity is found in the purchase of unsubscribed part of the share issue.

5. ***SEBI's Control on Mutual Fund:***

   SEBI (Mutual funds) Regulation 1993, help to take over direct control of all mutual funds of government and private sector (excluding UTI).

   Under this new rule, the company floating a mutual fund should possess net assets of Rs. 5 crore which should consist of atleast 40% contribution from promoter's side.

6. ***Control over Foreign Institutional Investors:***

   SEBI has made it compulsory for every foreign institutional investor to get registered with SEBI for participating in Indian Capital Market. SEBI has issued directions in this regard.

7. ***Insider Trading:***

   Companies and their employees usually adopt malpractice in Indian Capital Market to variate share prices.

   To check this type of insider trading, SEBI introduced SEBI (insider Trading) Regulations, 1992, which will ensure honesty in the capital market and will develop a feeling of faith among investors to promote investments in capital market in the long-run.

2.6 SEBI'S POWERS IN RELATION TO STOCK EXCHANGES

The SEBI ordinance has given it the following powers:

(i) It may call periodical returns from stock exchanges.

(ii) It has the power to prescribe maintenance of certain documents by the stock exchanges.

(iii) SEBI may call upon the exchange or any member to furnish explanation or information relating to the affairs of the stock exchange or any members.

(iv) It has the power to approve bye-law of the stock exchange for regulation and control of the contracts.

(v) It can amend bye-laws of stock exchange.

Notes

(vi) In certain areas it can grant to licence the dealers in securities.

(vii) It can compel a public company to list its shares.

Securities Contract (Regulation) Act empowers Central Government to delegate some of its powers, to SEBI. They are as follows:

1. Power to grant recognition to a stock exchange.
2. Power to direct any stock exchange to amend the rules relating to constitution of stock exchange, admission of new members, etc.
3. Power to supersede governing body of any stock exchange.
4. Power to suspend business of a recognised stock exchange.
5. Power to prohibit contracts in certain cases

2.7 DERIVATIVES

A derivative is a contract between two or more parties whose value is based on an agreed-upon underlying financial asset (like a security) or set of assets (like an index). Common underlying instruments include bonds, commodities, currencies, interest rates, market indexes, and stocks.

Derivative is a financial instrument whose value is based on or value is derived from one or more underlying assets. The under lying asset may be a share, stock market index, a commodity, an interest rate or a currency.

When the price of asset changes value of derivative will also change.it is a contract between two parties where one party agrees to buy or sell any asset at specified dates and rate.

Derivative is similar to insurance. Insurance protects against specific risk like fire, flood accident, whereas derivatives protects from market risks.

Key Points

- A derivative is a contract between two or more parties whose value is based on an agreed-upon underlying financial asset, index, or security.
- Futures contracts, forward contracts, options, swaps, and warrants are commonly used derivatives.
- Derivatives can be used to either mitigate risk (hedging) or assume risk with the expectation of commensurate reward (speculation).

Understanding Derivatives

Derivatives are secondary securities whose value is solely based (derived) on the value of the primary security that they are linked to–called the underlying. Typically, derivatives are considered advanced investing.

There are two classes of derivative products: "lock" and "option." Lock products (e.g. swaps, futures, or forwards) bind the respective parties from the outset to the agreed-upon terms over the life of the contract.

Option products (e.g. stock options), on the other hand, offer the holder the right, but not the obligation, to buy or sell the underlying asset or security at a specific price on or before the option's expiration date.

Notes

While a derivative's value is based on an asset, ownership of a derivative doesn't mean ownership of the asset. Futures contracts, forward contracts, options, swaps, and warrants are commonly used derivatives.

Futures Contracts

A futures contract, for example, is a derivative because its value is affected by the performance of the underlying asset. A futures contract is a contract to buy or sell a commodity or security at a predetermined price and at a preset date in the future.

Futures contracts are standardized by specific quantity sizes and expiration dates. Futures contracts can be used with commodities, such as oil and wheat, and precious metals such as gold and silver.

Equity Options

An equity or stock option is a type of derivative because its value is "derived" from that of the underlying stock. Options come in forms: calls and puts. A call option gives the holder the right to buy the underlying stock at a preset price (called the strike price) and by a predetermined date outlined in the contract (called the expiration date).

A put option gives the holder the right to sell the stock at the preset price and date outlined in the contract. There's an upfront cost to an option called the option premium.

The risk-reward equation is often thought to be the basis for investment philosophy and derivatives can be used to either mitigate risk (hedging), or they can be used for speculation where the level of risk versus reward would be considered.

For example, a trader may attempt to profit from an anticipated drop in an index's price, such as the S&P 500, by selling (or going "short") the related futures contract. Derivatives used as a hedge allow the risks associated with the underlying asset's price to be transferred between the parties involved in the contract.

Derivative Exchanges and Regulations

Some derivatives are traded on national securities exchanges and are regulated by the U.S. Securities and Exchange Commission (SEC). Other derivatives are traded over-the-counter (OTC), which involve individually negotiated agreements between parties.

Futures

Most derivatives are traded on exchanges. Commodity futures, for example, trade on a futures exchange, which is a marketplace in which various commodities are bought and sold. Brokers and commercial traders are members of the exchange and need to be registered with the National Futures Association (NFA) and the Commodity Futures Trading Commission (CFTC).

The CFTC regulates the futures markets and is a federal agency that is charged with regulating the markets so that the markets function in a fair manner. The oversight can include preventing fraud, abusive trading practices, and regulating brokerage firms.

Options

Options contracts are traded on the Chicago Board Options Exchange (CBOE), which is the world's largest options market. The members of these exchanges are regulated by the SEC, which monitors the markets to ensure they are functioning properly and fairly.

OTC Transactions

It's important to note that regulations can vary somewhat, depending on the product and its exchange. In the currency market, for example, the trades are done via over-the-counter

(OTC), which is between brokers and banks versus a formal exchange. Two parties, such as a corporation and a bank, might agree to exchange a currency for another at a specific rate in the future.

Banks and brokers are regulated by the SEC. However, investors need to be aware of the risks with OTC markets since the transactions do not have a central marketplace nor the same level of regulatory oversight as those transactions done via a national exchange.1

Two-Party Derivatives

- A commodity futures contract is a contract to buy or sell a predetermined amount of a commodity at a preset price on a date in the future.
- Commodity futures are often used to hedge or protect investors and businesses from adverse movements in the price of the commodity.
- For example, commodity derivatives are used by farmers and millers to provide a degree of "insurance." The farmer enters the contract to lock in an acceptable price for the commodity, and the miller enters the contract to lock in a guaranteed supply of the commodity.
- Although both the farmer and the miller have reduced risk by hedging, both remain exposed to the risks that prices will change.

Example of Commodity Derivative

For example, while the farmer is assured of a specified price for the commodity, prices could rise (due to, for instance, a shortage because of weather-related events) and the farmer will end up losing any additional income that could have been earned.

Likewise, prices for the commodity could drop, and the miller will have to pay more for the commodity than he otherwise would have.

For example, let's assume that in April 2020 the farmer enters a futures contract with a miller to sell 5,000 bushels of wheat at $4.404 per bushel in July. On the expiration date in July 2017, the market price of wheat falls to $4.350, but the miller has to buy at the contract price of $4.404, which is higher than the prevailing market price of $4.350. Instead of paying $21,750 (4.350 x 5,000), the miller will pay $22,020 (4.404 x 5,000), while the farmer recoups a higher-than-market price.

However, had the price risen to $5 per bushel, the miller's hedge would've allowed the wheat to be purchased at a $4.404 contract price versus the $5 prevailing price at the July expiration date. The farmer, on the other hand, would've sold the wheat at a lower price than the $5 prevailing market price.

Benefits of Derivatives

Let's use the story of a fictional farm to explore the mechanics of several varieties of derivatives. Gail, the owner of Healthy Hen Farms, is worried about the recent fluctuations in chicken prices or volatility within the chicken market due to reports of bird flu.

Gail wants to protect her business against another spell of bad news. So she meets with an investor who enters into a futures contract with her.

The investor agrees to pay $30 per bird when the birds are ready for slaughter in six months' time, regardless of the market price. If at that time, the price is above $30, the investor will get the benefit as they will be able to buy the birds for less than the market cost and sell them on the market at a higher price for a profit. If the price falls below $30, Gail will get the benefit because she will be able to sell her birds for more than the current market price, or more than what she would get for the birds in the open market.

Notes

Derivatives and Hedging

By entering into a futures contract, Gail is protected from price changes in the market, as she has locked in a price of $30 per bird. She may lose out if the price flies up to $50 per bird on a mad cow scare, but she will be protected if the price falls to $10 on news of a bird flu outbreak. By hedging with a futures contract, Gail is able to focus on her business and limit her worry about price fluctuations.

It's important to remember that when companies hedge, they're not speculating on the price of the commodity. Instead, the hedge is merely a way for each party to manage risk. Each party has their profit or margin built into their price, and the hedge helps to protect those profits from being eliminated by market moves in the price of the commodity.

Whether the price of the commodity moves higher or lower than the futures contract price by expiry, both parties hedged their profits on the transaction by entering into the contract with each other.

Derivative Swap

Derivatives can also be used with interest-rate products. Interest rate derivatives are most often used to hedge against interest rate risk.

Interest rate risk can occur when a change in interest rates causes the value of the underlying asset's price to change.

Loans, for example, can be issued as fixed-rate loans, (same interest rate through the life of the loan), while others might be issued as variable-rate loans, meaning the rate fluctuates based on interest rates in the market. Some companies might want their loans switched from a variable rate to a fixed rate.

For example, if a company has a really low rate, they might want to lock it in to protect them in case rates rise in the future.

Other companies might have debt with a high fixed-rate versus the current market and want to switch or swap that fixed-rate for the current, lower variable rate in the market. The exchange can be done via an interest-rate swap in which the two parties exchange their payments so that one party receives the floating rate and the other party the fixed rate.

Example of Interest Rate Swap

Continuing our example of Healthy Hen Farms, let's say that Gail has decided that it's time to take Healthy Hen Farms to the next level. She has already acquired all the smaller farms near her and wants to open her own processing plant. She tries to get more financing, but the lender, Lenny, rejects her.

Lenny's reason for denying financing is that Gail financed her takeovers of the other farms through a massive variable-rate loan, and Lenny is worried that if interest rates rise, she won't be able to pay her debts.

He tells Gail that he will only lend to her if she can convert the loan to a fixed-rate loan. Unfortunately, her other lenders refuse to change her current loan terms because they are hoping interest rates will increase, too.

Gail gets a lucky break when she meets Sam, the owner of a chain of restaurants. Sam has a fixed-rate loan about the same size as Gail's, and he wants to convert it to a variable-rate loan because he hopes interest rates will decline in the future.

For similar reasons, Sam's lenders won't change the terms of the loan. Gail and Sam decide to swap loans. They work out a deal in which Gail's payments go toward Sam's loan, and his payments go toward Gail's loan. Although the names on the loans haven't changed, their contract allows them both to get the type of loan they want.

The transaction is a bit risky for both of them because if one of them defaults or goes bankrupt, the other will be snapped back into their old loan, which may require payment for which either Gail or Sam may be unprepared. However, it allows them to modify their loans to meet their individual needs.

Credit Derivative

- A credit derivative is a contract between two parties and allows a creditor or lender to transfer the risk of default to a third party. The contract transfers the credit risk that the borrower might not pay back the loan.
- However, the loan remains on the lender's books, but the risk is transferred to another party. Lenders, such as banks, use credit derivatives to remove or reduce the risk of loan defaults from their overall loan portfolio and in exchange, pay an upfront fee, called a premium.

Example of Credit Derivative

- Lenny, Gail's banker, ponies up the additional capital at a favorable interest rate and Gail goes away happy. Lenny is pleased as well because his money is out there getting a return, but he is also a little worried that Sam or Gail may fail in their businesses.
- To make matters worse, Lenny's friend Dale comes to him asking for money to start his own film company. Lenny knows Dale has a lot of collateral and that the loan would be at a higher interest rate because of the more volatile nature of the movie industry, so he's kicking himself for loaning all of his capital to Gail.
- Fortunately for Lenny, derivatives offer another solution. Lenny spins Gail's loan into a credit derivative and sells it to a speculator at a discount to the true value. Although Lenny doesn't see the full return on the loan, he gets his capital back and can issue it out again to his friend Dale. Lenny likes this system so much that he continues to spin out his loans as credit derivatives, taking modest returns in exchange for less risk of default and more liquidity.

Options Contracts

- Years later, Healthy Hen Farms is a publicly-traded corporation (HEN) and is America's largest poultry producer. Gail and Sam are both looking forward to retirement.
- Over the years, Sam bought quite a few shares of HEN. In fact, he has more than $100,000 invested in the company.
- Sam is getting nervous because he is worried that another shock, perhaps another outbreak of bird flu, might wipe out a huge chunk of his retirement money. Sam starts looking for someone to take the risk off his shoulders. Lenny is now a financier extraordinaire and active writer or seller of options, agrees to give him a hand.
- Lenny outlines a deal–called a put option–in which Sam pays Lenny a fee–or premium–for the right (but not the obligation) to sell Lenny the HEN shares in a year's time at their current price of $25 per share. If the share prices plummet, Lenny protects Sam from the loss of his retirement savings.
- Healthy Hen Farms remains stable until Sam and Gail have both pulled their money out for retirement. Lenny profits from the fees and his booming trade as a financier. Lenny is OK because he has been collecting the fees and can handle the risk.

The Bottom Line

This tale illustrates how derivatives can move risk (and the accompanying rewards) from the risk-

Notes

averse to the risk seekers. Although Warren Buffett once called derivatives "financial weapons of mass destruction," derivatives can be very useful tools, provided they are used properly.2

Like all other financial instruments, derivatives have their own set of pros and cons, but they also hold unique potential to enhance the functionality of the overall financial system.

Derivatives are of two categories

- Exchange traded
- Over the counter

1) Exchange traded derivatives, as the name signifies are traded through organized exchanges around the world. These instruments can be bought and sold through these exchanges, just like the stock market

2) Over the counter (popularly known as OTC) derivatives are not traded through the exchanges. They are not standardized and have varied features. Some of the popular OTC instruments are forwards, swaps, swaptions etc. Derivatives are used by investors for the following purposes:

- To provide leverage (or gearing), such that a small movement in the underlying value can cause a large difference in the value of the derivative
- To speculate and make a profit if the value of the underlying asset moves the way they expect (e.g., moves in a given direction, stays in or out of a specified range, reaches a certain level)
- To hedge or mitigate risk in the underlying, by entering into a derivative contract whose value moves in the opposite direction to their underlying position and cancels part or all of it out
- To obtain exposure to the underlying where it is not possible to trade in the underlying (e.g., weather derivatives)
- To create option ability where the value of the derivative is linked to a specific condition or event (e.g. the underlying reaching a specific price level).

Objectives

i) **Hedging**

Derivatives allow risk related to the price of the underlying asset to be transferred from one party to another.

For example, a wheat farmer and a miller could sign a derivative contract to exchange a specified amount of cash for a specified amount of wheat in the future. Both parties have reduced a future risk: for the wheat farmer, the uncertainty of the price, and for the miller, the availability of wheat.

ii) **Business purposes**

Derivatives can serve legitimate business purposes. For example, a corporation borrows a large sum of money at a specific interest rate.The rate of interest on the loan resets every six months. The corporation is concerned that the rate of interest may be much higher in six months.

The corporation could buy a forward rate agreement (FRA), which is a contract to pay a fixed rate of interest six months after purchases on a notional amount of money. If the interest rate after six months is above the contract rate, the seller will pay the difference to the corporation, or FRA buyer.

If the rate is lower, the corporation will pay the difference to the seller. The purchase of the FRA serves to reduce the uncertainty concerning the rate increase and stabilize earnings.

iii) Speculation and arbitrage

Derivatives can be used to acquire risk, rather than to hedge against risk.

Thus, some individuals and institutions will enter into a derivative contract to speculate on the value of the underlying asset, betting that the party seeking insurance will be wrong about the future value of the underlying asset.

Speculators look to buy an asset in the future at a low price according to a derivative contract when the future market price is high, or to sell an asset in the future at a high price according to a derivative contract when the future market price is low.

Benefits of derivatives

1. They help in transferring risks from risk adverse people to risk oriented people.
2. They help in the discovery of future as well as current prices.
3. They catalyze entrepreneurial activity.
4. They increase the volume traded in markets because of participation of risk adverse people in greater numbers.
5. They increase savings and investment in the long run.

2.8 TYPES OF DERIVATIVES

1. FORWARDS
2. FUTURES
3. OPTIONS
   a. CALL OPTION
   b. PUT OPTION
4. SWAPS

1. FORWARDS

A forward contract is an agreement between two parties — a buyer and a seller to purchase or sell something at a later date at a price agreed upon today A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price.

Any type of contractual agreement that calls for the future purchase of a good or service at a price agreed upon today and without the right of cancellation is a forward contract.

Features of forwards

- They are bilateral contracts in which all contract details such as delivery date, price and quantity are negotiated bilaterally by the parties to the contact
- Each contact is custom designed

Notes

- The contract has to be settled by delivery by delivery of assets Limitations Since these are customised contracts it cannot be traded in stock exchange Risk is more because there is possibility of default from any party.

2. FUTURES

A 'Future' is a contract to buy or sell the underlying asset for a specific price at a pre-determined time. If you buy a futures contract, it means that you promise to pay the price of the asset at a specified time.

If you sell a future, you effectively make a promise to transfer the asset to the buyer of the future at a specified price at a particular time.

They are contracts to buy or sell an asset on or before a future date at a price specified today. A futures contract differs from a forward contract in that the futures contract is a standardized contract written by a clearing house that operates an exchange where the contract can be bought and sold; the forward contract is a non-standardized contract written by the parties themselves.

Clearing corporation provides guarantees for the contract by taking cash or assets as securities which is called as margin money.

3. OPTIONS

Options are contracts that give the owner the right, but not the obligation, to buy or sell an asset like stock, commodity, currency, index, or debt, at a specified price during a specified period of time. The price at which the sale takes place is known as the strike price, and is specified at the time the parties enter into the option. The option contract also specifies a maturity date.

Each option has a buyer, called the holder, and a seller, known as the writer. In the case of a security that cannot be delivered such as an index, the contract is settled in cash. For the holder, the potential loss is limited to the price paid to acquire the option. When an option is not exercised, it expires.

Types

Call Option

The buyer of a Call option has a right to buy a certain quantity of the underlying asset, at a specified price on or before a given date in the future, he however has no obligation whatsoever to carry out this right. A customer will buy a call option when he believes that underlying asset price will move higher

Put option

The buyer of a Put option has the right to sell a certain quantity of an underlying asset, at a specified price on or before a given date in the future, he however has no obligation whatsoever to carry out this right. A person buys a put option when he believes that asset price will become low

- European option – an option that can be exercised at any time after the expiration date.
- American option – an option that may be exercised on any trading day on or before expiry date.

- Bermudan option – an option that may be exercised only on specified dates on or before expiration.

Benefits of options

- They are means of insurance against adverse price movement
- It provide high leverage as with a small investment in form of premium
- Trading options are cheaper in stock exchange

Key Differences

The major difference between an option and forwards or futures is that the option holder has no obligation to trade, whereas both futures and forwards are legally binding agreements. Also, futures differ from forwards in that they are standardized and the parties meet through an open public exchange, while futures are private agreements between two parties and their terms are therefore not public.

Options can be standardized and traded through an exchange or they can be privately bought or sold, with terms crafted to suit the needs of the parties involved.

4. SWAPS

Swaps are contracts to exchange cash (flows) on or before a specified future date based on the underlying value of currencies exchange rates, bonds/interest rates, commodities exchange, stocks or other assets. It is an agreement between two or more counterparties to exchange sets of cash flows over a period in the future.

A swap is nothing but a barter or exchange A swap is the exchange of one set of cash flows for another. It is a contract between two parties in which the first party promises to make a payment to the second and the second party promises to make a payment to the first. Both payments take place on specified dates.

SUMMARY

- The stock exchange is an organised and centralised market for the purchase and sale of industrial and financial securities of all descriptions, viz., Stocks, Shares, Debentures etc. It is a market for transactions in old securities.
- Practically, it is a place where the buyer of a security may find a seller who is ready to sell his holdings at a fair and reasonable price provided the security has been listed.
- According to the Securities Contracts (Regulations) Act of 1956, a stock exchange 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'.
- Stock Exchange market is a vital component of a stock market. It facilitates the transaction between traders of financial instruments and targeted buyers.

Notes

- A stock exchange in India adheres to a set of rules and regulations directed by Securities and Exchange Board of India or SEBI. The said authoritative body functions to protect the interest of investors and aims to promote the stock market of India.
- A stock exchange is an important factor in the capital market. It is a secure place where trading is done in a systematic way. Here, the securities are bought and sold as per well-structured rules and regulations.
- Securities mentioned here includes debenture and share issued by a public company that is correctly listed at the stock exchange, debenture and bonds issued by the government bodies, municipal and public bodies.
- Typically bonds are traded Over-the-Counter (OTC), but a few corporate bonds are sold in a stock exchange. It can enforce rules and regulation on the brokers and firms that are enrolled with them.
- In other words, a stock exchange is a forum where securities like bonds and stocks are purchased and traded. This can be both an online trading platform and offline (physical location).
- After the new issue or the original issue of securities is complete; securities become secondhand and are traded (i.e. bought and sold) at the floor of the stock exchange-through brokers and other intermediaries.
- The literal meaning of stock exchange is an exchange of stock (or shares and other securities) between buyers and sellers.
- Under the Securities Contract (Regulation) Act, 1956, the term stock exchange is defined "as an association, organisation or body of individuals-, whether incorporated or not-established for the purpose of assisting, regulating and controlling the business in buying, selling and dealing in securities."
- The trading platform of a stock exchange is accessible only to trading members. They play a significant role in the secondary market by bringing together the buyers and the sellers. The brokers give buy/sell orders either on their own account or on behalf of clients. As these buy and sell order matches, the trades are executed.
- The exchange can admit a broker as its member only on the basis of the terms specified in the Securities Contracts (Regulation) Act, 1956, the SEBI Act 1992, the rules, circulars, notifications, guidelines, and the byelaws, rules and regulations of the concerned exchange. No stock broker or sub- broker is allowed to buy, sell or deal in securities, unless he or she holds a certificate of registration from the SEBI.
- Members of London Stock Exchange: The members of London Stock Exchange are divided into two classes: (i) Jobbers, and (ii) Brokers.
- Every member of the exchange has to express clearly whether he would act as a Jobber or as a Broker at the time of his admission. He, however, cannot change his position during the course of the year.
- Major stock exchanges in India There are two major types of Stock Exchanges in India, namely the – Bombay Stock Exchange (BSE): This particular stock exchange was established in 1875 in Mumbai at Dalal Street. It renowned as the oldest stock exchange not just in Asia and is the 'World's 10th largest Stock Exchange'.
- The estimated market capitalisation of Bombay Stock Exchange as of April stands at $ 4.9 Trillion and has around 6000 companies publicly listed under it. The performance of BSE

is measured by the Sensex, and it reached its all-time high in June in 2019, when it touched 40312.07.

- Securities and Exchange Board of India (SEBI) was initially constituted on 12th April, 1988 as a non-statutory body through a resolution of the Government for dealing with all matters relating to the development and regulation of securities market and investor protection and to advices the Government on all these matters.
- The need for manpower is also determined on the basis of work-load analysis, wherein the company tries to calculate the number of persons required for various jobs with reference to a planned output after giving weightage to factors such as absenteeism, idle time, etc.

abc

KEY WORDS

- **Primary market:** This market creates securities and acts as a platform where firms float their new stock options and bonds for the general public to acquire. It is where companies enlist their shares for the first time.
- **Secondary market:** The secondary market is also known as the stock market; it acts as a trading platform for investors. Here, investors trade in securities without involving the companies who issued them in the first place with the help of brokers. This market is further broken down into – auction market and dealer market.
- **Constitution:** It is an association of members which may be a voluntary and non-profit association or company limited by shares or guarantee.
- **Membership:** Membership is a 'must' for transacting business since non-members are not allowed to enter the stock-exchange. Membership is strictly limited, i.e., no one is allowed to be a member unless there is a vacancy.
- **Management:** The general administration of a stock exchange is administered by a committee of management and is called by different names in different exchanges. The selected Executive Committee of different stock exchanges carries on management of their day-to-day activities through sub-committees such as Listing Committee, Defaulters' Committee, Arbitration Committee, etc. A Jobber is an independent dealer in securities, i.e., he deals in securities in his own account. He has no direct contact with the intending purchaser and seller.
- **Authorised Clerks:**A member of the stock exchange can appoint authorised clerks or assistants to assist him. The authorised clerks are merely employees of the members, and cannot do business in their own name.
- **Brokers and Jobbers:**A broker is a commission agent who buys and sells securities on behalf of non-members. He executes the order of his clients and earns commission from them.

Notes

REVIEW QUESTIONS

1. Define stock Exchange . State its major functions.
2. what is online trading ? state its advantages .
3. What are the different types of speculation or speculators.
4. Differentiate between speculation and investment
5. Describe duties of a stock broker
6. Explain settlement cycle
7. What is SENSEX?
8. What do you mean by Depository Participant?

FURTHER READINGS

1. Mukund Sharma , H.R.Appanaiah Stock and Commodity Market-Himalayan Publication International Financial Management.
2. Dr.Preeti Singh ,Stock and Commodity Market- Himalayan Publication International Financial Management khan,Indian Financial System 6th edition ,Tata McGraw Hill
3. Garner, Carley. A Trader's First Book on Commodities. (New Jersey: FT Press, 2010): Futures Trading Act of 1921, Declared unconstitutional in Hill v. Wallace 259 U.S. 44 (1922), the Grain Futures Act of 1922 and Board of Trade of City of Chicago v. Olsen 262 U.S. 1 (1923).
4. Cronon, William. Pricing the Future: Grain. Nature's Metropolis: Chicago and the Great West. University of Chicago, 1991. pp.109-133

UNIT 3

TRADING IN STOCK MARKET

Notes

Structure

3.1 Introduction
3.2 The Trading procedure
3.3 Depositories
3.4 Operators at Stock Exchange
3.5 National Security Depository Limited (NSDL)
3.6 Central Depository Services Limited (CDSL)
3.7 Dematerialisation
Summary
Key Words
Review Questions
Further Readings

3.0 LEARNING OBJECTIVES

After reading this chapter students will be able to:

- Understand the concept and function of stock Exchange
- Discuss the power and function of SEBI .
- Know the concept of NSDL and CDSL
- Explain the concept of Derivatives

3.1 INTRODUCTION

Stock trading refers to the buying and selling of shares in a particular company; if you own the stock, you own a piece of the company.

A stock market, equity market, or share market is the aggregation of buyers and sellers of stocks (also called shares), which represent ownership claims on businesses; these may include securities listed on a public stock exchange, as well as stock that is only traded privately, such as shares of private companies which are sold to investors through equity crowdfunding platforms. Investment in the stock market is most often done via stockbrokerages and electronic trading platforms. Investment is usually made with an investment strategy in mind.

Notes

Stocks can be categorized by the country where the company is domiciled. For example, Nestlé and Novartis are domiciled in Switzerland and traded on the SIX Swiss Exchange, so they may be considered as part of the Swiss stock market, although the stocks may also be traded on exchanges in other countries, for example, as American depositary receipts (ADRs) on U.S. stock markets.

The total market capitalization of equity backed securities worldwide rose from US$2.5 trillion in 1980 to US$68.65 trillion at the end of 2018. As of December 31, 2019, the total market capitalization of all stocks worldwide was approximately US$70.75 trillion.

As of 2016, there are 60 stock exchanges in the world. Of these, there are 16 exchanges with a market capitalization of $1 trillion or more, and they account for 87% of global market capitalization. Apart from the Australian Securities Exchange, these 16 exchanges are all in either North America, Europe, or Asia.

By country, the largest stock markets as of January 2020 are in the United States of America (about 54.5%), followed by Japan (about 7.7%) and the United Kingdom (about 5.1%).

3.2 STOCK MARKET

A stock market, equity market, or share market is the aggregation of buyers and sellers of stocks (also called shares), which represent ownership claims on businesses; these may include securities listed on a public stock exchange, as well as stock that is only traded privately, such as shares of private companies which are sold to investors through equity crowdfunding platforms. Investment in the stock market is most often done via stockbrokerages and electronic trading platforms. Investment is usually made with an investment strategy in mind.

Stocks can be categorized by the country where the company is domiciled. For example, Nestlé and Novartis are domiciled in Switzerland and traded on the SIX Swiss Exchange, so they may be considered as part of the Swiss stock market, although the stocks may also be traded on exchanges in other countries, for example, as American depositary receipts (ADRs) on U.S. stock markets.

Trading in Stock Market

Definition

It is a place where shares of pubic listed companies are traded. The primary market is where companies float shares to the general public in an initial public offering (IPO) to raise capital.

Description

Once new securities have been sold in the primary market, they are traded in the secondary market—where one investor buys shares from another investor at the prevailing market price or at whatever price both the buyer and seller agree upon.

The secondary market or the stock exchanges are regulated by the regulatory authority. In India, the secondary and primary markets are governed by the Security and Exchange Board of India (SEBI).

A stock exchange facilitates stock brokers to trade company stocks and other securities. A stock may be bought or sold only if it is listed on an exchange.

Thus, it is the meeting place of the stock buyers and sellers. India's premier stock exchanges are the Bombay Stock Exchange and the National Stock Exchange. Stock trading refers to the buying and selling of shares in a particular company; if you own the stock, you own a piece of the company.

Notes

Before selling the securities through stock exchange, the companies have to get their securities listed in the stock exchange. The name of the company is included in listed securities only when stock exchange authorities are satisfied with the financial soundness and other aspects of the company.

Previously the buying and selling of securities was done in trading floor of stock exchange; today it is executed through computer.

Size of the markets

The total market capitalization of equity backed securities worldwide rose from US$2.5 trillion in 1980 to US$68.65 trillion at the end of 2018. As of December 31, 2019, the total market capitalization of all stocks worldwide was approximately US$70.75 trillion.

As of 2016, there are 60 stock exchanges in the world. Of these, there are 16 exchanges with a market capitalization of $1 trillion or more, and they account for 87% of global market capitalization. Apart from the Australian Securities Exchange, these 16 exchanges are all in either North America, Europe, or Asia.

By country, the largest stock markets as of January 2020 are in the United States of America (about 54.5%), followed by Japan (about 7.7%) and the United Kingdom (about 5.1%).

Stock exchange

A stock exchange is an exchange (or bourse) where stockbrokers and traders can buy and sell shares (equity stock), bonds, and other securities. Many large companies have their stocks listed on a stock exchange. This makes the stock more liquid and thus more attractive to many investors. The exchange may also act as a guarantor of settlement. These and other stocks may also be traded "over the counter" (OTC), that is, through a dealer. Some large companies will have their stock listed on more than one exchange in different countries, so as to attract international investors.

Stock exchanges may also cover other types of securities, such as fixed-interest securities (bonds) or (less frequently) derivatives, which are more likely to be traded OTC.

Trade in stock markets means the transfer (in exchange for money) of a stock or security from a seller to a buyer. This requires these two parties to agree on a price. Equities (stocks or shares) confer an ownership interest in a particular company.

Participants in the stock market range from small individual stock investors to larger investors, who can be based anywhere in the world, and may include banks, insurance companies, pension funds and hedge funds. Their buy or sell orders may be executed on their behalf by a stock exchange trader.

Some exchanges are physical locations where transactions are carried out on a trading floor, by a method known as open outcry. This method is used in some stock exchanges and commodities exchanges, and involves traders shouting bid and offer prices. The other type of stock exchange has a network of computers where trades are made electronically. An example of such an exchange is the NASDAQ.

A potential buyer bids a specific price for a stock, and a potential seller asks a specific price for the same stock. Buying or selling at the Market means you will accept any ask price or bid price for the stock. When the bid and ask prices match, a sale takes place, on a first-come, first-served basis if there are multiple bidders at a given price.

The purpose of a stock exchange is to facilitate the exchange of securities between buyers and sellers, thus providing a marketplace. The exchanges provide real-time trading information

Notes

on the listed securities, facilitating price discovery.

The New York Stock Exchange (NYSE) is a physical exchange, with a hybrid market for placing orders electronically from any location as well as on the trading floor. Orders executed on the trading floor enter by way of exchange members and flow down to a floor broker, who submits the order electronically to the floor trading post for the Designated market maker ("DMM") for that stock to trade the order.

The DMM's job is to maintain a two-sided market, making orders to buy and sell the security when there are no other buyers or sellers. If a bid-ask spread exists, no trade immediately takes place – in this case the DMM may use their own resources (money or stock) to close the difference. Once a trade has been made, the details are reported on the "tape" and sent back to the brokerage firm, which then notifies the investor who placed the order. Computers play an important role, especially for program trading.

The NASDAQ is an electronic exchange, where all of the trading is done over a computer network. The process is similar to the New York Stock Exchange. One or more NASDAQ market makers will always provide a bid and ask the price at which they will always purchase or sell 'their' stock.

The Paris Bourse, now part of Euronext, is an order-driven, electronic stock exchange. It was automated in the late 1980s. Prior to the 1980s, it consisted of an open outcry exchange. Stockbrokers met on the trading floor of the Palais Brongniart. In 1986, the CATS trading system was introduced, and the order matching system was fully automated.

People trading stock will prefer to trade on the most popular exchange since this gives the largest number of potential counter parties (buyers for a seller, sellers for a buyer) and probably the best price. However, there have always been alternatives such as brokers trying to bring parties together to trade outside the exchange.

Some third markets that were popular are Instinet, and later Island and Archipelago (the latter two have since been acquired by Nasdaq and NYSE, respectively). One advantage is that this avoids the commissions of the exchange. However, it also has problems such as adverse selection. Financial regulators have probed dark pools.

Market Participants

Market participants include individual retail investors, institutional investors (e.g., pension funds, insurance companies, mutual funds, index funds, exchange-traded funds, hedge funds, investor groups, banks and various other financial institutions), and also publicly traded corporations trading in their own shares. Robo-advisors, which automate investment for individuals are also major participants.

Demographics of market participation

Indirect vs. Direct Investment

Indirect investment involves owning shares indirectly, such as via a mutual fund or an exchange traded fund. Direct investment involves direct ownership of shares.

Direct ownership of stock by individuals rose slightly from 17.8% in 1992 to 17.9% in 2007, with the median value of these holdings rising from $14,778 to $17,000. Indirect participation in the form of retirement accounts rose from 39.3% in 1992 to 52.6% in 2007, with the median value of these accounts more than doubling from $22,000 to $45,000 in that time.

Rydqvist, Spizman, and Strebulaev attribute the differential growth in direct and indirect

Notes

holdings to differences in the way each are taxed in the United States. Investments in pension funds and 401ks, the two most common vehicles of indirect participation, are taxed only when funds are withdrawn from the accounts.

Conversely, the money used to directly purchase stock is subject to taxation as are any dividends or capital gains they generate for the holder. In this way the current tax code incentivizes individuals to invest indirectly.

Participation by income and wealth strata

- Rates of participation and the value of holdings differ significantly across strata of income. In the bottom quintile of income, 5.5% of households directly own stock and 10.7% hold stocks indirectly in the form of retirement accounts.
- The top decile of income has a direct participation rate of 47.5% and an indirect participation rate in the form of retirement accounts of 89.6%.
- The median value of directly owned stock in the bottom quintile of income is $4,000 and is $78,600 in the top decile of income as of 2007. The median value of indirectly held stock in the form of retirement accounts for the same two groups in the same year is $6,300 and $214,800 respectively.
- Since the Great Recession of 2008 households in the bottom half of the income distribution have lessened their participation rate both directly and indirectly from 53.2% in 2007 to 48.8% in 2013, while over the same period households in the top decile of the income distribution slightly increased participation 91.7% to 92.1%.
- The mean value of direct and indirect holdings at the bottom half of the income distribution moved slightly downward from $53,800 in 2007 to $53,600 in 2013. In the top decile, mean value of all holdings fell from $982,000 to $969,300 in the same time. The mean value of all stock holdings across the entire income distribution is valued at $269,900 as of 2013.

Participation by race and gender

- The racial composition of stock market ownership shows households headed by whites are nearly four and six times as likely to directly own stocks than households headed by blacks and Hispanics respectively.
- As of 2011 the national rate of direct participation was 19.6%, for white households the participation rate was 24.5%, for black households it was 6.4% and for Hispanic households it was 4.3%.
- Indirect participation in the form of 401k ownership shows a similar pattern with a national participation rate of 42.1%, a rate of 46.4% for white households, 31.7% for black households, and 25.8% for Hispanic households.
- Households headed by married couples participated at rates above the national averages with 25.6% participating directly and 53.4% participating indirectly through a retirement account. 14.7% of households headed by men participated in the market directly and 33.4% owned stock through a retirement account. 12.6% of female-headed households directly owned stock and 28.7% owned stock indirectly.

Determinants and possible explanations of stock market participation

- In a 2003 paper by Vissing-Jørgensen attempts to explain disproportionate rates of participation along wealth and income groups as a function of fixed costs associated with investing.
- Her research concludes that a fixed cost of $200 per year is sufficient to explain why nearly half of all U.S. households do not participate in the market.

Notes

- Participation rates have been shown to strongly correlate with education levels, promoting the hypothesis that information and transaction costs of market participation are better absorbed by more educated households.
- Behavioral economists Harrison Hong, Jeffrey Kubik and Jeremy Stein suggest that sociability and participation rates of communities have a statistically significant impact on an individual's decision to participate in the market.
- Their research indicates that social individuals living in states with higher than average participation rates are 5% more likely to participate than individuals that do not share those characteristics.
- This phenomenon also explained in cost terms. Knowledge of market functioning diffuses through communities and consequently lowers transaction costs associated with investing.

History

The term bourse is derived from the 13th-century inn named "Huis ter Beurze" (center) in Bruges. From predominantly Dutch-speaking cities of the Low Countries (like Bruges and Antwerp), the term 'beurs' spread to other European states where it was corrupted into 'bourse', 'borsa', 'bolsa', 'börse', etc.

Early history

In 12th-century France, the courtiers de change were concerned with managing and regulating the debts of agricultural communities on behalf of the banks. Because these men also traded with debts, they could be called the first brokers.

The Italian historian Lodovico Guicciardini described how, in late 13th-century Bruges, commodity traders gathered outdoors at a market square containing an inn owned by a family called Van der Beurze, and in 1409 they became the "Brugse Beurse", institutionalizing what had been, until then, an informal meeting.

The idea quickly spread around Flanders and neighboring countries and "Beurzen" soon opened in Ghent and Rotterdam. International traders, and specially the Italian bankers, present in Bruges since the early 13th-century, took back the word in their countries to define the place for stock market exchange: first the Italians (Borsa), but soon also the French (Bourse), the Germans (börse), Russians (birža), Czechs (burza), Swedes (börs), Danes and Norwegians (børs).

In most languages the word coincides with that for money bag, dating back to the Latin bursa, from which obviously also derives the name of the Van der Beurse family.

In the middle of the 13th century, Venetian bankers began to trade in government securities. In 1351 the Venetian government outlawed spreading rumors intended to lower the price of government funds. Bankers in Pisa, Verona, Genoa and Florence also began trading in government securities during the 14th century.

This was only possible because these were independent city-states not ruled by a duke but a council of influential citizens. Italian companies were also the first to issue shares. Companies in England and the Low Countries followed in the 16th century.

Around this time, a joint stock company—one whose stock is owned jointly by the shareholders—emerged and became important for colonization of what Europeans called the "New World".

Birth of formal stock markets

Replica of an East Indiaman of the Dutch East India Company/United East Indies Company (VOC). The Dutch East India Company was the first corporation to be listed on an official

stock exchange. In 1611, the world's first stock exchange (in its modern sense) was launched by the VOC in Amsterdam. In Robert Shiller's own words, the VOC was "the first real important stock" in the history of finance.

One of the oldest known stock certificates, issued by the VOC chamber of Enkhuizen, dated 9 Sep 1606. The first formal stock market in its modern sense – as one of the indispensable elements of modern capitalism – was a pioneering innovation by the VOC managers and shareholders in the early 1600s.

A 17th-century engraving depicting the Amsterdam Stock Exchange (Amsterdam's old bourse, a.k.a. Beurs van Hendrick de Keyser in Dutch), built by Hendrick de Keyser (c. 1612).

The Amsterdam Stock Exchange was the world's first official (formal) stock exchange when it began trading the VOC's freely transferable securities, including bonds and shares of stock.

Courtyard of the Amsterdam Stock Exchange (Beurs van Hendrick de Keyser) by Emanuel de Witte, 1653. The Amsterdam Stock Exchange is said to have been the first stock exchange to introduce continuous trade in the early 17th century.

The process of buying and selling the VOC's shares, on the Amsterdam Stock Exchange, became the basis of the world's first official (formal) stock market. (...) This enigmatic business [i.e. the inner workings of the stock exchange in Amsterdam, primarily the practice of VOC and WIC stock trading] which is at once the fairest and most deceitful in Europe, the noblest and the most infamous in the world, the finest and the most vulgar on earth. It is a quintessence of academic learning and a paragon of fraudulence; it is a touchstone for the intelligent and a tombstone for the audacious, a treasury of usefulness and a source of disaster, (...).

The stock market — the daytime adventure serial of the well-to-do — would not be the stock market if it did not have its ups and downs. (...) And it has many other distinctive characteristics.

Apart from the economic advantages and disadvantages of stock exchanges — the advantage that they provide a free flow of capital to finance industrial expansion, for instance, and the disadvantage that they provide an all too convenient way for the unlucky, the imprudent, and the gullible to lose their money — their development has created a whole pattern of social behavior, complete with customs, language, and predictable responses to given events.

What is truly extraordinary is the speed with which this pattern emerged full blown following the establishment, in 1611, of the world's first important stock exchange — a roofless courtyard in Amsterdam — and the degree to which it persists (with variations, it is true) on the New York Stock Exchange in the nineteen-sixties.

Present-day stock trading in the United States — a bewilderingly vast enterprise, involving millions of miles of private telegraph wires, computers that can read and copy the Manhattan Telephone Directory in three minutes, and over twenty million stockholder participants — would seem to be a far cry from a handful of seventeenth-century Dutchmen haggling in the rain.

But the field marks are much the same. The first stock exchange was, inadvertently, a laboratory in which new human reactions were revealed. By the same token, the New York Stock Exchange is also a sociological test tube, forever contributing to the human species' self-understanding. The behaviour of the pioneering Dutch stock traders is ably documented in a book entitled "Confusion of Confusions," written by a plunger on the

Notes

Amsterdam market named Joseph de la Vega; originally published in 1688, (...)

Business ventures with multiple shareholders became popular with commenda contracts in medieval Italy (Greif, 2006, p. 286), and Malmendier (2009) provides evidence that shareholder companies date back to ancient Rome.

Yet the title of the world's first stock market deservedly goes to that of seventeenth-century Amsterdam, where an active secondary market in company shares emerged. The two major companies were the Dutch East India Company and the Dutch West India Company, founded in 1602 and 1621.

Other companies existed, but they were not as large and constituted a small portion of the stock market.

In the 17th and 18th centuries, the Dutch pioneered several financial innovations that helped lay the foundations of the modern financial system. While the Italian city-states produced the first transferable government bonds, they did not develop the other ingredient necessary to produce a fully fledged capital market: the stock market. In the early 1600s the Dutch East India Company (VOC) became the first company in history to issue bonds and shares of stock to the general public.

As Edward Stringham (2015) notes, "companies with transferable shares date back to classical Rome, but these were usually not enduring endeavors and no considerable secondary market existed (Neal, 1997, p. 61)."

The Dutch East India Company (founded in the year of 1602) was also the first joint-stock company to get a fixed capital stock and as a result, continuous trade in company stock occurred on the Amsterdam Exchange. Soon thereafter, a lively trade in various derivatives, among which options and repos, emerged on the Amsterdam market.

Dutch traders also pioneered short selling – a practice which was banned by the Dutch authorities as early as 1610. Amsterdam-based businessman Joseph de la Vega's Confusion de Confusiones (1688) was the earliest known book about stock trading and first book on the inner workings of the stock market (including the stock exchange).

Crowd gathering on Wall Street (New York City) after the 1929 crash, one of the worst stock market crashes in history. There are now stock markets in virtually every developed and most developing economies, with the world's largest markets being in the United States, United Kingdom, Japan, India, China, Canada, Germany (Frankfurt Stock Exchange), France, South Korea and the Netherlands.

Importance

- Even in the days before perestroika, socialism was never a monolith. Within the Communist countries, the spectrum of socialism ranged from the quasi-market, quasi-syndicalist system of Yugoslavia to the centralized totalitarianism of neighboring Albania.
- One time I asked Professor von Mises, the great expert on the economics of socialism, at what point on this spectrum of statism would he designate a country as "socialist" or not. At that time, I wasn't sure that any definite criterion existed to make that sort of clear-cut judgment. And so I was pleasantly surprised at the clarity and decisiveness of Mises's answer.
- "A stock market," he answered promptly. "A stock market is crucial to the existence of capitalism and private property.
- For it means that there is a functioning market in the exchange of private titles to the means of production. There can be no genuine private ownership of capital without a stock market: there can be no true socialism if such a market is allowed to exist."

Function and Purpose

Notes

- The stock market is one of the most important ways for companies to raise money, along with debt markets which are generally more imposing but do not trade publicly. This allows businesses to be publicly traded, and raise additional financial capital for expansion by selling shares of ownership of the company in a public market.
- The liquidity that an exchange affords the investors enables their holders to quickly and easily sell securities. This is an attractive feature of investing in stocks, compared to other less liquid investments such as property and other immoveable assets.
- History has shown that the price of stocks and other assets is an important part of the dynamics of economic activity, and can influence or be an indicator of social mood. An economy where the stock market is on the rise is considered to be an up-and-coming economy. The stock market is often considered the primary indicator of a country's economic strength and development.
- Rising share prices, for instance, tend to be associated with increased business investment and vice versa. Share prices also affect the wealth of households and their consumption. Therefore, central banks tend to keep an eye on the control and behavior of the stock market and, in general, on the smooth operation of financial system functions. Financial stability is the raison d'être of central banks.
- Exchanges also act as the clearinghouse for each transaction, meaning that they collect and deliver the shares, and guarantee payment to the seller of a security. This eliminates the risk to an individual buyer or seller that the counterparty could default on the transaction.
- The smooth functioning of all these activities facilitates economic growth in that lower costs and enterprise risks promote the production of goods and services as well as possibly employment. In this way, the financial system is assumed to contribute to increased prosperity, although some controversy exists as to whether the optimal financial system is bank-based or market-based.
- Recent events such as the Global Financial Crisis have prompted a heightened degree of scrutiny of the impact of the structure of stock markets (called market microstructure), in particular to the stability of the financial system and the transmission of systemic risk.

Behavior of stock prices

Changes in stock prices are mostly caused by external factors such as socioeconomic conditions, inflation, exchange rates. Intellectual capital does not affect a company stock's current earnings. Intellectual capital contributes to a stock's return growth. When a government adds a lot of money to the economy, then the economy will do pretty well.

See Stock market cycles.

- The efficient-market hypothesis (EMH) is a hypothesis in financial economics that states that asset prices reflect all available information at the current time.
- The 'hard' efficient-market hypothesis does not explain the cause of events such as the crash in 1987, when the Dow Jones Industrial Average plummeted 22.6 percent—the largest-ever one-day fall in the United States.[55]
- This event demonstrated that share prices can fall dramatically even though no generally agreed upon definite cause has been found: a thorough search failed to detect any 'reasonable' development that might have accounted for the crash.

(Note that such events are predicted to occur strictly by randomness, although very rarely.)

Notes

- It seems also to be true more generally that many price movements (beyond those which are predicted to occur 'randomly') are not occasioned by new information; a study of the fifty largest one-day share price movements in the United States in the post-war period seems to confirm this.
- A 'soft' EMH has emerged which does not require that prices remain at or near equilibrium, but only that market participants cannot systematically profit from any momentary 'market anomaly'.
- Moreover, while EMH predicts that all price movement (in the absence of change in fundamental information) is random (i.e. non-trending), many studies have shown a marked tendency for the stock market to trend over time periods of weeks or longer. Various explanations for such large and apparently non-random price movements have been promulgated.
- For instance, some research has shown that changes in estimated risk, and the use of certain strategies, such as stop-loss limits and value at risk limits, theoretically could cause financial markets to overreact. But the best explanation seems to be that the distribution of stock market prices is non-Gaussian (in which case EMH, in any of its current forms, would not be strictly applicable).
- Other research has shown that psychological factors may result in exaggerated (statistically anomalous) stock price movements (contrary to EMH which assumes such behaviors 'cancel out'). Psychological research has demonstrated that people are predisposed to 'seeing' patterns, and often will perceive a pattern in what is, in fact, just noise, e.g. seeing familiar shapes in clouds or ink blots.
- In the present context, this means that a succession of good news items about a company may lead investors to overreact positively, driving the price up. A period of good returns also boosts the investors' self-confidence, reducing their (psychological) risk threshold.
- Another phenomenon—also from psychology—that works against an objective assessment is group thinking. As social animals, it is not easy to stick to an opinion that differs markedly from that of a majority of the group.
- An example with which one may be familiar is the reluctance to enter a restaurant that is empty; people generally prefer to have their opinion validated by those of others in the group.
- In one paper the authors draw an analogy with gambling. In normal times the market behaves like a game of roulette; the probabilities are known and largely independent of the investment decisions of the different players.
- In times of market stress, however, the game becomes more like poker (herding behavior takes over). The players now must give heavy weight to the psychology of other investors and how they are likely to react psychologically.
- In the period running up to the 1987 crash, less than 1 percent of the analysts' recommendations had been to sell (and even during the 2000–2002 bear market, the average did not rise above 5%).
- In the run-up to 2000, the media amplified the general euphoria, with reports of rapidly rising share prices and the notion that large sums of money could be quickly earned in the so-called new economy stock market.
- Stock markets play an essential role in growing industries that ultimately affect the economy through transferring available funds from units that have excess funds (savings) to those who are suffering from funds deficit (borrowings).

Notes

- In other words, capital markets facilitate funds movement between the above-mentioned units. This process leads to the enhancement of available financial resources which in turn affects the economic growth positively.
- Economic and financial theories argue that stock prices are affected by macroeconomic trends. Macroeconomic trends include such as changes in GDP, unemployment rates, national income, price indices, output, consumption, unemployment, inflation, saving, investment, energy, international trade, immigration, productivity, aging populations, innovations, international finance. increasing corporate profit, increasing profit margins, higher concentration of business, lower company income, less vigorous activity, less progress, lower investment rates, lower productivity growth, less employee share of corporate revenues, decreasing Worker to Beneficiary ratio (year 1960 5:1, year 2009 3:1, year 2030 2.2:1), increasing female to male ratio college graduates.
- Many different academic researchers have stated that companies with low P/E ratios and smaller-sized companies have a tendency to outperform the market. Research has shown that mid-sized companies outperform large cap companies, and smaller companies have higher returns historically.

Irrational behavior

Sometimes, the market seems to react irrationally to economic or financial news, even if that news is likely to have no real effect on the fundamental value of securities itself. However, this market behaviour may be more apparent than real, since often such news was anticipated, and a counter reaction may occur if the news is better (or worse) than expected.

Therefore, the stock market may be swayed in either direction by press releases, rumors, euphoria and mass panic.

Over the short-term, stocks and other securities can be battered or buoyed by any number of fast market-changing events, making the stock market behavior difficult to predict. Emotions can drive prices up and down, people are generally not as rational as they think, and the reasons for buying and selling are generally accepted.

Behaviorists argue that investors often behave irrationally when making investment decisions thereby incorrectly pricing securities, which causes market inefficiencies, which, in turn, are opportunities to make money.

However, the whole notion of EMH is that these non-rational reactions to information cancel out, leaving the prices of stocks rationally determined.

The Dow Jones Industrial Average biggest gain in one day was 936.42 points or 11%.

3.3 STOCK EXCHANGE

A stock exchange is an institution which provides a platform for buying and selling of existing securities. As a market, the stock exchange facilitates the exchange of a security (share, debenture etc.) into money and vice versa. Stock exchanges help companies raise finance, provide liquidity and safety of investment to the investors and enhance the credit worthiness of individual companies.

Meaning of Stock Exchange

According to Securities Contracts (Regulation) Act 1956, stock exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying and selling or dealing in securities.

Notes

Functions of a Stock Exchange

The efficient functioning of a stock exchange creates a conducive climate for an active and growing primary market for new issues. An active and healthy secondary market in existing securities leads to positive environment among investors.

The following are some of the important functions of a stock exchange.

1. Providing Liquidity and Marketability to Existing Securities: The basic function of a stock exchange is the creation of a continuous market where securities are bought and sold. It gives investors the chance to disinvest and reinvest. This provides both liquidity and easy marketability to already existing securities in the market.
2. Pricing of Securities: Share prices on a stock exchange are determined by the forces of demand and supply. A stock exchange is a mechanism of constant valuation through which the prices of securities are determined. Such a valuation provides important instant information to both buyers and sellers in the market.
3. Safety of Transaction: The membership of a stock exchange is wellregulated and its dealings are well defined according to the existing legal framework. This ensures that the investing public gets a safe and fair deal on the market.
4. Contributes to Economic Growth: A stock exchange is a market in which existing securities are resold or traded. Through this process of disinvestment and reinvestment savings get channelised into their most productive investment avenues. This leads to capital formation and economic growth.
5. Spreading of Equity Cult: The stock exchange can play a vital role in ensuring wider share ownership by regulating new issues, better tradingpractices and taking effective steps in educating the public about investments.
6. Providing Scope for Speculation: The stock exchange provides sufficient scope within the provisions of law for speculative activity in a restricted and controlled manner. It is generally accepted that a certain degree of healthy speculation is necessary to ensure liquidity and price continuity in the stock market.

History of the Stock Market in India

The history of the stock market in India goes back to the end of the eighteenth century when long-term negotiable securities were first issued. In 1850 the Companies Act was introduced for the first time bringing with it the feature of limited liability and generating investor interest in corporate securities. The first stock exchange in India was set-up in 1875 as The Native Share and Stock Brokers Association in Bombay. Today it is known as the Bombay Stock Exchange (BSE). This was followed by the development of exchanges in Ahmedabad (1894), Calcutta(1908) and Madras(1937). It is interesting to note that stock exchanges were first set up in major centers of trade and commerce. Until the early 1990s, the Indian secondary market comprised regional stock exchanges with BSE heading the list. After the reforms of 1991, the Indian secondary market acquired a three tier form. This consists of:

- Regional Stock Exchanges
- National Stock Exchange (NSE)
- Over the Counter Exchange of India (OTCEI)

Trading and Settlement Procedure

Trading in securities is now executed through an on-line, screen-based electronic trading system. Simply put, all buying and selling of shares and debentures are done through a computer terminal. There was a time when in the open outcry system, securities were bought and sold on the floor of the stock exchange. Under this auction system, deals were struck among brokers, prices were shouted out and the shares sold to the highest bidder.

However, now almost all exchanges have gone electronic and trading is done in the broker's office through a computer terminal. A stock exchange has its main computer system with many terminals spread across the country. Trading in securities is done through brokers who are members of the stock exchange. Trading has shifted from the stock market floor to the brokers office.

Every broker has to have access to a computer terminal that is connected to the main stock exchange. In this screen-based trading, a member logs on to the site and any information about the shares (company, member, etc.) he wishes to buy or sell and the price is fed into the computer. The software is so designed that the transaction will be executed when a matching order is found from a counter party.

The whole transaction is carried on the computer screen with both the parties being able to see the prices of all shares going up and down at all times during the time that business is transacted and during business hours of the stock exchange.

The computer in the brokers office is constantly matching the orders at the best bid and offer price. Those that are not matched remain on the screen and are open for future matching during the day.

Electronic trading systems or screen-based trading has certain advantages:

1. It ensures transparency as it allows participants to see the prices of all securities in the market while business is being transacted. They are able to see the full market during real time.
2. It increases efficiency of information being passed on, thus helping in fixing prices efficiently. The computer screens display information on prices and also capital market developments that influence share prices.
3. It increases the efficiency of operations, since there is reduction in time, cost and risk of error.
4. People from all over the country and even abroad who wish to participate in the stock market can buy or sell securities through brokers or members without knowing each other. That is, they can sit in the broker's office, log on to the computer at the same time and buy or sell securities. This system has enabled a large number of participants to trade with each other, thereby improving the liquidity of the market.
5. A single trading platform has been provided as business is transacted at the same time in all the trading centres.

   Thus, all the trading centres spread all over the country have been brought onto one trading platform, i.e., the stock exchange, on the computer.

   Now, screen-based trading or on-line trading is the only way in which you can buy or sell shares. Shares can be held either in physical form or an electronic book entry form of holding and transferring shares can also be adopted. This electronic form is called dematerialised form.

Notes

Steps in the Trading and Settlement Procedure

It has been made compulsory to settle all trades within 2 days of the trade date, i.e., on a T+2 basis, since 2003. Prior to the reforms, securities were bought and sold, i.e., traded and all positions in the stock exchange were settled on a weekly/fortnightly settlement cycle whether it was delivery of securities or payment of cash. This system prevailed for a long time as it increased the volume of trading on the exchange and provided liquidity to the system.

However, since trades were to be settled on specified dates, this gave rise to speculation and price of shares used to rise and fall suddenly due to trading and defaults by brokers. A new system, i.e, rolling settlement, was introduced in 2000, so that whenever a trade took place it would be settled after some days.

Since 2003, all shares have to be covered under the rolling settlement system on a T+2 basis, meaning thereby that transactions in securities are settled within 2 days after the trade date. Since rolling settlement implies fast movement of shares, it requires effective implementation of electronic fund transfer and dematerialisation of shares.

The following steps are involved in the screen-based trading for buying and selling of securities:

1. If an investor wishes to buy or sell any security he has to first approach a registered broker orsub-broker and enter into an agreement with him. The investor has to sign a broker-client agreement and a client registration form before placing an order to buy or sell securities. He has also to provide certain other details and information. These include:
   - PAN number (This is mandatory)
   - Date of birth and address.
   - Educational qualification and occupation.
   - Residential status (Indian/NRI).
   - Bank account details.
   - Depository account details.
   - Name of any other broker with whom registered.
   - Client code number in the client registration form.

   The broker then opens a trading account in the name of the investor.
2. The investor has to open a 'demat' account or 'beneficial owner' (BO) account with a depository participant (DP) for holding and transferring securities in the demat form. He will also have to open a bank account for cash transactions in the securities market.
3. The investor then places an order with the broker to buy or sell shares. Clear instructions have to be given about the number of shares and the price at which the shares should be bought or sold.

   The broker will then go ahead withthe deal at the above mentioned price or the best price available. An order confirmation slip is issued to the investor by the broker.
4. The broker then will go on-line and connect to the main stock exchange and match the share and best price available.
5. When the shares can be bought or sold at the price mentioned, it will be communicated to the broker's terminal and the order will be executed electronically. The broker will issue a trade confirmation slip to the investor.
6. After the trade has been executed, within 24 hours the broker issues a Contract Note. This

Notes

note contains details of the number of shares bought or sold, the price, the date and time of deal, and the brokerage charges. This is an important document as it is legally enforceable and helps to settle disputes/claims between the investor and the broker. A Unique Order Code number is assigned to each transaction by the stock exchange and is printed on the contract note.

7. Now, the investor has to deliver the shares sold or pay cash for the shares bought. This should be done immediately after receiving the contract note or before the day when the broker shall make payment or delivery of shares to the exchange. This is called the pay-in day.
8. Cash is paid or securities are delivered on pay-in day, which is before the T+2 day as the deal has to be settled and finalised on the T+2 day. The settlement cycle is on T+2 day on a rolling settlement basis, w.e.f. 1 April 2003.
9. On the T+2 day, the exchange will deliver the share or make payment to the other broker. This is called the pay-out day. The broker then has to make payment to the investor within 24 hours of the payout day since he has already received payment from the exchange.
10. The broker can make delivery of shares in demat form directly to the investor's demat account. The investor has to give details of his demat account and instruct his depository participant to take delivery of securities directly in hisbeneficial owner account.

Dematerialisation and Depositories

All trading in securities is now done through computer terminals. Since all systems are computerised, buying and selling of securities are settled through an electronic book entry form. This is mainly done to eliminate problems like theft, fake/forged transfers, transfer delays and paperwork associated with share certificates or debentures held in physical form.

This is a process where securities held by the investor in the physical form are cancelled and the investor is given an electronic entry or number so that she/he can hold it as an electronic balance in an account. This process of holding securities in an electronic form is called dematerialisation.

For this, the investor has to open a demat account with an organisation called a depository. In fact, now all Initial Public Offers (IPOs) are issued in dematerialisation form and more than 99% of the turnover is settled by delivery in the demat form.

The Securities and Exchange Board of India (SEBI) has made it mandatory for the settlement procedures to take place in demat form in certain select securities. Holding shares in demat form is very convenient as it is just like a bank account.

Physical shares can be converted into electronic form or electronic holdings can be reconverted into physical certificates (rematerialisation). Dematerialisation enables shares to be transferred to some other account just like cash and ensures settlement of all trades through a single account in shares.

These demat securities can even be pledged or hypothecated to get loans. There is no danger of loss, theft or forgery of share certificates. It is the broker's responsibility to credit the investor's account with the correct number of shares.

Working of the Demat System

1. A depository participant (DP), either a bank, broker, or financial services company, may be

Notes

identified.

2. An account opening form and documentation (PAN card details, photograph, power of attorney) may be completed.
3. The physical certificate is to be given to the DP along with a dematerialisation request form.
4. If shares are applied in a public offer, simple details of DP and demat account are to be given and the shares on allotment would automatically be credited to the demat account.
5. If shares are to be sold through a broker, the DP is to be instructed to debit the account with the number of shares.
6. The broker then gives instruction to his DP for delivery of the shares to the stock exchange.
7. The broker then receives payment and pay the person for the shares sold.
8. All these transactions are to be completed within 2 days, i.e., delivery of shares and payment received from the buyer is on a T+2 basis, settlement period.

Depository

Just like a bank keeps money in safe custody for customers, a depository also is like a bank and keeps securities in electronic form on behalf of the investor. In the depository a securities account can be opened, all shares can be deposited, they can be withdrawn/ sold at any time and instruction to deliver or receive shares on behalf of the investor can be given. It is a technology driven electronic storage system. It has no paper work relating to share certificates, transfer, forms, etc. All transactions of the investors are settled with greater speed, efficiency and use as all securities are entered in a book entry mode.

In India, there are two depositories. National Securities Depositories Limited (NSDL) is the first and largest depository presently operational in India. It was promoted as a joint venture of the IDBI, UTI, and the National Stock Exchange.

The Central Depository Services Limited (CDSL) is the second depository to commence operations and was promoted by the Bombay Stock Exchange and the Bank of India.

Both these national level depositories operate through intermediaries who are electronically connected to the depository and serve as contact points with the investors and are called depository participants.

The depository participant (DP) serves as an intermediary between the investor and the Depository (NSDL or CSDL) who is authorised to maintain the accounts of dematerialised shares.

Financial institutions, banks, clearing corporations, stock brokers and nonbanking finance corporations are permitted to become depository participants. If the investor is buying and selling the securities through the broker or the bank or a non-banking finance corporation, it acts as a DP for the investor and complete the formalities.

National Stock Exchange of India (NSE)

The National Stock Exchange is the latest, most modern and technology driven exchange. It was incorporated in 1992 and was recognised as a stock exchange in April 1993. It started operations in 1994, with trading on the wholesale debt market segment.

Subsequently, it launched the capital market segment in November 1994 as a trading platform for equities and the futures and options segment in June 2000 for various derivative instruments.

Notes

NSE has set up a nationwide fully automated screen based trading system. The NSE was set up by leading financial institutions, banks, insurance companies and other financial intermediaries. It is managed by professionals, who do not directly or indirectly trade on the exchange. The trading rights are with the trading members who offer their services to the investors. The Board of NSE comprises senior executives from promoter institutions and eminent professionals, without having any representation from trading members.

Objectives of NSE

NSE was set up with the following objectives:

a. Establishing a nationwide trading facility for all types of securities.

b. Ensuring equal access to investors all over the country through an appropriate communication network.

c. Providing a fair, efficient and transparent securities market using electronic trading system.

d. Enabling shorter settlement cycles and book entry settlements.

e. Meeting international benchmarks and standards.

Within a span of ten years, NSE has been able to achieve its objectives for which it was set up. It has been playing a leading role as a change agent in transforming the Indian capital market.

STOCK MARKET INDEX

A stock market index is a barometer of market behaviour. It measures overall market sentiment through a set of stocks that are representative of the market. It reflects market direction and indicates day-to-day fluctuations in stock prices. An ideal index must represent changes in the prices of securities and reflect price movements of typical shares for better market representation. In the Indian markets the BSE, SENSEX and NSE, NIFTY are important indices.

Some important global stock market indices are:

- Dow Jones Industrial Average is among the oldest quoted stock market index in the US.
- NASDAQ Composite Index is the market capitalisation weightages of prices for stocks listed in the NASDAQ stock market.
- S and P 500 Index is made up of 500 biggest publicly traded companies in the US. The S and P 500 is often treated as a proxy for the US stock market.
- FTSE 100 consists of the largest 100 companies by full market value listed on the London Stock Exchange. The FTSE 100 is the benchmark index of the European market.

NSE has been able to take the stock market to the door step of the investors.

It has ensured that technology has been harnessed to deliver the services to the investors across the country at the lowest cost.

It has provided a nation wide screen based automated trading system with a high degree of transparency and equal access to investors irrespective of geographical location.

Notes

Market Segments of NSE

The Exchange provides trading in the following two segments.

(i) **Whole Sale Debt Market Segment:** This segment provides a trading platform for a wide range of fixed income securities that include central government securities, treasury bills, state development loans, bonds issued by public sector undertakings, floating rate bonds, zero coupon bonds, index bonds, commercial paper, certificate of deposit, corporate debentures and mutual funds.

(ii) **Capital Market Segment:** The capital market segment of NSE provides an efficient and transparent platform for trading in equity, preference, debentures, exchange traded funds as well as retail Government securities.

Over the Counter Exchange of India (OTCEI)

The OTCEI is a company incorporated under the Companies Act 1956. It was set-up to provide small and medium companies an access to the capital market for raising finance in a cost effective manner. It was also meant to provide investors with a convenient, transparent and efficient avenue for capital market investment. It is fully computerised, transparent, single window exchange which commenced trading in 1992.

This exchange is established on the lines of NASDAQ (National Association of Securities Dealers Automated Quotations) the OTC exchange in USA. It has been promoted by UTI, ICICI, IDBI, IFCI, LIC, GIC, SBI Capital markets and Can Bank Financial Services.

Over the counter market may be defined as a place where buyers seeksellers and vice-versa and then attempt to arrange terms and conditions for purchase/sale acceptable to both the parties. It is a negotiated market place that exists any where as opposed to the auction market place, represented by the activity on securities exchanges.

Thus, in the OTC exchange, trading takes place when a buyer or seller walks up to an OTCEI counter, taps on the computer screen, finds quotes andeffects a purchase or sale depending on whether the prices meet their targets. There is no particular market place in the geographical sense.

The objectives of OTCEI are to provide quicker liquidity to securities at afixed and fair price, liquidity for less traded securities or that of small companies, a simplified process of buying and selling and easy and cheaper means of making public sale of new issues. However, the OTCEI has now been withdrawn.

Advantages of OTC Market

1. It provides a trading platform to smaller and less liquid companies as they are not eligible for listing on a regular exchange.
2. It is a cost effective method for corporates as there is a lower cost of new issues and lower expenses of servicing the investors.
3. Family concerns and closely held companies can go public through OTC.
4. Dealers can operate both in new issues and secondary market at their option.
5. It gives greater freedom of choice to investors to choose stocks by dealers for market making in both primary and secondary markets.
6. It is a transparent system of trading with no problem of bad or short deliveries.
7. Information flows are free and more direct from market makers to customers since there is close contact between them.

3.4 THE TRADING PROCEDURE

Notes

The Trading procedure involves the following steps:

1. **Selection of a broker:**

   The buying and selling of securities can only be done through SEBI registered brokers who are members of the Stock Exchange. The broker can be an individual, partnership firms or corporate bodies. So the first step is to select a broker who will buy/sell securities on behalf of the investor or speculator.

2. **Opening Demat Account with Depository:**

   Demat (Dematerialized) account refer to an account which an Indian citizen must open with the depository participant (banks or stock brokers) to trade in listed securities in electronic form.

   Second step in trading procedure is to open a Demat account. The securities are held in the electronic form by a depository.

   Depository is an institution or an organization which holds securities (e.g. Shares, Debentures, Bonds, Mutual (Funds, etc.) At present in India there are two depositories: NSDL (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.)

   There is no direct contact between depository and investor. Depository interacts with investors through depository participants only.

   Depository participant will maintain securities account balances of investor and intimate investor about the status of their holdings from time to time.

3. **Placing the Order:**

   After opening the Demat Account, the investor can place the order. The order can be placed to the broker either (DP) personally or through phone, email, etc.

4. **Executing the Order:**

   As per the Instructions of the investor, the broker executes the order i.e. he buys or sells the securities. Broker prepares a contract note for the order executed. The contract note contains the name and the price of securities, name of parties and brokerage (commission) charged by him. Contract note is signed by the broker.

5. **Settlement:**

   This means actual transfer of securities. This is the last stage in the trading of securities done by the broker on behalf of their clients. There can be two types of settlement.

   (a) On the spot settlement:

   It means settlement is done immediately and on spot settlement follows. T + 2 rolling settlement. This means any trade taking place on Monday gets settled by Wednesday.

   (b) Forward settlement:

   It means settlement will take place on some future date. It can be T + 5 or T + 7, etc. All trading in stock exchanges takes place between 9.55 am and 3.30 pm. Monday to Friday.

Entities Involved In The Trading And Settlement Cycle

Clearing Corporation

An organization associated with an exchange to handle the confirmation, settlement and delivery

Notes

of transactions, fulfilling the main obligation of ensuring transactions are made in a prompt and efficient manner. They are also referred to as "clearing firms" or "clearing houses".

The first clearing corporation in India is National Securities Clearing Corporation Ltd (NSCCL), a wholly owned subsidiary of NSE.

Clearing Members

An exchange member that is permitted to clear trades directly with the clearinghouse, and which can accept trades for other clearing members and non-clearing member.The clearing member is responsible for matching the buy orders with the sell orders to make sure that the transactions are settled in return of commission.

Custodians

They are the clearing members and not trading members. They settle trades on behalf of trading members, when particular trade is assigned to them for settlement. The custodian is required to confirm whether he is going to settle that trade or not. If they confirm to settle that trade, then the clearing corporation assigns that particular obligation to them.

Clearing Banks

Clearing banks are a key link between the clearing members and the clearing corporation in the settlement of funds. Every clearing member is required to open a dedicated clearing account with one of the designated clearing banks. Based on the clearing member's obligation as determined through clearing, the clearing member makes funds available in the clearing account for the pay-in, and receives funds in the case of a payout.

3.5 DEPOSITORIES

A depository holds the securities in a dematerialized form for the investors in their beneficiary accounts. Each clearing member is required to maintain a clearing pool account with the depositories.

They are required to make available the required securities in the designated account on settlement day.

The depository runs an electronic file to transfer the securities from the accounts of the custodians/clearing member to that of the NSCCL (and vice versa) as per the schedule of allocation of the securities .

Depository services in the Indian Stock Market

The depository services originated recently in the Indian Stock market. Now-a- days on-line (scrip less or paperless) trading in the shares of any company is compulsory. To make it a success some new trading mechanism is needed.

Depository service is the name of that mechanism which makes possible the on-line trading in shares.

Through this system transfer of ownership in shares take place by means of book entry without the physical delivery of shares.

Notes

When a person wants to deal in shares of any company he/she has to open an account with the depository through a depository participant. Hence, there are four players who participate in this system. These are the following:

- The Depository
- The Depository Participant
- The Investor
- The Issuing Company

(1) The Depository

A depository is an institution which holds the shares of an investor in electronic form. It facilitates transactions in securities simply by means of book entry. At present, there are two depository institutions in India:

National Securities Depository Limited (NSDL)

Central Depository Services Limited (CDSL)

(2) The Depository Participant

Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act.

In a strictly legal sense, a DP is an entity who is registered as such with SEBI under the sub section 1A of Section 12 of the SEBI Act. As per the provisions of this Act, a DP can offer depositoryrelated services only after obtaining a certificate of registration from SEBI. As of 2012, there were 288 DPs of NSDL and 563 DPs of CSDL registered with SEBI.

Role of Depository participants

Similar to brokers, who act on behalf of a client in the stock market, a Depository Participant is your representative in the depository system.

Financial Institutions / Banks / Custodian / Stock Brokers etc. can become DPs provided they meet the necessary requirements and guidelines prescribed by SEBI. DP serves as a link between the investor and the Company through NSDL CDSL for dematerialisation of shares and other electronic transactions. DP provides various services with regard to your holdings such as

- Maintaining the securities account balances
- Enabling surrender (dematerialisation) and withdrawal (rematerialisation) of your securities to and from the depository.
- Delivering and receiving shares in your account on your instructions. Hence, shares bought by you on a stock exchange can be received directly in your account and similarly those sold by you can be delivered on your instructions.
- Keeping you updated with regard to status of your holdings periodically.

(3) The Investor

He is a person who wants to deal in shares and whose name is recorded with a depository. The investor is the real owner of the shares who has lodged them with the depository through book entry till the day he sells them.

Notes

(4) **The Issuing Company**

The issuing company is that organisation which issues the securities. The issuing company sends a list of the shareholders to the depositories.

Features

- A depository system has the following features:
- Day-to-day basis of reconciliation is made by NSDL;
- Securities are divisible and, as such, can be transacted by any quantity;
- Securities are allotted International Security Identification Number (ISIN) by SEBI;
- The benefit of depository system is enjoyed by the investor/owner of securities; and
- CDSL and NSDL are the Depository Participants to act as agent.

Advantages of depositories

- Bad deliveries are almost eliminated.
- The risks associated with physical certificates such as loss, theft, mutilation of certificate etc. are eliminated.
- It eliminates handling of huge volumes of paper work involved in filling in transfer deeds and lodging the transfer documents & Share Certificates with the Company.
- There will be immediate transfer and registration of your shares (at the end of every settlement cycle, which is 4 working days i.e. T+3) and you need not have to suffer delays on account of processing time.
- It leads to faster settlement cycle and faster realisation of sale proceeds.
- There will be a faster disbursement of corporate benefits like Rights, Bonus etc.
- The stamp duty on transfer of securities, which is 0.25% of the consideration on transfer of shares in physical form is not applicable and you may incur expenditure towards service charges of the Depository Participant.
- There could be a reduction in rates of interest on loans granted against pledge of dematerialised securities by various banks.
- There could be reduction in brokerage for trading in dematerialised securities.
- There could be reduction in transaction costs in dematerialised securities as compared to physical securities.
- Availability of periodical status report to investors on their holding and transactions.

Disadvantages

The Depository System is not free from snags. Some of them are:

- Number of frauds may be increased as there is no physical checking;
- Practically, to set up a single depository is not possible;
- MDS (Multiple Depository System) invites the problems of coordination.
- Although the Depository System is not free from snags, even then it is a boom to the world of capital market. It, no doubt, proves an efficient transfer system and helps the investors and the company in various forms. It overcomes the problems from bad

delivery, counterfeit certificates, etc. It also reduces various cost and expenses (i.e. Registration cost).

How do these Depositories work?

The key to exchanging stocks and the most necessary step is to open a Demat account. What a Demat account does is strongly related to what a depository does. At the point when you purchase shares, they are credited to your Demat account and when you sell the offers, they are debited from your Demat account.

So, where does a depository account come into the picture?

- A Demat account is only a middle person and it is CDSL and NSDL which actually hold your shares. So, when you open a Demat account to purchase shares, the shares are held by the depositories.
- Another significant function that depositories perform is when organizations need to appropriate dividends to their shareholders. Organizations will require data on its investors and this is when the share depositories prove to be useful.
- Earlier, before depositories, when you purchased shares from another person or sold to somebody, you needed to move share certificates. Presently, it is only a simple record move between two Demat accounts.

Function of Depository

One of the main function of the Depository is to transfer the ownership of shares from one investor's account to another investor's account whenever the trade takes place. It helps in reducing the paper work involved in trade, expedites the transfer and reduces the risk associated with physical shares such as damaged, theft, interceptions and subsequent misuse of the certificates or fake securities.

Another important function of depository is that it eliminate the risk associated with holding the securities in a physical form like loss,damage,theft or delay in deliveries etc.

What do these depositories offer?

Depositories offer the following services:

- Maintenance of Demat accounts.
- Dematerialization and dematerialization.
- Trade settlement.
- Liquidity to markets.
- Share transfers.
- Market and off-market transfers.
- Eliminate the risk of holding a physical asset.
- Provide safekeeping.
- Nomination/transmission.

Clearing and Settlement

Settlement Agencies:

Notes

NSCCL: The National Securities Clearing Corporation Limited is responsible for post-trade activities of a stock exchange. Clearing and settlement of trades and risk management are its central functions.

- Clearing Members: They are responsible for settling their obligations as determined by the NSCCL.
- Custodians: Custodian is a clearing member but not a trading member. He settles trades assigned to him by trading members.
- Clearing Banks: Clearing banks are a key link between the clearing members and NSCCL for funds settlement.
- Depositories: The depository runs an electronic file to transfer the securities from accounts of the custodians/clearing member to that of NSCCL. As per the schedule of allocation of securities determined by the NSCCL, the depositories transfer the securities on the pay-out day from the account of the NSCCL to those of members/custodians.
- Professional Clearing Member: NSCCL admits special category of members namely, professional clearing members. Professional Clearing Member (PCM) may clear and settle trades executed for their clients (individuals, institutions etc.).
- A PCM has no trading rights but has only clearing rights, i.e. he just clears the trades of his associate trading members and institutional clients.

Step 1. Trade details from Exchange to NSCCL (real-time and end of day trade file).

Step 2. NSCCL notifies the consummated trade details to CMs/custodians who affirm back. Based on the affirmation, NSCCL applies multilateral netting and determines obligations.

Step 3. Download of obligation and pay-in advice of funds/securities.

Step 4. Instructions to clearing banks to make funds available by pay-in time.

Step 5. Instructions to depositories to make securities available by pay-in-time.

Step 6. Pay-in of securities (NSCCL advises depository to debit pool account of custodians/CMs and credit its account and depository does it).

Step 7. Pay-in of funds (NSCCL advises Clearing Banks to debit account of custodians/CMs and credit its account and clearing bank does it).

Step 8. Pay-out of securities (NSCCL advises depository to credit pool account of custodians/CMs and debit its account and depository does it).

Step 9. Pay-out of funds (NSCCL advises Clearing Banks to credit account of custodians/CMs and debit its account and clearing bank does it).

Step 10. Depository informs custodians/CMs through DPs.

Step 11. Clearing Banks inform custodians/CMs

Process of Trading/Clearing and Settlement

The core processes involved in clearing and settlement include:

a) **Trade Recording:** The key details about the trades are recorded to provide the basis for settlement. These details are automatically recorded in the electronic trading system of the exchanges.

b) **Trade Confirmation:** Trades that are meant for settlement by the custodians are indicated with a custodian participant code, and the same is subject to confirmation by the respective

custodian. The custodian is required to confirm the settlement of these trades on T+1 day by the cut-off time of 1:00 pm.

c) **Determination of Obligation:** The next step is the determination of what the counterparties owe, and what the counterparties are due to receive on the settlement date.

The NSCCL interposes itself as a central counterparty between the counter-parties to trade and net the positions so that a member has a security-wise net obligation to receive or deliver a security, and has to either pay or receive funds.

The settlement process begins as soon as the members' obligations are determined through the clearing process. The settlement process is carried out by the clearing corporation with the help of clearing banks and depositories. The clearing corporation provides a major link between the clearing banks and the depositories. This link ensures The actual movement of funds as well as securities on the prescribed pay-in and pay-out day.

d) Pay-in of Funds and Securities: This requires the members to bring in their funds/securities to the clearing corporation. The CMs make the securities available in the designated accounts with the two depositories (the CM pool account in the case of the NSDL, and the designated settlement accounts in the case of CDSL). The depositories move the securities available in the pool accounts to the pool account of the clearing corporation.

Likewise, the CMs with funds obligations make the funds available in the designated accounts with the clearing banks.

The clearing corporation sends electronic instructions to the clearing banks to debit the designated CMs' accounts to the extent of the payment obligations. The banks process these instructions, debit the accounts of the CMs, and credit the accounts of the clearing corporation. This constitutes the pay-in of funds and securities.

e) Pay-out of Funds and Securities: After processing for shortages of funds/securities and arranging for the movement of funds from surplus banks to deficit banks through RBI clearing, the clearing corporation sends electronic instructions to the depositories/clearing banks to release the pay-out of securities/funds.

The depositories and clearing banks debit the accounts of the clearing corporation and credit the accounts of CMs. This constitutes the pay-out of funds and securities.

Rolling settlement

Rolling settlement is a system to settle share transactions in predefined number or days. It is a mechanism of settling trades done on a stock exchange on the Day Day of Trade (T) plus "X" trading days. "X" trading days could be any number of days like 1,2,3,4 or 5 days. So, if we say the rolling settlement for a transaction is T+2 then it means that the transaction will be settled in

TODAY + Next 2 Days. In other words, in T+2 environment, a trade done on T day is settled on the 3rd working day excluding the T day.

Investors and Speculators

The main function of the stock exchange is to provide facilities to its members i.e the buyers and sellers to transact their business and to settle the transactions. The buyers and sellers are classified into two categories.

I. Investors

II. Speculators

Notes

Investors

The investors buy the securities with a view to invest their savings in profitable income earning securities. They generally retain the securities for a considerable length of time. They are assured of a profit in cash. They are also called genuine investors.

Speculators

The speculators buy securities with a hope to sell them at a profit, in future. They do not retain their holdings for a longer period. They buy the securities with the object of selling them and not to retain them. They are interested only in price differentials. They are not genuine investors.

In reality, there is no pure speculator or an investor. Each investor is speculator to some extent. Similarly, every speculator is an investor, to certain extent. Hence, the difference between the two is a matter of degree only.

3.6 OPERATORS AT STOCK EXCHANGE

Members of stock exchange

(a) Jobbers

A jobber is a slang term for a market maker on the London Stock Exchange prior to October 1986. Jobbers, also called "stockjobbers," acted as market makers. They held shares on their own books and created market liquidity by buying and selling securities, and matching investors' buy and sell orders through their brokers, who were not allowed to make markets.

The term "jobber" is also used to describe a small-scale wholesaler or middleman in the retail goods trade.

Jobbers are security merchants dealing in shares, debentures as independent operators. They buy and sell securities on their own behalf and try to earn through price changes. Jobbers cannot deal on behalf of public and are barred from taking commission. In India, they are called Taraniwalas.

Key Points

- A jobber, also known as a stockjobber, was a market maker on the London Stock Exchange.
- Jobbers held shares on their own accounts and help boost market liquidity by matching investors' buy and sell orders through their brokers.
- The term jobber was used prior to October 1986, but little is known of their actual activities as they kept few records.
- Jobbers left few records of their affairs and neither journalists nor other observers retained much in the way of detailed accountings of their work.
- The jobber system evolved into a recognizably modern form during the course of the 19th century, as the range of securities types broadened.

Understanding Jobbers

- Little is known about jobbers' activities because they kept few records, but in the early 19th

century, London had hundreds of jobbing firms. Jobbers' numbers declined dramatically over the course of the 20th century until they ceased to exist in October 1986.

- This month was when the "Big Bang," a major shift in the London Stock Exchange's operations, occurred. London's financial sector was suddenly deregulated, fixed commissions were replaced by negotiated commissions, and electronic trading was implemented.
- Jobbers left few records of their affairs and neither journalists nor other observers retained much in the way of detailed accountings of their work. Histories of banks, stockbroking firms, and other concerns have been and will continue to be the basis of any historical record relating to jobbers.
- The Centre for Metropolitan History has compiled an archive of interviews with former jobbers which serves as a permanent record of the last half-century of a distinctive part of the financial life of London.

Special Considerations

- The jobber system evolved into a recognizably modern form during the course of the 19th century, as the range of securities types broadened.
- At least half the members of the London Stock Exchange began to specialize in making a continuous market in one of the leading types of these securities.
- The distinction between these market-makers, or jobbers, and the brokers who dealt with them on behalf of the public was a clear-cut one but was essentially based on custom and tradition until 1909 when a single capacity was formally embodied in the London Stock Exchange rules.
- By 1914, over 600 jobbing firms were in existence, along with many one-man jobbing operations.
- Those numbers steadily declined as the institutional investor supplanted the private one, and the scale of required jobbing capital increased dramatically.
- By the eve of "Big Bang," there were only five major jobbing firms on the floor of the London Stock Exchange, though this numerical decline did not necessarily denote a decline in the marketability provided by the system.

(b) Brokers

Brokers are commission agents, who act as intermediaries between buyers and sellers of securities. They do not purchase or sell securities on their behalf. They bring together the buyers and sellers and help them in making a deal. Brokers charge a commission from both the parties for their service. Brokers are experts in estimating trends of price and can effectively advice their clients in getting a fruitful gain. Brokers get orders from investing public and execute the orders through Jobbers and they are entitled to a prescribed sale of brokerage.

- A stockbroker is a professional trader who buys and sells shares on behalf of clients. The stockbroker may also be known as a registered representative or an investment advisor.
- Most stockbrokers work for a brokerage firm and handle transactions for a number of individual and institutional customers. Stockbrokers are often paid on a commission basis although compensation methods vary by employer.
- Brokerage firms and broker-dealers are also sometimes referred to as stockbrokers. This includes both full-service brokers and discount brokers, who execute trades but do not offer individualized investing advice.

Notes

- Most online brokers are discount brokers, at least at their basic levels of service, in which trades are executed for free or for a small set-price commission. Many online brokers now offer premium-level services with higher fees.

Key points

- A stockbroker or broker buys and sells stocks at the direction of clients.
- Most buy and sell orders are now made through online discount brokers. This automated process reduces fees.
- Wealthy individuals and institutions continue to use full-service brokers, who offer advice and portfolio management services as well as completing transactions.

Understanding the Role of a Stockbroker

Buying or selling stocks requires access to one of the major exchanges such as the New York Stock Exchange (NYSE) or the NASDAQ. To trade on these exchanges you must be a member of the exchange or belong to a member firm. Member firms and many of the individuals who work for them are licensed as brokers or broker-dealers by the Financial Industry Regulatory Authority (FINRA).

- While it is possible for an individual investor to buy stock shares directly from the company that issues them, it is much simpler to work with a stockbroker.
- Until recent years, it was prohibitively expensive to get access to the stock markets. It was cost-effective only for high net-worth investors or for large institutional investors, such as the managers of pension funds. They used full-service brokers and could pay hundreds of dollars for executing a trade.
- However, the rise of the internet and related advances in technology paved the way for discount brokers to provide online services with cheap, fast, and automated access to the markets. More recently, apps like Robinhood and SoFi have catered to micro-investors, allowing even fractional share purchases. Most accounts in the markets today are managed by the account owners and held by discount brokers.
- Brokers who are employed by discount broker firms may work as over-the-phone agents available to answer brief questions, or as branch officers in a physical location. They also may consult with clients subscribing to premium tiers of the online broker.
- Mobile phone apps like Robinhood and SoFi cater to micro-investors, allowing even fractional share purchases.
- A comparatively smaller number of stockbrokers work for investment banks or specialized brokerage firms. These companies handle large and specialized orders for institutional clients and high-net-worth individuals.
- Another recent development in broker services is the introduction of roboadvisers, algorithmic investment management carried out via web or mobile app interface. There is minimal individual interaction, keeping fees low.

Educational Requirements for Stockbrokers

A bachelor's degree in finance or business administration is typically required for stockbrokers. A strong understanding of financial laws and regulations, accounting methods, principles of economics and currency, financial planning and financial forecasting all are useful for working in the field.

Most successful stockbrokers have exceptional interpersonal skills and are able to maintain strong sales relationships.

Notes

Licensing Requirements for Stockbrokers

- Every country has its own credentialing requirements for stockbrokers.
- In the U.S., registered brokers must hold the FINRA Series 7 and Series 63 or 66 licenses, and be sponsored by a registered investment firm. Floor brokers in the U.S. must also be members of the stock exchange where they work.
- In Canada, would-be stockbrokers should be currently employed by a brokerage firm and are required to complete the Canadian Securities Course (CSC), Conduct and Practices Handbook (CPH), and the 90-day Investment Advisor Training Program (IATP).
- In Hong Kong, applicants must be working for a licensed brokerage firm and pass three exams from the Hong Kong Securities Institute (HKSI). Those who pass the exam must still be approved by the financial regulatory body to receive a license.
- In Singapore, becoming a trading representative requires passing four exams, Modules 1A, 5, 6, and 6A, administered by the Institute of Banking and Finance. The Monetary Authority of Singapore (MAS) and the Singapore Exchange (SGX) have licensing authority.
- In the United Kingdom, stockbroking is heavily regulated and brokers must achieve qualifications from the Financial Conduct Authority (FCA). Precise qualifications depend on the specific duties required of the broker as well as the employer.
- Global credentials are also becoming increasingly sought-after as signals of legitimacy and financial acumen. Examples include the certified financial planner (CFP) and chartered financial analyst (CFA) designations.

Seculation

Speculation refers to the buying and selling of securities in the hope of making a profit from expected change in the price of securities. Those who engage in such activity are known as 'speculators'. The motive is to take maximum advantage from fluctuations in the market. A speculator may buy securities in expectation of rise in price.

If his expectation comes true, he sells the securities for a higher price and makes a profit. Similarly a speculator may expect a price to fall and sell securities at the current high price to buy again when prices decline. He will make a profit if prices decline as expected.

What is a Speculator

A speculator utilizes strategies and typically a shorter time frame in an attempt to outperform traditional longer-term investors. Speculators take on risk, especially with respect to anticipating future price movements, in the hope of making gains that are large enough to offset the risk.

Speculators that take on excessive risk typically don't last long. Speculators exert control over long-term risks by employing various strategies such as position sizing, stop loss orders, and monitoring the statistics of their trading performance. Speculators are typically sophisticated risk-taking individuals with expertise in the markets in which they are trading.

Basics of Speculators

Speculators attempt to predict price changes and extract profit from the price moves in an asset. They may utilize leverage to magnify returns (and losses), although this is a personal choice of the individual.

There are different types of speculators in a market. For example, individual traders can be

Notes

speculators, if they purchase a financial instrument for short periods of time with intentions of profiting from its price changes.

Market makers can also be considered speculators because they take the opposite position to market participants and profit from the difference in bid and ask spreads. Prop shops or proprietary trading firms can also be considered speculators because they use leverage to purchase securities and make profits from changes in their price.

Normally, speculators operate in a shorter time frame than a traditional investor. For example, a person may call themself an investor if they buy 20 strong companies and plan to hold those stocks for at least 10 years, assuming the companies continue to perform well.

A speculator, on the other hand, may use all their portfolio capital to buy five stocks, or several futures contracts, expecting them to rise over the next few days, weeks, or months. Speculators typically utilize trading strategies that tell them when to buy, when to sell (at a loss or profit), and how big of a position to take.

Principles Behind Speculation

- Speculation sometimes gets confused with gambling. There is an important distinction, though. If a trader is using untested methods to trade, often based on hunches or feelings, it is highly likely they are gambling.
- If gambling, the trader is likely to lose over the long-run. Profitable speculation takes a lot of work, but with proper strategies, it is possible to gain a reliable edge in the marketplace.
- Profitable speculators look for repeating patterns in the marketplace. They look for commonalities between many rising and falling prices, in an attempt to use that information to profit from future ups and downs in price.
- It is detailed work, and because prices are always moving and there are nearly infinite variables to consider, each speculator often develops their own unique way of trading.

Key Points

- Speculators are sophisticated investors or traders who purchase assets for short periods of time and employ strategies in order to profit from changes in its price.
- Speculators are important to markets because they bring liquidity and assume market risk. Conversely, they can also have a negative impact on markets, when their trading actions result in a speculative bubble that drives up an asset's price to unsustainable levels.

Speculators' Impact on the Market

- If a speculator believes that a particular asset is going to increase in value, they may choose to purchase as much of the asset as possible. This activity, based on the perceived increase in demand, drives up the price of the particular asset.
- If this activity is seen across the market as a positive sign, it may cause other traders to purchase the asset as well, further elevating the price. This can result in a speculative bubble, where the speculator activity has driven the price of an asset above its true value.
- The same can be seen in reverse. If a speculator believes a downward trend is on the horizon, or that an asset is currently overpriced, they sell as much of the asset as possible while prices are higher. This act begins to lower the price of the asset. If other traders act similarly, the price will continue to fall until the activity in the market stabilizes.
- In this way, even many investors become speculators from time to time. They get caught up

in the frenzy of the big ups and down. While they may have initiated their position with the intention of being long-term investors, if they start to buy and sell solely because they think other people are buying or selling, they have entered the realm speculation—possibly even gambling, if they are unsure of what they are doing—as opposed to investing.

The benefits of speculation are:

(i) It leads to smooth change and prevents wide fluctuations in security prices at different times and places.

(ii) Speculative activity and the resulting effect in the prices of securities provided a guidance to the public about the market situation.

Kind of Speculators

There are four types of speculators who are active on the stock exchanges in India. Traders engaged in speculative activity in the stock market are identified by different names based on the type of activity they in general employ in. The eminent among them are bears, bulls, lame duck and stag.

1. **Bull (Tejiwala)**

   A trader who awaits a rise in price of securities is referred as a bull.in anticipation of rise in price he make purchases with intention of selling them in future. The bulls will be able to make profit only if the prices rise as predicted, otherwise they suffer loss.

2. **Bear(Mandiwala)**

   A bear is a skeptic who expects a decline of securities. He will sell the shares in expectation of fall in price , to buy them in future in cheaper price. the bear speculator tends to force down the prices of securities. A bear is a pessimistic speculator.

3. **Lame Duck**

   A lame duck is a bear who is involved in a short sale but is not able to meet his commitment to deliver the securities sold by him due to hike in prices of securities subsequent to the short sale. When a bear has made contracts to sell and find s it difficult to meet his commitment due to non availability of securities , he is called as lame duck.

4. **Stag**

   A stag is a trader who applies for shares in the new issues market just like a genuine investor. A stag is an optimist like the bull. He expects a hike in the prices of securities that he has applied for. He predicts that when the new shares are listed in the stock exchange for trading, they would be quoted at a premium, above their issue price. A stag is a cautious speculator in the stock exchange He is also called a premium hunter.

WHO IS STOCK BROKER?

A stockbroker is a regulated professional individual, usually associated with a brokerage firm or broker-dealer, who buys and sells stocks and other securities for both retail and institutional clients, through a stock exchange or over the counter, in return for a fee or commission.

A stockbroker invests in the stock market for individuals or corporations. Only members of the stock exchange can conduct transactions, so whenever individuals or corporations want to buy or sell stocks they must go through a brokerage house.

Stockbrokers often advice and counsel their clients on appropriate investments. Brokers

Notes

explain the workings of the stock exchange to their clients and gather information from them about their needs and financial ability, and then determine the best investments for them. The broker then sends the order out to the floor of the securities exchange by computer or by phone.

Duties of Stock Brokers

Stock brokers take on a tremendous amount of responsibility. Not only are they responsible for managing their client's money, but they must stay up-to-date on the latest tax laws, market research and financial news to provide their client with the best return.

Customer Service

Since customers rely heavily on their stock broker to deal with their investments, brokers must help maintain a level of trust and security by contacting their customers weekly or monthly to update them on their portfolio or new investment opportunities.

Disclosure and Advisement

Brokers are required to disclose all information related to any investment recommendation – including risks. Brokers must be honest with their clients and cannot provide false, misleading or exaggerated statements.

Trade Execution

A stock broker initiates trades – buys and sells – on behalf of their client. This is typically done electronically, but some brokers execute trades by phone or in-person on a physical trading floor. Trades depend on what the stock broker feels is necessary for their client's portfolio at the time their investments are analyzed.

Client Recommendations

It is imperative that a stock broker fully understand his customer's investment goals, financial situation and her risk tolerance. When researching and recommending investments for his client, a stock broker must do so based on his customer's needs by selecting investments that are suitable for her portfolio.

For example, a stock broker would not recommend a high-risk stock for a client with a low-risk portfolio.

Fiduciary Duty and Fair Dealing

Stock brokers earn a living through commissions; therefore, there is a risk for conflict between a stock broker's interest and the interests of his clients. The broker, however, has a fiduciary duty to put the needs of his clients above his own.

A stock broker is also subject to the rules created by regulatory agencies, such as the Financial Industry Regulatory Authority. These regulatory agencies require all stock brokers to be honest, trade fair and only make trades that meet the needs of the client – not themselves.

BROKER CHARGES

A fee charged by an agent, or agent's company to facilitate transactions between buyers and sellers. The brokerage fee is charged for services such as negotiations, sales, purchases, delivery or advice on the transaction. Commission charged by the broker is also known as brokerage.

The two depositories in India are :

- National Securities Depository Ltd. (NSDL)

- Central Depository Services (India) Ltd. (CDSL)

3.7 NATIONAL SECURITY DEPOSITORY LIMITED (NSDL)

The advent of automated trading in India brought with it several associated benefits such as transparency in trading and equal opportunity for market players all over the country but the problems related to settlement of trades such as high instances of bad deliveries and long settlement cycles continued.

As an answer to these settlement problems and in order to provide a safe and efficient system of trading and settlement, National Securities Depository Ltd. was inaugurated in November 1996.

NSDL was set up with an initial capital of INR one billion (USD 28 million), promoted by Industrial Development Bank of India (IDBI), Unit Trust of India (UTI) and National Stock Exchange of India Ltd. (NSEIL).

Subsequently, State Bank of India, Oriental Bank of Commerce, Citibank NA, Standard Chartered Bank, HDFC Bank Limited, The Hongkong and Shanghai Banking Corporation Limited, Deutsche Bank, Dena Bank and Canara Bank have became a shareholder of NSDL.

An investor who buys securities from exchanges connected to NSDL may receive his delivery in the dematerialised form as dematerialised securities can be delivered in the physical segment at the option of the seller.

Therefore, those investors who buy securities from these exchanges should necessarily open a depository account to take delivery of demat securities. Also, SEBI has made it compulsory for all categories of investors to settle trades in demat form with respect to a select list of scrips since January 4, 1999. Therefore, investors trading in these scrips will necessarily need a depository account to settle their trades. The list of scrips is being continuously expanded by SEBI.

Therefore, every investor who trades in securities may have to open a depository account. NSDL, the first and largest depository in India, established in August 1996 and promoted by institutions of national stature responsible for economic development of the country has since established a national infrastructure of international standards that handles most of the securities held and settled in dematerialised form in the Indian capital market.

In the depository system, the ownership and transfer of securities takes place by means of electronic book entries. At the outset, this system rids the capital market of the dangers related to handling of paper

Benefits

- **Elimination of all risks associated with physical certificates** - Dealing in physical securities have associated security risks of theft of stocks, mutilation of certificates, loss of certificates during movements through and from the registrars, thus exposing the investor to the cost of obtaining duplicate certificates etc. This problem does not arise in the depository environment.
- **Elimination of bad deliveries** - In the depository environment, once holdings of an investor are dematerialised, the question of bad delivery does not arise i.e. they cannot be held "under objection". In the physical environment, buyer was required to take the risk of transfer and face uncertainty of the quality of assets purchased. In a depository environment good money certainly begets good quality of assets.

Notes

- **No stamp duty for transfer of any kind of securities in the depository:** This waiver extends to equity shares, debt instruments and units of mutual funds.
- **Immediate transfer and registration of securities** - In the depository environment, once the securities are credited to the investors account on pay out, he becomes the legal owner of the securities.
- There is no further need to send it to the company's registrar for registration.
- Having purchased securities in the physical environment, the investor has to send it to the company's registrar so that the change of ownership can be registered. This process usually takes around three to four months and is rarely completed within the statutory framework of two months thus exposing the investor to opportunity cost of delay in transfer and to risk of loss in transit.
- To overcome this, the normally accepted practice is to hold the securities in street names i.e. not to register the change of ownership. However, if the investors miss a book closure the securities are not good for delivery and the investor would also stand to loose his corporate entitlements.
- **Faster settlement cycle** - The settlement cycle follow rolling settlement on T+2 basis i.e. the settlement of trades will be on the 2nd working day from the trade day. This will enable
- Faster turnover of stock and more liquidity with the investor.
- Faster disbursement of non-cash corporate benefits like rights, bonus, etc. - NSDL provides for direct credit of non-cash corporate entitlements to an investors account, thereby ensuring faster disbursement and avoiding risk of loss of certificates in transit.
- Reduction in brokerage by many brokers for trading in dematerialised securities Brokers provide this benefit to investors as dealing in dematerialised securities reduces their back office cost of handling paper and also eliminates the risk of being the introducing broker..
- Reduction in handling of huge volumes of paper
- Periodic status reports to investors on their holdings and transactions, leading to better controls.
- Elimination of problems related to change of address of investor - In case of change of address, investors are saved from undergoing the entire change procedure with each company or registrar. Investors have to only inform their DP with all relevant documents and the required changes are effected in the database of all the companies, where the investor is a registered holder of securities.
- Elimination of problems related to transmission of demat shares - In case of dematerialised holdings, the process of transmission is more convenient as the transmission formalities for all securities held in a demat account can be completed by submitting documents to the DP whereas, in case of physical securities the surviving joint holder(s)/legal heirs/nominee has to correspond independently with each company in which shares are held.
- Elimination of problems related to selling securities on behalf of a minor - A natural guardian is not required to take court approval for selling demat securities on behalf of a minor.
- Ease in portfolio monitoring since statement of account gives a consolidated position of investments in all instruments.

Participants of NSDL

- NSDL performs its functions through its participants. The following are some of the important NSDL participants:
- IIT Trust, Corporation Services, Global Trust Bank, HDFC Bank, City Bank Custodial services, Morgan Stanley Custodial Services, Reliance Share and Stock brocking, Janata Sahakari Bank, Industrial Development Bank of India, State Bank of India, Standard Chartered National Securities Clearing Corporation, Deutsche Bank.

Legal aspects of NSDL

- NSDL was established by passing of the Depositories Act, 1996, but with retrospective effect from September 1995. Companies Act and Securities Contact Regulation Act were amended suitably to facilitate the operations of NSDL.
- Section 22A of the Indian Securities Contract Regulations Act dealing with restrictions on transfer of shares was deleted. Sections 108 and 111 of the Indian Companies Act were amended to dispense with transfer forms and other formalities relating to the physical transfer of shares. The statements issued by the depository are considered valid documents of title.

Aspect of safety and security

- An entity can be made operational as a DP only after registration by SEBI, which is based on the recommendation from NSDL and SEBIs own independent evaluation. SEBI has prescribed criteria for becoming a DP in the regulations.
- Depository Participants are allowed to effect any debit and credit to an account only on the basis of valid instruction from the client.
- Every day, there is a system driven mandatory reconciliation between DP and NSDL.
- There are periodic inspections into the activities of both DP and R&T agent by NSDL. This also includes records based on which the debit/credit are effected.
- The data interchange between NSDL and its business partners is protected by protection measures of international standards such as encryption hardware lock. The protection measures adopted by NSDL are more than what is prescribed in the SEBI Regulations.
- All transactions are recorded at NSDL Central System and in the databases maintained by business partners.
- All investors have a right to receive their statement of accounts periodically from the DP.
- Every month NSDL forwards statement of account to a random sample of investors as a counter check.
- In the depository, the depository holds the investor accounts on trust. Therefore, if the DP goes bankrupt the creditors of the DP will have no access to the holdings in the name of the clients of the DP. These investors can transfer their holdings to an account held with another DP.
- Certification in Depository Operations : NSDL has introduced a Certification Programme in Depository Operations, and it has been made compulsory for all DPs to appoint a person

Notes

qualified in this certification in each of its branches. This way, NSDL wants to ensure that each branch of a DP that services investors has atleast one person who has thorough knowledge about depository system

Transactions of the NDSL

As we have seen already, the transactions of the stock market are divided into two categories namely,

- New issues and
- Secondary market transactions

1. **New issues**

   Generally, the investor has the option to receive the shares either in physical form or in the electronic mode. When shares are allotted to the investor, he should specify his choice clearly. If he wishes to hold securities in the electronic form, he should specify the depository participant to which, the allotted shares are to be delivered.

   Shares will be allotted according to SEBIs guidelines but the despatch of shares to the depository participant will take place according to the instructions of the investor. Nowadays, SEBI has made it mandatory for the companies to have new issues in the dematerialised form by book entries in the pass book. Transactions in Demat are not subject to stamp duty.

2. **Secondary market**

   The trading procedures for the secondary market transactions are the same but the settlement and clearing procedures are different. It may so happen that the seller opts to deliver the shares from the depository while the buyer wishes to take delivery in the physical form and vice versa.

   That is, the seller has the shares in the physical mode while the buyer prefers the electronic mode. When both, the buyer and the seller prefer the electronic mode, the transaction would be smooth.

Value added Services Offered by NSDL

Basic Services

The basic services of NSDL include services to brokers, banks, investors and other agencies which issue securities, and participate in the Indian financial market. In order to avail these services, an investor has to open a depository account with DPs. The depository account is of three types - beneficiary account, clearing member account and intermediary account.

Dematerialisation

- The process by which a physical security certificate is converted into electronic balances.
- To begin with, an investor is required to deface the certificates and surrender them to the DPs.
- Next, the DPs sends the relevant certificates to the concerned authority of NSDL.
- Once the authorised issuer verifies the claim, the confirmation is made and the securities are submitted in the depository account of the investor.

Rematerialisation

- The process by which the securities are held in electronic form, are converted into physical certificates.
- To begin with, an investor is required to submit a rematerialisation request to the concerned DPs.
- The DPs block the specific holding of the investor which has been submitted for rematerialisation.
- The DPs send the service request to the NSDL and the concerned issuer for confirmation.
- Once confirmed, the issuer blocks the balance submitted for rematerialisation and the NSDL is updated with the same information and the transaction is processed.

Market Transfer

As an investor, you can purchase/sell the securities held by you in the dematerialized format.

Off-Market Transfer

Any trade which does not settle via the clearing house is an Off-Market Trade. They include delivery of securities from sub-brokers or trade-for-trade transaction.

Inter-depository transfer

An inter-depository transfer is a transfer of securities in the form of one account in one depository to an account in another depository.

Transmission

It is the devolution of the shares to another instead of self. This is operation by law under cases of death, succession, bankruptcy, marriage or inheritance.

Corporate actions

These are the benefits in the form of ESOPs, dividends, bonus etc. which are given by corporates to the investors.

Value Added Services

- Automatic Delivery out Instructions: If you need to move your securities from CM Pool Account to CM Delivery Account automatically, you need a series of instructions for the same. Such instructions on your behalf have to be authorised by the clearing corporation. This facilitates the clearing corporation to execute all the auto-transactions on your behalf.
- Dividend Distribution: Dividend distribution is only given in the form of dividends to the shareholder as a form of corporate cash benefits.
- Lending and Borrowing: This is applicable only to intermediaries approved and authorised under the Securities Lending Scheme, 1997 with SEBI. Also, the intermediary requires the approval of NSDL as well.
- Public Issue: The Securities and Exchange Board of India have issued a statement that all respective trades of public shares will be held only in demat form.

Notes

- SMS Alerts: NSDL also offers SMS alerts for all demat account holders with respect to all transactions, alerts and notifications free of cost.

NSDL CAS (Consolidate Account Statement)

This is a single statement which has the details of all your investments in the security market. It contains the following information of - equity share investment, mutual funds, bonds and debentures, government bonds and certificates and money market instruments like treasury bills. This statement also helps an investor to electronically access their investment portfolio.

i. NSDL e-Services: E-services by NSDL facilitates faster execution of transactions. The various e-services are:

- Speed-e: A smart transaction facility which enables an investor to directly upload delivery instruction on SPEED-e website via a smart card or e-token. Its aim is to reduce the overall turnaround time.
- IDeAS (Internet-based Demat Account Statement): With this facility, you can view the balances and transactions which have been executed online in the demat account with a delay of maximum 30 minutes.
- STeADY (Securities Trading Information easy Access and DeliveryY): Specific to contract notes, brokers can electronically deliver/submit contract notes to custodians/ fund managers and it also allows for modification of the contract notes.
- Depository Account Validation (DAN): Under this facility, you as investor can validate/ authenticate identities such as client ID, DP ID, PAN and other basic details via the online platform.
- SPICE (Submission of Power of attorney based Instructions for Clients Electronically): With this service, Clearing Members can submit auto pay-in instructions to participants (where Clients maintain demat accounts) on SPEED-e facility to debit from their respective demat accounts of the Clients and credit their Clearing Member (CM) Pool Accounts. These clearing members have authorized Power of Attorney to conduct on behalf of the Clearing Member.
- SIMPLE (Submission of Instruction through Mobile Phone Login Easily: If you have registered for SPEED-e services, you can issue transfer instructions with the registered mobile number with NSDL.

Authorized Banks for NSDL

The following are the authorised banks and principal shareholders in NSDL:

- Axis Bank
- Citibank
- Deutsche Bank
- HSBC
- State Bank of India
- HDFC Bank
- Union Bank of India
- Standard Chartered Bank

- Dena Bank
- Canara Bank
- Oriental Bank of Commerce

3.8 CENTRAL DEPOSITORY SERVICES LIMITED

CSDL is the second largest Indian depository based in Mumbai.CDSL was promoted by BSE Ltd. jointly with leading banks such as State Bank of India; Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank and Union Bank of India.

CDSL was set up with the objective of providing convenient, dependable and secure depository services at affordable cost to all market participants. Some of the important milestones of CDSL system are:

- CDSL received the certificate of commencement of business from SEBI in February, 1999.
- Honourable Union Finance Minister, Shri Yashwant Sinha flagged off the operations of CDSL on July 15, 1999.
- Settlement of trades in the demat mode through BOI Shareholding Limited, the clearing house of BSE Ltd., started in July 1999.
- All leading stock exchanges like the BSE Ltd. (formerly known as Bombay Stock Exchange Ltd.), National Stock Exchange and MCX Stock Exchange Limited have established connectivity with CDSL.

Benefits

Dematerialisation of securities with CDSL offers numerous benefits to the issuer of securities. Some of the benefits are:

- In the demat form transfer of securities takes place at CDSL and if the entire issue of a security is held in demat form, the issuer can save considerable time and money being incurred on its share department / RTA.
- Dematted securities are not subject to loss, theft, mutilation or misuse by faking or forging certificates, thereby saving companies from lengthy correspondence, litigation and complaint handling. It will therefore eliminate instances of bad delivery.
- All non-cash corporate actions such as rights, bonus, subdivision of holdings, conversion of securities, issuing securities on mergers/amalgamations and in initial public offerings (IPO) can be handled in demat form without any hassles in the shortest possible time and at very low cost.
- With the CDSL's centralised database, the issuer can get upto-the-moment information on any changes in its holding pattern of a security. Thus, the company effectively monitors the change in holding and is alert to any undue threat.

Safety

- CDSL has acquired state-of-the-art equipment including the HP 64 Bit Enterprise server system (super computer technology with the robustness of enterprise class), which is the highest performing RISC/UNIX server system available in the marketplace.

Notes

- This system is connected to a near fault tolerant storage system from EMC2 Corporation. This is the world's best storage system and the first of its kind to be installed in India, nay Asia.
- The software developed has all the security features conforming to world standards. The software facilitates a robust accounting and transaction management system.
- CDSL's system is based on a centralised database with on-line connectivity with Depository Participants (DPs) who provide on-line services to investors. All data pertaining to investor holdings are stored at CDSL. CDSL has also established extensive back up systems, where a back up of the data is also stored at a remote site.
- CDSL ensures the security and integrity of all data by protecting it from any misuse or manipulation by unauthorised users as all communications between CDSL and its users is encrypted. There is no dial-up access for any user and only authorised users can access the system.
- The hardware, software and connectivity systems are reviewed continuously to strengthen the systems & procedures and to comply with the stringent international standards.

Differences between CDSL and NSDL

- **Stock Exchange:** CDSL works for BSE and NSDL works for NSE; the trades can utilize both of the depositories for exchanging and settlement of securities.
- **Promoters:** Another contrast between the two is their promoters. NSDL is backed by IDBI Bank Ltd., the Unit trust of India, and NSE. CDSL is promoted simply by BSE as of December 2019.
- **Establishment year:** NSDL was established in 1996 and CDSL was established in 1999.
- Demat Account number format: There is a distinction between CDSL and NSDL Demat account number. Demat accounts held with CDSL have 16 numeric digits in them and NSDL Demat accounts have two alphanumeric digits-'IN' and 14 numeric digits.
- **Several depositories:** CDSL has 599 depository participants registered with itself and NSDL has 278 depository participants registered on its system. This is according to the latest numbers.

3.9 DEMATERIALISATION

Dematerialisation is the process by which a client can get physical certificates converted into electronic balances. It ("Demat" in short form) signifies conversion of a share certificate from its physical form to electronic form. The term Demat, in India, refers to a dematerialised account for individual Indian citizens to trade in listed stocks or debentures, as required by The Securities Exchange Board of India (SEBI). In a Demat account, shares and securities are held electronically instead of the investor taking physical possession of certificates.

An investor will have to first open an account with a Depository Participant and then request for the dematerialisation of his share certificates through the Depository Participant so that the dematerialised holdings can be credited into that account. This is very similar to opening a Bank Account. The Demat account number is quoted for all transactions to enable electronic settlements of trades to take place.

An investor intending to dematerialise its securities needs to have an account with a DP. The client has to deface and surrender the certificates registered in its name to the DP. After

Notes

intimating NSDL electronically, the DP sends the securities to the concerned Issuer/ R&T agent. NSDL in turn informs the Issuer/ R&T agent electronically, using NSDL Depository system, about the request for dematerialisation.

If the Issuer/ R&T agent finds the certificates in order, it registers NSDL as the holder of the securities (the investor will be the beneficial owner) and communicates to NSDL the confirmation of request electronically. On receiving such confirmation, NSDL credits the securities in the depository account of the Investor with the DP.

India has adopted this system of electronic book keeping thereby eliminating the need for paper and shares or securities are held in electronic form. Before the introduction of the depository system by the Depository Act, 1996, the process of sale, purchase and transfer of shares was difficult and there was a high risk of loss.

Features

- Holdings in only those securities that are admitted for dematerialisation by NSDL can be dematerialised.
- Only those holdings that are registered in the name of the account holder can be dematerialised.
- Names of the holders of the securities should match with the names given for the demat account.
- If the same set of joint holders held securities in different sequence of names, these joint holders by using Transposition cum Demat facility can dematerialise the securities in the same account even though share certificates are in different sequence of names. e.g., If there are two share certificates one in the name of X first and Y second and another in the name of Y first and X second, then these shares can be dematerialised in the depository account which is in any name combination of X and Y i.e., either X first and Y second or Y first and X second. Separate accounts need not be opened to demat each share certificate. If shares are in the name combinations of X and Y, it cannot be dematerialised into the account of either X or Y alone.
- Check the demat performance of the companies whose shares are to be given for dematerialisation.
- Demat requests received from client (registered owner) with name not matching exactly with the name appearing on the certificates merely on account of initials not being spelt out fully or put after or prior to the surname, can be processed, provided the signature of the client on the Dematerialisation Request Form (DRF) tallies with the specimen signature available with the Issuers or its R & T agent.
- A client may, in the normal course, receive demat confirmation in about 30 days from the date of submission of demat request to the DP.
- There are special processes for Securities issued by Government of India and simultaneous transmission and demat.

How Does the Depository System Operate?

- The operations in the Depository System involve the participation of a Depository, Depository Participants (DP), Company/Registrars and Investors.
- The company is also called the Issuer. A Depository is an organisation that facilitates

Notes

holding of securities in the electronic form and enables DPs to provide services to investors relating to transaction in securities.

- There are two depositories in India, namely NSDL and CDSL. As per SEBI guideline, the minimum net worth stipulated for a depository is Rs. 100 crores. NSDL (National Securities Depository Limited) was established in August 1996 and is the first depository in India. CDSL (Central Depository Securities Limited) is the other depository and was established in 1999..
- A Depository Participant is the agent of the Depository and is the medium through which the shares are held in the electronic form.
- They are also the representatives of the investor, providing the link between the investor and the company through the Depository.
- A DP can be a financial organisation like – banks, brokers, financial institutions, custodians, etc., acting as an agent of the Depository to make its services available to the investors.
- The Depository system functions very much like the banking system. A bank holds funds in accounts whereas a Depository holds securities in accounts for its clients. A bank transfers funds between accounts whereas a Depository transfers securities between accounts.
- In both the systems, the transfer of funds or securities happens without the actual handling of funds or securities. Both the banks and the Depository are accountable for safe keeping of funds and securities respectively.

Opening a Demat Account:

In order to start dealing in securities in electronic form, one needs to open a demat account with a DP of his choice.

An investor is allowed to open more than one account with existing DP or with different DPs. A maximum of three persons are allowed to open a joint demat account in their names. There is no stipulated minimum balance of securities to be kept in a demat account.

Following is the procedure of opening a Demat account:

1. Choose a DP.
2. Fill up an account opening form provided by DP, and sign an agreement with DP in a standard format prescribed by the depository.
3. DP provides the investor with a copy of the agreement and schedule of charges for his future reference.

   DP opens the account and provides the investor with a unique account number, also known as Beneficiary Owner Identification Number (BOID).

Demat Conversion Process:

Converting physical records of investments into electronic records is called dematerialising securities. An investor having securities in physical form must get them dematerialised, if he intends to sell them. In order to dematerialise physical securities investors must fill in a DRF (Demat Request Form) which is available with the DP and submit the same along with physical certificates. Every security has an ISIN (International Securities Identification Number). Separate DRFs must be filled for each ISIN Number.

The complete process of dematerialisation is as follows:

1. Surrender of certificates by the investor for dematerialisation to the depository participant.
2. Depository participant intimates Depository of the request through the system.
3. Depository participant submits the certificates to the registrar of the Issuer Company.
4. Registrar confirms the dematerialisation request from depository.
5. After dematerialising the certificates, Registrar updates accounts and informs depository of the completion of dematerialisation.
6. Depository updates its accounts and informs the depository participant.
7. Depository participant updates the demat account of the investor.

Advantages

There are several benefits associated with the Demat system:

- It is a safe and convenient way to hold securities.
- It ensures immediate transfer of securities. There is no stamp duty on transfer of securities.
- Risks associated with physical certificates such as bad delivery, fake securities, delays, thefts, etc. are eliminated.
- There is a major reduction in paperwork involved in transfer of securities, and reduction in transaction cost, etc. No odd lot problem exists; even one share can be sold.
- Change in address recorded with DP and gets registered with all companies in which investor holds securities eliminating the need to correspond with each of them separately.
- Transmission of securities is done by DP eliminating correspondence with companies.
- Automatic credit into demat account of shares; arising out of bonus/split/consolidation/ merger etc. can take place.
- Holding investments in equity and debt instruments in a single account is possible. Besides the above benefits, there are some additional advantages listed as below:

Benefit to the Company:

The depository system helps in reducing the cost of new issues due to lower printing and distribution costs. It increases the efficiency of the registrars and transfer agents and the Secretarial Department of the company. It provides better facilities for communication and timely services with shareholders, investors, etc.

Benefit to the Investors:

The depository system reduces risks involved in holding physical certificates, e.g., loss, theft, mutilation, forgery, etc. It ensures transfer settlements and reduces delay in registration of shares. It ensures faster communication to investors. It helps avoid bad delivery problems due to signature differences, etc. It ensures faster payment on sale of shares. No stamp duty is paid on transfer of shares. It provides more acceptability and liquidity of securities.

Notes

Benefits to Brokers:

It reduces risks of delayed settlement. It ensures greater profit due to increase in volume of trading. It eliminates chances of forgery, bad delivery. It increases efficiency of trading, profitability and confidence in investors.

Disadvantages of the Demat System:

- The disadvantages of dematerialization of securities can be summarized as follows:
- Trading in securities may become uncontrolled in case of dematerialized securities.
- It is compulsory for the capital market regulator to keep a close watch on the trading in dematerialized securities and to check that trading does not act as a detriment to investors
- The role of key market players in case of dematerialized securities, such as stock-brokers, needs to be supervised as they have the capability of manipulating the market.
- Multiple regulatory frameworks have to be followed, including the Depositories Act, Regulations and the various By-Laws of various depositories.
- Additionally, agreements are entered at various levels in the process of dematerialization. Investors may find the process complicated.

SUMMARY

- A stock exchange facilitates stock brokers to trade company stocks and other securities. A stock may be bought or sold only if it is listed on an exchange. Thus, it is the meeting place of the stock buyers and sellers. India's premier stock exchanges are the Bombay Stock Exchange and the National Stock Exchange.
- The secondary market or the stock exchanges are regulated by the regulatory authority. In India, the secondary and primary markets are governed by the Security and Exchange Board of India (SEBI).
- The Securities and Exchange Board of India was established by the Government of India on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. It was to function under the overall administrative control of the Ministry of Finance of the Government of India.
- The SEBI was given a statutory status on 30 January 1992 through an ordinance. The ordinance was later replaced by an Act of Parliament known as the Securities and Exchange Board of India Act, 1992.
- Reasons for the Establishment of SEBI The capital market has witnessed a tremendous growth during 1980's, characterised particularly by the increasing participation of the public. This ever expanding investors population and market capitalisation led to a variety of malpractices on the part of companies, brokers, merchant bankers, investment consultants and others involved in the securities market.
- The glaring examples of these malpractices include existence of self -styled merchant bankers unofficial private placements, rigging of prices, unofficial premium on new issues, nonadherence of provisions of the Companies Act, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. These malpractices and unfair trading practices have eroded investor confidence and multiplied investor

grievances. The Government and the stock exchanges were rather helpless in redressing the investor's problems because of lack of proper penal provisions in the existing legislation. In view of the above, the Government of India decided to set-up a separate regulatory body known asSecurities and Exchange Board of India.

- The basic purpose of SEBI is to create an environment to facilitate efficient mobilisation and allocation of resources through the securities markets. It also aims to stimulate competition and encourage innovation. This environment includes rules and regulations, institutions and their interrelationships, instruments, practices, infrastructure and policy framework.
- Before selling the securities through stock exchange, the companies have to get their securities listed in the stock exchange. The name of the company is included in listed securities only when stock exchange authorities are satisfied with the financial soundness and other aspects of the company.
- The buying and selling of securities can only be done through SEBI registered brokers who are members of the Stock Exchange. The broker can be an individual, partnership firms or corporate bodies. So the first step is to select a broker who will buy/sell securities on behalf of the investor or speculator.
- Demat (Dematerialized) account refer to an account which an Indian citizen must open with the depository participant (banks or stock brokers) to trade in listed securities in electronic form. Second step in trading procedure is to open a Demat account.
- The securities are held in the electronic form by a depository. Depository is an institution or an organization which holds securities (e.g. Shares, Debentures, Bonds, Mutual (Funds, etc.) At present in India there are two depositories: NSDL (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.).
- Depository participant will maintain securities account balances of investor and intimate investor about the status of their holdings from time to time.
- NSDL performs its functions through its participants. The following are some of the important NSDL participants:
- The basic services of NSDL include services to brokers, banks, investors and other agencies which issue securities, and participate in the Indian financial market. In order to avail these services, an investor has to open a depository account with DPs. The depository account is of three types - beneficiary account, clearing member account and intermediary account.
- CDSL works for BSE and NSDL works for NSE; the trades can utilize both of the depositories for exchanging and settlement of securities. Another contrast between the two is their promoters. NSDL is backed by IDBI Bank Ltd., the Unit trust of India, and NSE. CDSL is promoted simply by BSE as of December 2019. NSDL was established in 1996 and CDSL was established in 1999.

abc

KEY WORDS

- **Stock trading:** It refers to the buying and selling of shares in a particular company; if you own the stock, you own a piece of the company.
- **Dematerialisation:** The process by which a physical security certificate is converted into electronic balances.
- **Rematerialisation:** The process by which the securities are held in electronic form, are converted into physical certificates.

Notes

- **Market Transfer:** As an investor, you can purchase/sell the securities held by you in the dematerialized format.
- **Off-Market Transfer:** Any trade which does not settle via the clearing house is an Off-Market Trade. They include delivery of securities from sub-brokers or trade-for-trade transaction.
- **Inter-depository transfer:** An inter-depository transfer is a transfer of securities in the form of one account in one depository to an account in another depository.
- **Transmission:** It is the devolution of the shares to another instead of self. This is operation by law under cases of death, succession, bankruptcy, marriage or inheritance.
- **Corporate actions:** These are the benefits in the form of ESOPs, dividends, bonus etc. which are given by corporates to the investors.
- **Bulls and Bears:** The term does not refer to animals but to market sentiment of the investors. A Bullish phase refers to a period of optimism and a Bearish phase to a period of perssimism on the Bourses.
- **Badla:** This refers to a carry forward system of settlement, particularly at the BSE. It is a facility that allows the postponement of the delivery or payment of a transaction from one settlement period to another.
- **Odd lot trading:** Trading in multiples of 100 stocks or less.
- **Penny Stocks:** These are securities that have no value on the stock exchange but whose trading contributes to speculation.

REVIEW QUESTIONS

1. Explain the entities or players involved in clearing mechanism.
2. Explain the clearing and settlement process
3. Explain the role/functions of NSDL and CDSL
4. Benefits of dematerialization or depositary system.

FURTHER READINGS

1. Mukund Sharma , H.R.Appanaiah Stock and Commodity Market-Himalayan Publication International Financial Management.
2. Dr.Preeti Singh ,Stock and Commodity Market- Himalayan Publication International Financial Management khan,Indian Financial System 6th edition ,Tata McGraw Hill
3. Garner, Carley. A Trader's First Book on Commodities. (New Jersey: FT Press, 2010): Futures Trading Act of 1921, Declared unconstitutional in Hill v. Wallace 259 U.S. 44 (1922), the Grain Futures Act of 1922 and Board of Trade of City of Chicago v. Olsen 262 U.S. 1 (1923).
4. Cronon, William. Pricing the Future: Grain. Nature's Metropolis: Chicago and the Great West. University of Chicago, 1991. pp.109-133

UNIT 4

COMMODITIES MARKET

Notes

Structure

4.0 Learning Objectives
4.1 Introduction
4.2 Commodity Market
4.3 Transactions in Commodity Market
4.4 Participants in Commodity Derivative market
4.5 Types of Commodity Derivatives
4.6 Efficiency in Commodity future markets
4.7 Governing Body
4.8 Major Commodity Exchanges in India.
4.9 Commodity Exchange - A Reference to the Indian Scenario
Summary
Key Words
Review Questions
Further Readings

4.0 LEARNING OBJECTIVES

After reading this chapter students will be able to:

- Understand the meaning of Commodity market
- Describe the concept Transactions in Commodity Market
- Know the various kinds of Commodity Derivatives
- Know the major commodity exchanges in India.

4.1 INTRODUCTION

A commodity market is a market that trades in the primary economic sector rather than manufactured products, such as cocoa, fruit and sugar. Hard commodities are mined, such as gold and oil.Futures contracts are the oldest way of investing in commodities.

Futures are secured by physical assets. Commodity markets can include physical trading and derivatives trading using spot prices, forwards, futures, and options on futures. Farmers have used a simple form of derivative trading in the commodity market for centuries for price risk management.

Notes.

A financial derivative is a financial instrument whose value is derived from a commodity termed an underlier. Derivatives are either exchange-traded or over-the-counter (OTC).

An increasing number of derivatives are traded via clearing houses some with central counterparty clearing, which provide clearing and settlement services on a futures exchange, as well as off-exchange in the OTC market.

Derivatives such as futures contracts, Swaps (1970s-), Exchange-traded Commodities (ETC) (2003-), forward contracts have become the primary trading instruments in commodity markets. Futures are traded on regulated commodities exchanges.

Over-the-counter (OTC) contracts are "privately negotiated bilateral contracts entered into between the contracting parties directly".

Exchange-traded funds (ETFs) began to feature commodities in 2003. Gold ETFs are based on "electronic gold" that does not entail the ownership of physical bullion, with its added costs of insurance and storage in repositories such as the London bullion market.

According to the World Gold Council, ETFs allow investors to be exposed to the gold market without the risk of price volatility associated with gold as a physical commodity.

History

Commodity-based money and commodity markets in a crude early form are believed to have originated in Sumer between 4500 BC and 4000 BC. Sumerians first used clay tokens sealed in a clay vessel, then clay writing tablets to represent the amount—for example, the number of goats, to be delivered. These promises of time and date of delivery resemble futures contract.

Early civilizations variously used pigs, rare seashells, or other items as commodity money. Since that time traders have sought ways to simplify and standardize trade contracts.

Gold and silver markets evolved in classical civilizations. At first, the precious metals were valued for their beauty and intrinsic worth and were associated with royalty.

In time, they were used for trading and were exchanged for other goods and commodities, or for payments of labor.Gold, measured out, then became money. Gold's scarcity, its unique density and the way it could be easily melted, shaped, and measured made it a natural trading asset.

Beginning in the late 10th century, commodity markets grew as a mechanism for allocating goods, labor, land and capital across Europe. Between the late 11th and the late 13th century, English urbanization, regional specialization, expanded and improved infrastructure, the increased use of coinage and the proliferation of markets and fairs were evid[illegible]ercialization.

The spread of markets is illustrated by the 1466 installation of reliable scales in the villages of Sloten and Osdorp so villagers no longer had to travel to Haarlem or Amsterdam to weigh their locally produced cheese and butter.

The Amsterdam Stock Exchange, often cited as the first stock exchange, originated as a market for the exchange of commodities. Early trading on the Amsterdam Stock Exchange often involved the use of very sophisticated contracts, including short sales, forward contracts, and options.

"Trading took place at the Amsterdam Bourse, an open aired venue, which was created as a commodity exchange in 1530 and rebuilt in 1608. Commodity exchanges themselves were a relatively recent invention, existing in only a handful of cities."

In 1864, in the United States, wheat, corn, cattle, and pigs were widely traded using standard instruments on the Chicago Board of Trade (CBOT), the world's oldest futures and options exchange. Other food commodities were added to the Commodity Exchange Act and traded through CBOT

Notes

in the 1930s and 1940s, expanding the list from grains to include rice, mill feeds, butter, eggs, Irish potatoes and soybeans.

Successful commodity markets require broad consensus on product variations to make each commodity acceptable for trading, such as the purity of gold in bullion. Classical civilizations built complex global markets trading gold or silver for spices, cloth, wood and weapons, most of which had standards of quality and timeliness.

Through the 19th century "the exchanges became effective spokesmen for, and innovators of, improvements in transportation, warehousing, and financing, which paved the way to expanded interstate and international trade."

Reputation and clearing became central concerns, and states that could handle them most effectively developed powerful financial centers.

BRIEF HISTORY OF COMMODITY MARKETS

Trading commodities goes back to the dawn of human civilization as tribal clans and newly established kingdoms would barter and trade with one another for food, supplies, and other items. Trading commodities indeed predates that of stocks and bonds by many centuries. The rise of empires such as ancient Greece and Rome can be directly linked to their ability to create complex trading systems and facilitate the exchange of commodities across vast swaths.

Today, commodities are still exchanged throughout the world and on a massive scale. Things have also become more sophisticated with the advent of exchanges and derivatives markets, Exchanges regulate and standardized commodity trading, allowing for liquid and efficient markets.

Perhaps the most influential modern commodities market is the Chicago Board of Trade (CBOT), established in 1848, where it originally traded only agricultural commodities such as wheat, corn, and soybeans in order to help farmers and commodity consumers manage risks by removing price uncertainty from agricultural products such as wheat and corn. Today, it lists options and futures contracts on a wide range of products including gold, silver, U.S. Treasury bonds, and energy products. The Chicago Mercantile Exchange (CME) Group merged with the Chicago Board of Trade (CBOT) in 2007, adding interest rates and equity index products to the group's existing product agricultural offerings.

Some commodities exchanges have merged or gone out of business in recent years. The majority of exchanges carry a few different commodities, although some specialize in a single group. In the U.S., the Chicago Mercantile Exchange (CME), the New York Mercantile Exchange (NYMEX), the Intercontinental Exchange (ICE) dominate the space. Each exchange offers a wide range of global benchmarks across major asset classes.

4.2 COMMODITIES MARKET

The term commodity refers to any material, which can be bought and sold. Commodities in a market's context refer to any movable property other than actionable claims, money and securities. Commodities represent the fundamental elements of utility for human beings.

Commodity market refers to markets that trade in primary rather then manufactured products. Soft commodities are agricultural products such as wheat, coffee, cocoa and sugar. Hard commodities are mined, such as (gold, rubber and oil).

Commodities are hard assets ranging from wheat to gold to oil. The U.S. government defines commodities in the 1936 Commodity Exchange Act.1 The Act covers trading in agricultural and

Notes

natural resource commodities. Although the Act treats financial products like commodities, it doesn't consider them to be commodities. The Act also bans trade in onions as a commodity.

Objectively, a commodities market is a place where selected commodities are traded between members, based on fixed rules and regulations. In a commodities market, the objectives of trading can be any one of these two:

- To take delivery of the commodities in order to actually use them, or
- To profit from the price movements of the commodities

To regulate the trading of commodities, we have many commodity exchanges operating in the market. Primarily, India has six national commodity exchanges namely,

- Multi Commodity Exchange (MCX)
- National Commodity and Derivatives Exchange (NCDEX)
- Indian Commodity Exchange (ICEX)
- National Multi Commodity Exchange (NMCE)
- ACE Derivatives Exchange (ACE)
- Universal Commodity Exchange(UCX)

In 2018, the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) also launched a segment for trading in commodities on their exchanges.

Types of Commodities Traded in these Markets

Let's again take a little detour and visit your local supermarket for a bit. You'll find various kinds of goods put up for sale there, isn't it? You'll see manufactured products like stationery items, utensils and clothes.

And you'll also see stuff that's grown or produced - like fruits and vegetables. Much like this, the goods traded in the commodities market can also clearly be classified into one of types of commodities - hard commodities and soft commodities.

Hard commodities

Hard commodities include natural resources like metals and oil reserves that make up the backbone of a country's economy. Some other examples of hard commodities include gold, silver, iron, steel, aluminium and copper.

Metals like these often act as key contributing agents to a country's export trade. The need and availability of these resources can be monitored on a global scale, mainly because the demand and supply for these hard commodities can be easily gauged or speculated.

Soft Commodities

Soft commodities are basically goods that are grown and nurtured. Think of agricultural produce, cattle and other livestock and any other agricultural or allied products. Unlike hard commodities, it's not easy to gauge the price movements of these goods mainly because they are influenced by a number of factors - both local and global.

For instance, crops can be impacted either positively or adversely due to seasonal patterns and weather changes. And there's no way these things can be predicted accurately in advance.

Notes

Definition of Commodities Market :

A commodities Market is an organised market that functions under established rules and regulations. This market is the place for the purchase and sale of commodities.

J. F. Pyle has defined organised market in this way:

Commodity exchanges are specialised organised markets which provide a place where their members buy and sell commodities or contract for future delivery under established rules and regulations.

The commodities which are generally traded in at the commodity exchanges include the following:

(i) Natural produce of the soil e.g. cotton, wheat, tea, jute etc.

(ii) Mineral products like copper, gold, mica, lead etc.

(iii) Some manufactured products like gunny bags, clothing, hides, artificial jams etc.

All types of commodities are not fit for dealings in the commodity exchanges.

The products which possess the following characteristics are fit for dealing in commodies Market :

1. **Homogeneity:**

   The commodity must be homogeneous i.e., all units of a particular commodity must be perfectly identical so that all dealers may mean the same commodity when they mention it in their dealings.

2. **Durability:**

   It must be durable so as to last for a period of a future contract (ordinarily more than one year). If it perishes rather quickly, con-tracts for its purchase and sale will be frustrated.

3. **Gradability:**

   The commodity should be such as will lend itself to grading. If the commodity cannot be classified into well-known grades, trading will be difficult for every time the quality will have to be ascertained.

4. **Price Fluctuation:**

   There must be frequent fluctuations in the price of the commodity. If there were no price fluctuations, the speculators would have no intention to speculate in it at the exchange.

5. **Open Supply:**

   The supply of the commodity should be open and free and should not be monopolized by one or a few persons. Again, the supply of the commodity or its price must not be controlled by the Govt.

Objectives of Commodity Exchanges

The organised market represents a public organisation consisting of buyers, sellers, producers, traders and dealers dealing in one or more commodities which constitute the articles of trade in the market. The exchange for commodity is a private association of dealers and is not for making money or profit or for fixing prices.

Its objectives are to provide an open platform for the interaction of free play of the forces of demand and supply. It only registers the prices reflecting the forces of demand and supply. Buying and selling, trading practices and actual working of the organised market are governed by a code of rules and regulations and these can ensure fair dealings, fair prices and equity.

Notes

Nature of Commodity Exchanges

Organised market has the following features:

1. Best facilities available for close and continuous contact between total demand and total supply both present and potential.
2. All businesses are governed by rules and regulations and these rules are strictly enforced by the exchange authorities.
3. Usually the exchange enjoys internal autonomy and it is self-regulated, self-administered and self-disciplined autonomous body. At present, almost in all organised markets there are special legislations to control the activities of these organised markets.
4. There is free competition of buyers and sellers. The forward markets for commodities and securities are also known as two-way auction markets. Open public outcry gives offers and bids by sellers and buyers. They also use finger signals to declare their prices and amounts.
5. Every forward market has a clearing house organisation to facilitate clearing of all dealings and their settlement. The clearing house guarantees payment of dues and taking and giving of delivery of commodities or securities during the settlement period.
6. An organised market acts as a clearing house of market information, i.e., collection of all facts and figures and regular publicity of all relevant statistical information which helps the traders to estimate and forecast price trends, changes in demand and supply. Constant price quotation services enable people to make their purchases and sales with certainty and confidence.
7. The speculative trader is a necessary and vital part of any broad and stable commodity or se¬curities market. Speculation is an integral part of market mechanism whether in stock exchange or in commodity exchange.
8. It is a convenient central market place.

Key Points

- A commodity market involves buying, selling, or trading a raw product, such as oil, gold, or coffee.
- There are hard commodities, which are generally natural resources, and soft commodities, which are livestock or agricultural goods.
- Spot commodities markets involve immediate delivery, while derivatives markets entail delivery in the future.
- Investors can gain exposure to commodities by investing in companies that have exposure to commodities or investing in commodities directly via futures contracts.
- The major U.S. commodity exchanges are the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Board of Trade, and the New York Mercantile Exchange.

Functions of Commodity Exchanges

Commodity exchanges are generally utilised for wholesale dealings in agricultural commodities or the products of some important primary industries like lumbering.

These exchanges perform the following important functions:

1. **Providing a Market Place:**

   A commodity exchange provides a convenient place where the members can meet at fixed

hours and transact business in a commodity according to a certain well established rules and regulations. This type of facility is very important for trading in such commodities as are produced in abundance and cover a very wide field as far as trading therein is con-cerned.

2. **Regulating Trading:**

   As organised markets commodity exchanges establish and enforce rules and regulations with a view to facilitating trade on sound lines. The rules define the duties of members and lay down methods for business transaction.

3. **Collecting and Disseminating Market Information:**

   The buyers and sellers on the commodity exchange enter into deals for settlement in future after making an assessment the trends of price and the prospects of a rise or fall in prices of a commodity. The commodity exchange acts as an association of these traders collecting the necessary information and the relevant statistical data and pub-lishing it for the benefit of traders all over the country.

4. **Grading of Commodities:**

   Commodities which are traded on the commodity exchanges have, to be graded according to quality. In this manner, the dealers can quickly enter into agreements for the purchase and sale of commodities by description.

5. **Settling Disputes through Arbitration:**

   The commodity exchange provides machinery for the arbitration of trade disputes.

Where to invest in commodities?

There are six major commodity trading exchanges in India as listed below.

1. Multi Commodity Exchange - MCX
2. National Commodity and Derivatives Exchange - NCDEX
3. National Multi Commodity Exchange - NMCE
4. Indian Commodity Exchange - ICEX
5. Ace Derivatives Exchange - ACE
6. The Universal Commodity Exchange - UCX

In 2015, the regulatory body of the commodities trading - Forward Market Commission (FMC) merged with the Securities and Exchange Board of India (SEBI). Commodity trading in these exchanges requires standard agreements as per the instructions so that trades can be executed without visual inspection. In general, commodities are classified into four types:

1. Metals - Silver, Gold, Platinum, and Copper
2. Energy - Crude oil, Natural gas, Gasoline, and Heating oil
3. Agriculture - Corn, Beans, Rice, Wheat, etc.,
4. Livestock and Meat - Eggs, Pork, Cattle, etc.,

How Commodity Markets Work

Commodities markets allow producers and consumers of commodity products to gain access to them in a centralized and liquid marketplace. These market actors can also use commodities derivatives

Notes

to hedge future consumption or production. Speculators, investors, and arbitrageurs also play an active role in these markets. Certain commodities, such as precious metals, have been thought of to be a good hedge against inflation, and a broad set of commodities as an alternative asset class can help diversify a portfolio. Because the prices of commodities tend to move in opposition to stocks, some investors also rely on commodities during periods of market volatility.

In the past, commodities trading required significant amounts of time, money, and expertise, and was primarily limited to professional traders. Today, there are more options for participating in the commodity markets.

Types of Commodity Markets

Generally speaking, commodities trade either in spot markets or derivatives markets. Spot markets are also referred to as "physical markets" or "cash markets" where buyers and sellers exchange physical commodities for immediate delivery.

Derivatives markets involve forwards, futures, and options. Forwards and futures are derivatives contracts that use the spot market as the underlying asset. These are contracts that give the owner control of the underlying at some point in the future, for a price agreed upon today. Only when the contracts expire would physical delivery of the commodity or other asset take place, and often traders will roll over or close out their contracts in order to avoid making or taking delivery altogether.

Forwards and futures are generically the same, except that forwards are customizable and trade over-the-counter (OTC), whereas futures are standardized and traded on exchanges.

Examples of Commodities Markets

The major exchanges in the U.S., which trade commodities, are domiciled in Chicago and New York with several exchanges in other locations within the country. The Chicago Board of Trade (CBOT) was established in Chicago in 1848. Commodities traded on the CBOT include corn, gold, silver, soybeans, wheat, oats, rice, and ethanol. The Chicago Mercantile Exchange (CME) trades commodities such as milk, butter, feeder cattle, cattle, pork bellies, lumber, and lean hogs.

The New York Board of Trade (NYBOT) commodities include coffee, cocoa, orange juice, sugar, and ethanol trading on its exchange. The New York Mercantile Exchange (NYMEX) trades commodities on its exchange such as oil, gold, silver, copper, aluminum, palladium, platinum, heating oil, propane, and electricity.

Key commodity markets in regional centers include the Kansas City Board of Trade (KCBT) and the Minneapolis Grain Exchange (MGE). These exchanges are primarily focused on agriculture commodities. The London Metal Exchange and Tokyo Commodity Exchange are prominent international commodity exchanges.

Commodities are predominantly traded electronically; however, several U.S. exchanges still use the open outcry method. Commodity trading conducted outside the operation of the exchanges is referred to as the over-the-counter (OTC) market.

Electronic Commodities Trading

In traditional stock market exchanges such as the New York Stock Exchange (NYSE), most trading activity took place in the trading pits in face-to-face interactions between brokers and dealers in open outcry trading. In 1992 the Financial Information eXchange (FIX) protocol was introduced, allowing international real-time exchange of information regarding market transactions. The U.S.

Securities and Exchange Commission ordered U.S. stock markets to convert from the fractional system to a decimal system by April 2001. Metrification, conversion from the imperial system of measurement to the metrical, increased throughout the 20th century.

Eventually FIX-compliant interfaces were adopted globally by commodity exchanges using the FIX Protocol. In 2001 the Chicago Board of Trade and the Chicago Mercantile Exchange (later merged into the CME group, the world's largest futures exchange company) launched their FIX-compliant interface.

By 2011, the alternative trading system (ATS) of electronic trading featured computers buying and selling without human dealer intermediation. High-frequency trading (HFT) algorithmic trading, had almost phased out "dinosaur floor-traders".

Complexity and Interconnectedness of Global Market

The robust growth of emerging market economies (EMEs, such as Brazil, Russia, India, and China), beginning in the 1990s, "propelled commodity markets into a supercycle". The size and diversity of commodity markets expanded internationally, and pension funds and sovereign wealth funds started allocating more capital to commodities, in order to diversify into an asset class with less exposure to currency depreciation.

In 2012, as emerging-market economies slowed down, commodity prices peaked and started to decline. From 2005 through 2013, energy and metals' real prices remained well above their long-term averages. In 2012, real food prices were their highest since 1982.

The price of gold bullion fell dramatically on 12 April 2013 and analysts frantically sought explanations. Rumors spread that the European Central Bank (ECB) would force Cyprus to sell its gold reserves in response to its financial crisis.

Major banks such as Goldman Sachs began immediately to short gold bullion. Investors scrambled to liquidate their exchange-traded funds (ETFs) and margin call selling accelerated. George Gero, precious metals commodities expert at the Royal Bank of Canada (RBC) Wealth Management section reported that he had not seen selling of gold bullion as panicked as this in his forty years in commodity markets.

The earliest commodity exchange-traded fund (ETFs), such as SPDR Gold Shares NYSE Arca: GLD and iShares Silver Trust NYSE Arca: SLV, actually owned the physical commodities. Similar to these are NYSE Arca: PALL (palladium) and NYSE Arca: PPLT (platinum).

However, most Exchange Traded Commodities (ETCs) implement a futures trading strategy. At the time Russian Prime Minister Dmitry Medvedev warned that Russia could sink into recession. He argued that "We live in a dynamic, fast-developing world.

It is so global and so complex that we sometimes cannot keep up with the changes". Analysts have claimed that Russia's economy is overly dependent on commodities.

Contracts in the commodity market

A Spot contract is an agreement where delivery and payment either takes place immediately, or with a short lag. Physical trading normally involves a visual inspection and is carried out in physical markets such as a farmers market.

Derivatives markets, on the other hand, require the existence of agreed standards so that trades can be made without visual inspection.

Notes

Standardization

US soybean futures, for something else, are of not being standard grade if they are "GMO or a mixture of GMO and Non-GMO No. 2 yellow soybeans of Indiana, Ohio and Michigan origin produced in the U.S.A. (Non-screened, stored in silo)".

They are of "deliverable grade" if they are "GMO or a mixture of GMO and Non-GMO No. 2 yellow soybeans of Iowa, Illinois and Wisconsin origin produced in the U.S.A. (Non-screened, stored in silo)". Note the distinction between states, and the need to clearly mention their status as GMO (genetically modified organism) which makes them unacceptable to most organic food buyers.

Similar specifications apply for cotton, orange juice, cocoa, sugar, wheat, corn, barley, pork bellies, milk, feed stuffs, fruits, vegetables, other grains, other beans, hay, other livestock, meats, poultry, eggs, or any other commodity which is so traded.

Standardization has also occurred technologically, as the use of the FIX Protocol by commodities exchanges has allowed trade messages to be sent, received and processed in the same format as stocks or equities. This process began in 2001 when the Chicago Mercantile Exchange launched a FIX-compliant interface that was adopted by commodity exchanges around the world.

4.3 TRANSACTIONS IN COMMODITY MARKET

Broadly speaking there are two types of transactions — Cash and Futures. The commodity markets, therefore, have the characteristics of organised markets. In some commodity markets only cash contracts are executed but generally commodity markets are future markets.

1. **Cash Contracts (Physical Market):**

   The cash contracts for the purchase or sale of commodities are those which call for payment of the full contract price in cash on delivery. Such contracts are made in the cash or physical market. In fact they are also referred to physical contracts in the sense that they deal in actual or physical products.

   The cash or physical contracts may be subdivided into two subclasses:

(i) **Spot Transactions:**

Spot transactions are those cash contracts which involve the payment for the price by buyer and the delivery of the specified grade of goods by sellers immediately. These contracts relate to the purchase or sale of commodities on spot. The essence of such contracts is the ready delivery and acceptance of the delivery of the goods sold.

Spot Market :Market where commodities are brought and sold in physical form by paying cash is a spot market.

For example, if you are a farmer or dealer of Chana and you have physical holding of 10 kg of Chana with you which you want to sell in the market. You can do so by selling your holdings in either of the three commodities exchanges in India in spot market at the existing market or spot price.

(ii) Forward Contracts:

Forward dealings are those cash contracts made in the cash or physical market which call for the delivery of goods and payment of the price after a specified period on a fixed date. The basic feature common to both the spot contracts and the forward contracts is that they are made and settled not necessarily in the premises of the commodity exchange. That is to say, the cash contracts are generally made outside the exchange.

Notes

2. **Futures Contracts:**

   A futures contract is a special type of agreement made strictly under the rules of a commodity which may or may not call for the actual delivery of goods and payment of price in cash on a future date.

   A futures contract has been defined "as a contract for the future delivery of some commodity without reference to specific lots, made under the rules of some commercial body, in a set form, by which the conditions as to units of amount, the quality and time of delivery are stereotyped, and only the determination of the total amounts and the price is left open to the contracting parties".

Futures Market : The market where the commodities are brought and sold by entering into cotract to settle the transaction at some future date and at a specific price is called futures market.

This definition brings out the following features of a futures contract:

(i) Such contracts are meant exclusively for future settlement through the exact data of settlement is decided by reference to the wishes of the seller and the established rules of the commodity exchange.

(ii) Such contracts do not specify the particular grade of a commodity but impliedly refer to a basic grade called the contract grade accepted as the common grade for all futures dealings.

(iii) The details in respect of the unit of amount, the time of settlement, the quality etc. are mentioned in the rules and regulations and are common to all such contracts. The contracting parties have to decide upon the price at which the contract is to be settled sometime in one of the trading months specified by the exchange.

The meaning of futures will be clear if the following basic features of such contracts are referred to:

1. Futures contracts are made only in the ring of the commodity exchanges and not outside the exchanges.
2. Only members of commodity exchange can enter into such a deal. No outsider can become a party to a futures agreement.
3. Such contracts can be made only in multiples of a fixed unit of trading specified in the rules of the exchange. No such contracts can be made in fractions of these units.
4. The futures contracts are settled only in the trading months adopted by exchange. Every exchange specifies 3 to 4 months in a year for settlement of such contracts.
5. The time of delivery is not specified in these contracts. It is left to the choice of the seller. The seller may settle the contract on any day of the trading month for which the delivery was fixed.
6. As per rules of the exchange the contracting parties have to deposit a certain percentage of the contract price with the exchange as "margin money' whenever they make a futures contract.
7. Since futures contracts are entered into only under the rules of the commodity exchange concerned, all disputes between contracting parties are required to be settled through arbitration by the machinery provided for the purpose.

   The futures contracts differ from cash contracts not only in respect of the above features but also in regard to the basic purposes for which they are made. All futures contracts are generally made for the purpose of speculation or hedging.

   The general procedure for settlement is the neutralisation of the original contract by an opposite contract on settlement so that only difference between the current and the contract price is paid.

Notes

It is rarely that actual delivery of goods is taken and price paid in settlement of futures contracts. Cash contracts are made for actual purchase and sale of the commodities. Under these contracts the commodity is delivered and the price paid in full, though in some cases price differences may be paid.

The futures market is also called the exchange market as against physical market which is another name for cash market.

The futures trading are the most important feature of business activity on the commodity exchange. In fact, the commodity exchanges are organised mainly for futures contracts. The futures contracts are made for speculative and hedging purposes.

Difference between Forwards and Futures Contract

Forwards Contract:

1. Essentially, OTC contracts involve only the buyer and the seller.
2. Both the parties in forwards contract have necessarily to perform the contract.
3. There is no payment of any initial margins in forwards contract.
4. In forwards contract the maturity and size of the contract may be customised.
5. Settlement takes place only on the date of maturity on forwards contract.
6. Credit or Counter-party risk is high in forwards contract.
7. Markets for forward contracts are not very liquid.
8. In forwards contract physical delivery takes place on the maturity date.

Futures Contract:

1. Futures contract is traded through an ex-change. Buyer, Seller and Exchange are involved.
2. Futures contract need not necessarily culminate in delivery of the underlying.
3. To trade in futures contract, one has to become a member of the exchange by paying the initial margin and maintain a variable margin account too with the Futures Exchange.
4. The maturity and size of contracts are standardized in futures contract.
5. In futures contract settlement is on a daily basis on all the outstanding contracts (marking to market on a daily basis).
6. The Futures Exchange takes care of credit or counter-party risk.
7. Futures contracts are highly liquid and can be closed out easily.
8. Hardly 2% of the total contracts are delivered and taken delivery of in futures contract.

Derivatives

Derivatives are instruments whose value is determined based on the value of an underlying asset. Forwards, futures and options are some of the well-known derivatives instruments widely used by the traders in commodities markets.

4.4 PARTICIPANTS IN COMMODITY DERIVATIVE MARKET

1) Hedgers

They use derivatives markets to reduce or eliminate the risk associated with price of a commodity. They trade in the futures market to transfer their risk of movement in prices of the commodity they are actually physically dealing. Some of the hedgers are listed below and their objective from trading in this market:-

a) Exporters: People who need protection against higher prices of commodities contracted from a future delivery but not yet purchased.

b) Importers: People who want to take advantage of lower prices against the commodities contracted for future delivery but not yet received:

c) Farmers: People who need protection against declining prices of crops still in the field or against the rising prices of purchased inputs such as feed.

d) Merchandisers, elevators: People who need protection against lower prices between the time of purchase or contract of purchase of commodities from the farmer and the time it is sold.

e) Processors: People who need protection against the increasing raw material cost or against decreasing inventory values.

2) Speculators

Speculators are those who may not have an interest in the ready contracts, etc. but see an opportunity of price movement favorable to them. They provide depth and liquidity to the market. They provide a useful economic function and are integral part of the futures the market. It would not be wrong to say that in absence of speculators the market will not liquid and may at times collapse.

3) Arbitrageurs

Arbitrage refers to the simultaneous purchase and sale in two markets so that the selling price is higher than the buying price by more than the transaction cost, resulting in risk-less profit.

Advantages of commodity Derivatives

1) **Management of risk:** This is most important function of commodity derivatives. Risk management is not about the elimination of risk rather it is about the management of risk. Commodity derivatives provide a powerful tool for limiting risks that farmers and organizations face in the ordinary conduct of their businesses.

2) **Efficiency in trading:** Commodity derivatives allow for free trading of risk components and that leads to improving market efficiency.

   Traders find commodity derivatives to be more attractive instrument than the underlying security. This is mainly because of the greater amount of liquidity in the market offered by derivatives as well as the lower transaction costs associated with trading a commodity derivative as compared to the costs of trading the underlying commodity derivative as compared to the costs of trading the underlying commodity in cash market.

3) **Speculation:** This is not the only use, and probably not the most important use, of commodity derivatives. Commodity derivatives are considered to be risky. If not used properly, these can leads to financial destruction in an organization.

Notes

4) **Price discover:** Another important application of commodity derivatives is the price discovery which means revealing information about future cash market prices through the futures market.

5) **Price stabilization function:** Commodity Derivatives market helps to keep a stabilising influence on spot prices by reducing the short-term fluctuations. In other words, derivative reduces both peak and depths and leads to price stabilisation effect in the cash market for underlying asset.

Risks faced by participants in commodity derivatives markets

Different kinds of risks faced by participants in commodity derivatives markets are:

- Credit risk
- Market risk
- Liquidity risk
- Legal risk
- Operational risk

a) **Credit risk:** Credit risk on account of default by counter party: This is very low or almost zeros because the Exchange takes on the responsibility for the performance of contracts.

b) **Market risk:** Market risk is the risk of loss on account of adverse movement of price.

c) **Legal risk:** Legal risk is that legal objections might be raised; regulatory framework might disallow some activities.

d) **Operational risk:** Operational risk is the risk arising out of some operational difficulties, like, failure of electricity or connectivity, due to which it becomes difficult to operate in the market.

Commodity Transaction Tax

- CTT is applicable for those dealing in trading of commodities. It is introduced to tax the commodity trading in India where both parties—buyer & seller of contract—will be taxed depending on the amount of contract size. CCT will be similar to the securities transaction tax (STT) levied on the purchase and sale of equities in the stock market. So far, commodity transactions have been exempted from any levy.
- While agricultural commodities will be exempted from CTT, non-farm commodities like gold, silver and non-ferrous metals such as copper and energy products like crude oil and natural gas will be taxed. Currently, STT of 0.1%-0.025% is levied on stock market transactions. STT has been reduced to Rs. 1 from Rs. 250 per lakh on redemption of exchange traded fund / mutual fund from fund houses and to Rs. 1 from Rs. 100 per lakh on redemption of ETF/MF from exchange.
- The tax led many investors to shift to commodity exchanges as there is no transaction charges levied on commodity trading. CTT will be allowed as a deduction if the income from such transactions form part of business income.
- CTT shall be levied on non-agricultural commodities futures contracts at the same rate as on equity futures that is at 0.01% of the price of the trade.
- According to the finance ministry estimate, CTT will bring revenues of around Rs.45 billion

Notes

to government. It is also aimed at bringing transparency in the commodity exchange market. However, CTT would raise transaction costs of the commodities traded on the exchanges.

- If CTT is imposed, Multi Commodity Exchange, National Commodities and Derivatives Exchange, National Multi Commodity Exchange, Indian Commodity Exchange and Ace Derivatives and Commodity Exchange would be affected.
- CTT is levied on the value of taxable commodities transaction as:

  —Sale of an option in good or an option in commodity derivative

  —Sale of an option in goods or an option in commodity derivative, where option is exercised

  —Sale of any other commodity derivative
- CTT is not new. The Finance Act 2008-09 proposed a levy of CTT at 0.017% for sale of an option in goods or an option in commodity derivative and sale of any other commodity derivative and 0.125% for sale of an option in goods or an option in commodity derivative, where option is exercised.
- Till now, traders have to pay brokerage on buying and selling the commodities. But from now on CTT will be charged which will increase the transaction cost of trading in non-agri commodities. The CTT will be additional burden on traders because they already pay deposit margin, brokerage, stamp duty and transaction charges.

4.5 TYPES OF COMMODITY DERIVATIVES

Two important types of commodity derivatives are

- Commodity options.
- Commodity futures.

(1) **Commodity Options contracts:** Like futures, options are also financial instruments used for hedging and speculation. The commodity option holder has the right, but not the obligation, to buy (or sell) a specific quantity of a commodity at a specified price on or before a specified date. Option contracts involve two parties – the seller of the option writes the option in favor of the buyer (holder) who pays a certain premium to the seller as a price for the option.

There are two basic types of commodity options: a call option and a put option.

- A call option gives the buyer, the right to buy the asset (commodity) at a given price. This 'given price' is called 'strike price'. For example: A bought a call at a strike price of Rs.500. On expiry the price of the asset is Rs.450. A will not exercise his call. Because he can buy the same asset form the market at Rs.450, rather than paying Rs.500 to the seller of the option.
- A put option gives the buyer a right to sell the asset at the 'strike price' to the buyer. Here the buyer has the right to sell and the seller has the obligation to buy. For example: B bought a put at a strike price of Rs.600. On expiry the price of the asset is Rs.619. A will not exercise his put option. Because he can sell the same asset in the market at Rs.619, rather than giving it to the seller of the put option for Rs.600.

(2) **Commodity Futures Contracts:** A futures contract is an agreement for buying or selling a commodity for a predetermined delivery price at a specific future time. Futures are standardized contracts that are traded on organized futures exchanges.

Notes

For example, suppose a farmer is expecting his crop of wheat to be ready in two months time, but is worried that the price of wheat may decline in this period. In order to minimize his risk, he can enter into a futures contract to sell his crop in two months' time at a price determined now. This way he is able to hedge his risk arising from a possible adverse change in the price of his commodity.

Futures contracts are products created by exchanges. A futures contract is an agreement that requires a party to a agreeing either to sell or buy something at a designated future date at a predetermined price.

As the value of a futures contract is derived from the value of the underlying instrument they are commonly called derivative instruments,

The basic economic function of futures markets is to provide an opportunity for market participants to hedge against the risk of adverse price movement.

The futures contracts based on a financial instrument or a financial index are known as financial futures. Financial futures can be classified as stock index futures, interest rate futures, and currency futures.

Financial futures contracts exist to provide risk management services to participants. Risk and uncertainty in the form of price volatility and opportunism are major factors giving rise to future trading.

Futures trading evolved out of autonomous forward contracting by merchants, dealers and processors, designed to increase business efficiency.

Indeed, early futures markets were viewed as delivery markets in which transactions were facilitated by the provision of uniform rules on grade and delivery terms, and the security provided by the clearing houses in guaranteeing individual contracts.

This evolution from spot, to forward, to futures contracts suggest a progressive adaptation of institutions to more efficient methods of dealing with price risk.

It is frequently argued that a pre-condition for futures trading is a well developed cash market and the breakdown of forward contracting. Futures markets develop because they are a more efficient means of transferring those contract rights attached to price. Spot and forward contracting may become too costly.

However, these three contracting modes are not mutually exclusive ways of transacting. Indeed, the development of futures markets improve the efficiency of spot and possibly of forward contracting.

It is perhaps best to view futures markets as 'side' markets designed to deal with price volatility that is poorly handled by spot and forward markets. This transactional superiority of futures markets comes mainly from their transaction – cost reducing attributes.

Futures markets, by forming prices relating to forward delivery dates, project their prices into the future. These prices are used by agents to plan future production to price forward contracts for the supply of commodities, and to tender for forward contracts.

Agents need not transact on future exchanges to use futures prices in this way, and the information contained in such prices is an externality to them.

Agents may also use futures markets in deciding whether to store a commodity (using the forward premium as an indicator of whether storage is expected to be profitable).

In addition, futures markets may help agents to decide the timing of inputs purchases and of processing activities according to the expected outcome of hedging. Agents in these latter two categories are, of course, transistors on futures markets.

Notes

Thus, futures markets perform a forward pricing function, and in these ways futures prices facilitate the allocation of resources between present and future uses.

Commodities suitable for futures trading

All the commodities are not suitable for futures trading. It must fulfill the following characteristics:

1) The commodity should have a suitable demand and supply conditions.
2) Prices should be volatile to necessitate hedging through futures price risk. As a result there would be a demand for hedging facilities.
3) Prices should be volatile to necessitate hedging through futures trading in this case persons with a spot market commitment face a price risk. As a result there would be a demand for hedging facilities.
4) The commodity should be free from substantial control from Govt. regulations (or other bodies) imposing restrictions on supply, distribution and prices of the commodity.
5) The commodity should be homogenous or, alternately it must be possible to specify a standard is necessary for the futures exchanges to deal in standardized contracts.
6) The commodity should be storable. In the absence of this condition arbitrage would not be possible and there would be no relationship between spot and futures.

Features of commodity Futures

a) Trading in futures is necessarily organized under the recognized association so that such trading is conducted with the procedure laid down in the Rules and Bye-laws of the association.
b) The units of price quotation and trading are fixed contracts, parties to the contracts not being capable of altering these units.
c) The delivery periods are specified.
d) The seller in a futures market has the choice to decide whether to deliver goods against outstanding sale contracts. In case he decides to deliver goods, he can do so not only at the location of the Association through which trading is organized but also at a number of other pre-specified delivery centres.

4.6 EFFICIENCY IN COMMODITY FUTURE MARKETS

Efficient futures markets provide a mechanism for managing the risk associated with the uncertainty of future events. The value of futures markets arises from their ability to predict the price of a given asset at a specified future date efficiently and without bias.

A market may be defined as efficient in the informational sense if the prices of the assets traded on that market instantaneously reflect all available information.

This definition is strong one and in terms of weak definition prices will reflect all available information up to the point where the cost of acquiring additional information is equal to the benefits derived from that information. Efficiency will be achieved through arbitrage between traders.

Market efficiency also implies that futures market prices are equal to expected future spot prices and risk premium which may be constant or time varying.

Notes

Alternatively, if markets are efficient and if no risk premium is present futures prices will be unbiased predictors of future spot prices only. Under the conditions of market efficiency and risk neutrality, we can frame the hypothesis that futures prices provide unbiased forecasts of spot prices. The concept of market efficiency is to be understood while taking time dimensions into consideration i.e. Markets may be efficient and unbiased in the long run, but may experience short-run inefficiencies and pricing biases.

The ability of futures markets to predict subsequent spot prices has been a controversial topic for a number of years. Empirical evidence to date is mixed; for any given market, some studies find evidence of efficiency, others of inefficiency.

In part, these apparently conflicting findings reflect differences in the time periods analyzed and the methods chosen for testing. A limitation of existing tests is the classification of markets as either efficient or inefficient with no assessment of the degree to which efficiency is present.

This topic presents tests for unbiasedness and efficiency across a range of commodity and financial futures markets, using a cointegration methodology, and develops a measure of relative efficiency. In general, the findings suggest that spot and futures prices are cointegrated with a slope coefficient that is close to unity, so that the postulated long-run relationship is accepted.

However, there is evidence that the long-run relationship does not hold in the short run; specifically, changes in the spot price are explained by lagged differences in spot and futures prices as well as by the basis. This suggests that market inefficiencies exist in the sense that past information can be used by agents to predict spot price movements.

How "Future Trading" Helps in Improving Agriculture Production in India

There is a considerable time gap between the time of initial investment and the receipt of returns from the final farm produce. Therefore, a farmer is highly vulnerable to price fluctuations as planning is done at the time of sowing based on the then prevailing prices.

Likewise, purchasers of agricultural commodities for use as inputs in production must make judgments on their availability and cost at different points of time during the year. To guard against price volatility and uncertainty in availability, sellers and buyers often enter into forward contracts. These contracts specify the quantity, quality and price of the commodity they would deliver for sale or acquire for purchase at a pre- decided date in the future.

'Future contracts' are, thus, standardised contracts to buy or sell a quantity of a standard quality of a commodity. These are traded in exchanges, through brokers, with no need for the buyer and seller to meet and negotiate.

An important feature is that a contract need not be settled by actual delivery. It can be matched by an offsetting contract taken by the buyer or seller, and the two can be squared at any point at some gain or loss.

To avoid paying margins, traders can buy an option to offer or acquire a contract at some specified future date. If the option is not exercised, because price movements are contrary to expectation, the loss is restricted to the premium paid to hold the option and the transaction costs of acquiring it.

Role of Futures Market:

Futures trading have an important role in bringing about improvements in agricultural production system:

i. Futures markets enable the farmers to deliver the crop at a specified price at some future date. The clearing houses of the commodity exchanges guarantee the performance of these

Notes

contracts. A farmer, who is uncertain about the prices of his produce, can cover his risk by selling a futures contract sometime before the harvest day.

ii. The futures prices are readily available for the farmers as the commodity exchanges disseminate prices on a continuous basis through various channels. If the price available in the futures market is not profitable to the farmer, he can change his cropping plan at the beginning of production itself.

iii. The futures market provides perfect collateral for the lenders to advance larger loans on easier terms to the farmers thereby ensuring a minimum-risk business for both the lender and the farmer.

iv. Futures market provides a convenient mechanism through which a farmer who wants to speculate on commodity but does not have the storage capacity can increase his speculative ability.

He can 'buy a position' while the crop is growing by buying a futures contract, and at the time of harvesting, can sell his crop in the cash market simultaneously squaring off his 'position in the futures market. This way he can gain from any price increase in both the spot as well as the futures market at the time of harvesting.

v. Commodity exchanges assist the producers and consumers in a fair price discovery and enable them to hedge their price risk.

The prices disseminate by exchanges are highly reliable and acceptable to both the business community and the farmers as they are discovered by discounting all information available at that point of time.

vi. The quality and delivery standards imposed by the exchanges in their products act as benchmarks and increase quality consciousness among farmers.

Future Trading in India

The first futures trade by an Indian FPO took place in 2014 when the Ram Rahim Pragati Producer Company – an enterprise started by 3,000 women belonging to self-help groups in a tribal area of Madhya Pradesh – hedged soyabean price risk on the National Commodity and Derivatives Exchange (NCDEX).

Between April 2016, when NCDEX began making formal efforts to directly engage with FPOs, and May 2018, FPOs had a miniscule 0.004% share of the agri-futures trade at NCDEX. More than half of the FPO futures trade of 50.8 crore was in soybeans, while another third was in maize. Bihar, Maharashtra and Madhya Pradesh account for 92% of the trade.

The Small farmers often hesitate to trade in the futures market due to their limited capacity as individuals. Future market is viewed with suspicion and termed as gambling.

Instead, they depend on traders in traditional marketing channels who charge high commissions, but provide easy access to credit and market.

However, FPOs, as aggregates of small farmers, can provide the scale of production needed if they receive sufficient information and support.

Progress

Indian commodity futures have had a long and chequered history. Until 2003, the futures contract was being traded only at regional exchanges that specialised in one or a few commodities. In 2003, the government mandated the setting up of nation-wide online commodity exchanges and allowed futures in a wide gamut of commodities.

Notes

There are four national level commodity exchanges, namely, the Multi Commodity Exchange (MCX), National Commodities and Derivatives Exchange of India (NCDEX), National Multi Commodity Exchange (NMCE) and the National Board of Trade (NBOT).

The first three exchanges trade in all the permitted commodities, while NBOT trades only in soyabean. The forwards Markets Commission (FMC) currently regulate the commodities futures market.

Exchange-traded commodities (ETCs)

Exchange-traded commodity is a term used for commodity exchange-traded funds (which are funds) or commodity exchange-traded notes (which are notes). These track the performance of an underlying commodity index including total return indices based on a single commodity. They are similar to ETFs and traded and settled exactly like stock funds. ETCs have market maker support with guaranteed liquidity, enabling investors to easily invest in commodities. They were introduced in 2003.

At first, only professional institutional investors had access, but online exchanges opened some ETC markets to almost anyone. ETCs were introduced partly in response to the tight supply of commodities in 2000, combined with record low inventories and increasing demand from emerging markets such as China and India.

Prior to the introduction of ETCs, by the 1990s ETFs pioneered by Barclays Global Investors (BGI) revolutionized the mutual funds industry. By the end of December 2009 BGI assets hit an all-time high of $1 trillion.

Gold was the first commodity to be securitised through an Exchange Traded Fund (ETF) in the early 1990s, but it was not available for trade until 2003. The idea of a Gold ETF was first officially conceptualised by Benchmark Asset Management Company Private Ltd in India, when they filed a proposal with the Securities and Exchange Board of India in May 2002.

The first gold exchange-traded fund was Gold Bullion Securities launched on the ASX in 2003, and the first silver exchange-traded fund was iShares Silver Trust launched on the NYSE in 2006. As of November 2010 a commodity ETF, namely SPDR Gold Shares, was the second-largest ETF by market capitalization.

Generally, commodity ETFs are index funds tracking non-security indices. Because they do not invest in securities, commodity ETFs are not regulated as investment companies under the Investment Company Act of 1940 in the United States, although their public offering is subject to SEC review and they need an SEC no-action letter under the Securities Exchange Act of 1934. They may, however, be subject to regulation by the Commodity Futures Trading Commission.

The earliest commodity ETFs, such as SPDR Gold Shares NYSE Arca: GLD and iShares Silver Trust NYSE Arca: SLV, actually owned the physical commodity (e.g., gold and silver bars). Similar to these are NYSE Arca: PALL (palladium) and NYSE Arca: PPLT (platinum). However, most ETCs implement a futures trading strategy, which may produce quite different results from owning the commodity.

Commodity ETFs trade provide exposure to an increasing range of commodities and commodity indices, including energy, metals, softs and agriculture. Many commodity funds, such as oil roll so-called front-month futures contracts from month to month. This provides exposure to the commodity, but subjects the investor to risks involved in different prices along the term structure, such as a high cost to roll.

Notes

ETCs in China and India gained in importance due to those countries' emergence as commodities consumers and producers. China accounted for more than 60% of exchange-traded commodities in 2009, up from 40% the previous year. The global volume of ETCs increased by a 20% in 2010, and 50% since 2008, to around 2.5 billion million contracts.

Over-the-counter (OTC) Commodities Derivatives

Over-the-counter (OTC) commodities derivatives trading originally involved two parties, without an exchange. Exchange trading offers greater transparency and regulatory protections. In an OTC trade, the price is not generally made public. OTC commodities derivatives are higher risk but may also lead to higher profits.

Between 2007 and 2010, global physical exports of commodities fell by 2%, while the outstanding value of OTC commodities derivatives declined by two-thirds as investors reduced risk following a five-fold increase in the previous three years.

Money under management more than doubled between 2008 and 2010 to nearly $380 billion. Inflows into the sector totaled over $60 billion in 2010, the second-highest year on record, down from $72 billion the previous year. The bulk of funds went into precious metals and energy products. The growth in prices of many commodities in 2010 contributed to the increase in the value of commodities funds under management.

Commodities Exchange

A commodities exchange is an exchange where various commodities and derivatives are traded: Most commodity markets across the world trade in agricultural products and other raw materials (like wheat, barley, sugar, maize, cotton, cocoa, coffee, milk products, pork bellies, oil, metals, etc.) and contracts based on them. These contracts can include spot prices, forwards, futures and options on futures. Other sophisticated products may include interest rates, environmental instruments, swaps, or freight contracts.

4.7 GOVERNING BODY

The governing body of the commodity markets is the 'Forward Markets Commission' (FMC). It is the major regulator of product futures markets in India. The body operates under the Ministry of Finance and their headquarter's in Mumbai .

Explanation:

- To increase the regulation of the commodity futures market and to make it stronger the FMC was merged with the Securities and Exchange Board of India (SEBI)
- The commodity market trades in the primary economic sector like fruits, sugar, cocoa. It provides an open market for demand and supply of goods and it only takes into account the prices that affect the demand and supply of goods.
- The main function of the governing body is to advise the government in regards to the administration of the Forward Contracts and to make recommendations for improving the systems and working of forwarding markets.

Notes

Need for regulating commodity market

The need for regulation arises on account of the fact that the benefits of futures markets accrue in competitive conditions. The regulation is needed to create competitive conditions.

In the absence of regulation, unscrupulous participants could use these leveraged contracts for manipulating prices. This could have undesirable influence on the spot prices, thereby affecting interests of society at large. Regulation is also needed to ensure that the market has appropriate risk management system.

The functions of the Forward Markets Commission.

a) FMC advises Central Government in respect of grant of recognition or withdrawal of recognition of any association.

b) It keeps forward markets under observation and takes such action in relation to them as it may consider necessary, in exercise of powers assign to it.

c) It collects and publishes information relating to trading conditions in respect of goods including information relating to demand, supply and prices and submits to the Government periodical reports on the operations of the Act and working of forward markets in commodities.

d) It makes recommendations for improving the organization and working of forward markets.

e) It undertakes inspection of books of accounts and other documents of recognized/ registered associations.

Powers of the Forward Market Commission

The Commission has powers of deemed civil court for :

(a) Summoning and enforcing the attendance of any person and examining him on oath;

(b) Requiring the discovery and production of any document;

(c) Receiving evidence on affidavits, and

(d) Requisitioning any public record or copy thereof from any office.

Regulatory measures prescribed by Forward Markets Commission

Forward Markets Commission provides regulatory oversight in order to ensure financial integrity (i.e. to prevent systematic risk of default by one major operator or group of operators), market integrity (i.e. to ensure that futures prices are truly aligned with the prospective demand and supply conditions) and to protect & promote interest of customers/non-members.

The Forward Markets Commission prescribes following regulatory measures:

a) Limit on net open position as on the close of an individual operator and at Member level to prevent excessive speculation.

b) Circuit-filters or limit on price fluctuations to allow cooling of market in the event of abrupt upswing or downswing in prices.

c) Imposition of margins to prevent defaults by Members/clients.

Notes

d) Physical delivery of contracts and penalty for default/delivery obligations.

e) Dialy mark to marketing of the contracts

Management of commodity exchanges

These exchanges are managed by the Board of Directors which is composed primarily of the members of the association. Members of commodity exchanges includes:

1) Ordinary Members: They are the promoters who have the right to have own account transa tions without having the right to execute transactions in the trading ring. They have to place orders with trading members or others who have the right to trade in the exchange.

2) Trading Members: These members execute buy and sell orders in the trading ring the exchange on their account, on account of ordinary members and other clients.

3) Trading-cum-Clearing Members: They have the right to participate in clearing and settlement in respect of transactions charred out on their account and on account of their clients.

4) Institutional Clearing Members: They have the right to participate in clearing and settlement on behalf of other members but do not have the trading rights.

5) Designated Clearing Bank: It provides banking facilities in respect of payin, pay-out and other monetary settlements.

Preconditions for a Successful Commodity Exchange

1) Clear Objectives: A commodity exchange needs a clear plan with a welldefined scope. The exchange must have a detailed business plan, operating budget and strategy to engage productively with stakeholders.

2) Good Governance: A commodity exchange must have a well-thought-out governance structure that emphasizes and responds to membership needs while maintaining an effective board and advisory structure that upholds business standards and meets performance targets.

3) Industry/Stakeholder Buy-in: commodity exchange leadership must meet with farmers, traders, processors, banks, the Central Bank, Ministry of Agriculture,

   Ministry of Finance and donors/relief agencies to generate support for the exchange.

4) Enabling Environment/Infrastructure: The host country needs to have legislation in place that consistently addresses agricultural, financial, trade and legal policies.

5) Well-Designed Trading and Clearing Systems: The exchange must develop a system that is appropriate to the environment in which it is operating.

6) Clear Rules, Consistent Enforcement: A commodity exchange must have clear, consistently applied and balanced rules and regulations designed to protect the integrity of the exchange.

7) Accurate Contracts: The exchange should work with members and the industry to develop and agreed contract to facilitate trades and more detailed commodities-specific contracts that contain standard information on quality standards, analysis, delivery and weights, demurrage, force majeure and arbitration, among others.

8) Extensive, Continuous Education and Trading: Training and certification of members

Notes

and brokers is critical to ensuring the integrity of the exchange.

9) Relevant and Adaptable: An exchange serves the market. It must therefore constantly re-evaluate its performance, regulations, systems and membership to ensure that it is delivering value and maintaining its integrity.

10) Large Volumes of Commodities Traded: To stay viable, exchanges must attract large volumes of commodity across its trading floor.

4.8 MAJOR COMMODITY EXCHANGES IN INDIA

There are numerous regional commodity exchanges in India, of which four exchanges are of national importance. The four exchanges are National commodity & Derivative Exchange Limited (NCDEX), Mumbai, Multi Commodity Exchange of India Limited (MCX), Mumbai, National Multi Commodity Exchange of India Limited (NMCEIL), Ahmedabad and Indian Commodity Exchange (ICEX), New Delhi. Other exchanges are situated in different parts of the country.

Besides in mid-2018, the BSE (Bombay stock exchange) and NSE (National stock exchange) got SEBI's approval to start dealing in commodities.

The major commodity exchanges in India in terms of volume of trade are given below:

1) The Multi Commodity Exchange of India Limited (MCX)
2) National Commodity and derivatives Exchange (NCDEX)
3) National Multi Commodity Exchange (NMCE)
4) Indian Commodity Exchange Limited (ICEX)
5) ACE Commodity exchange

1. **Multi Commodity Exchange of India Limited (MCX)**

The Multi Community Exchange of India Limited (MCX), India's first listed exchange, is a state-of-the-art, commodity futures exchanges that facilitates online trading, and clearing and settlement of commodity futures transactions, thereby providing a platform for risk management. It was established in 2003 and is based in Mumbai. It is regulated by the FMC. Vision & Mission of MCX

Vision

We envision a unified Indian commodity market that is driven by market forces and continually provides a level playfield for all stakeholders ranging from the primary producer to the end-consumer; corrects historical aberrations in the system; leverages technology to achieve exceptional efficiencies and ultimately lead to a common world market.

Mission

The Exchange will continue to minimize the adverse effects of price volatilities; providing commodity ecosystem participants with neutral, secure and transparent trade mechanisms; formulating quality parameters and trade regulations in conjunction with the regulatory authority.

Features

- MCX is a state of the art electronic commodity future exchange with permanent government recognition.
- MCX offers more than 40 commodities across various segments such as bullion, ferrous and non ferrousmetals , energy and agro commodities.

- It has introduced standardized commodity futures contracts on its platform.
- It has several strategic alliances with various leading global commodity exchanges.
- MCX COMDEX is India's first and only composite commodity price index.

2. **National Commodity & Derivatives Exchange Limited (NCDEX)**

National Commodities & Derivatives Exchange Limited (NCDEX) is promoted by national-level institutions. It is a public limited company incorporated in April 2003 and is a national level technology-driven Commodity Exchange, with an independent Board of Directors and driven by professionals. Its promoters include ICICI Bank, LIC NABARD, CANARA Bank, CRISIL etc.

It is providing a global commodity exchange platform for participants to trade in a broad range of commodity derivatives driven by international practices, professionalism and transparency.

NCDEX is regulated by SEBI and is subjected to other laws like the Companies Act, Stamp Act, Contracts Act, Securities Contracts Regulation Act and various other legislations.

NCDEX is in Mumbai and offers facilities to its members in more than 550 centers throughout India. NCDEX facilitates the trading of 57 commodities.

Key takeways

- NCDEX is a professionally managed online multi commodity exchange based in India and located in Mumbai.
- It was incorporated as a private limited company incorporated in April 2003 under the Companies Act, 1956. It was originally promoted by ICICI Bank , NSE , NABARD and LIC.
- It is the country's second largest commodity exchange which mainly deals in agricultural commodities.
- Its shareholders include national level institutions, large public sector bank and companies.
- It is regulated by the FMC.

Facilities provided by NCDEX include :

1. NCDEX offers trading in more than 31 agri& non agri commodities
2. NCDEX provides an agricultural commodity index called DHAANYA which is weighted value index.
3. It has introduced N-charts – an advanced web based charting tool provided to users free of cost, helping them in technical analysis.
4. Launched COMTRACK – a proprietary electronic warehouse accounting system
5. Exchange for physicals – recently announced EFP (Exchange for Physicals)

3. **National Multi Commodity Exchange (NMCE)**

National Multi Commodity Exchange of India Ltd. (NMCE) was promoted by commodity-relevant public institutions, viz., Central Warehousing Corporation (CWC), National Agricultural Cooperative Marketing Federation of India (NAFED), Gujarat Agro-Industries Corporation Limited (GAICL), Gujarat State Agricultural Marketing Board (GSAMB), National Institute of Agricultural Marketing (NIAM), and Neptune Overseas Limited (NOL).

While various integral aspects of commodity economy, viz., warehousing, cooperatives,

Notes

private and public sector marketing of agricultural commodities, research and training were adequately addressed in structuring the Exchange, finance was still a vital missing link. Punjab National Bank (PNB) took equity of the Exchange to establish that Linkage. Even today, NMCE is the only Exchange in India to have such investment and technical support from the commodity relevant institutions.

Mission

- Improving efficiency of marketing through online trading in dematerialized form
- Minimization of settlement risks
- Improving efficiency of operations by providing best infrastructure and latest technology
- Rationalizing the transaction fees to optimum level.
- Implementing best quality standards of warehousing grading and testing in tune with trade practices.
- Improving facilities for structured finance
- Improving quality of services rendered by suppliers
- Promoting awareness about on-line features trading services of NMCE across the length & breadth of the country.

4) Indian Commodity Exchange Limited (ICEX)

Indian Commodity Exchange Limited is a nation-wide screen based online derivatives exchange for commodities and has established a reliable, efficient and transparent trading platform. It has put in place assaying and warehousing facilities in order to facilitate deliveries. Vision & Mission of ICEX

- Provide fair, transparent and efficient trading platform to all participants.
- Meet the international benchmarks for the Indian commodity market.
- Provide equal opportunity and access to investors al over the country through the modern communication modes.
- Attract a wide array of end-users, financial intermediaries and hedgers.
- Become a major trading hub for most of the commodities.
- To provide product portfolio to suit the trading community needs in an efficient manner.

5. ACE Commodity Exchange

Kotak promoted, Ace Derivatives and Commodity Exchange Limited is a screen based online derivatives exchange for commodities in India. Ace Commodity Exchange earlier known as Ahmedabad Commodity Exchange has been in existence for more than 5 decades in commodity business; bringing in the best and transparent business practices in the Indian commodity space.

6. Indian Commodity Exchange, Gurgaon

This is a screen-based online exchange platform for commodities, located in Gurgaon. Its promoters include Reliance exchange Next Limited, MMTC Limited, India Bulls Financial Services Limited, India Potash and KRIBHCO etc. It deals with commodities such as Gold, silver, diamond, copper, lead, crude oil etc.

7. **International commodity Exchanges:**

   Futures' trading was evolved due to problems related to the maintenance of a year-round supply of commodities which are seasonal as is the case of agricultural produce. The leading commodity futures exchanges in the world are in the United States, Japan, United Kingdom, Brazil, Australia, Singapore etc.

   Major commodity exchanges of the world are New York Mercantile Exchange, London Metal Exchange, Chicago Board of Trade, Chicago Mercantile Exchange, Tokyo commodity exchange etc.

Working Methodology of Commodity Market

- Two kinds of trade is practiced in commodities. One is the spot trade, in which cash is paid against physical goods and the deal is closed.
- Second is futures trade. The basics for futures is the warehouse receipt. A person deposits a certain amount of goods in a warehouse and gets a warehouse receipt. This lets him to ask for physical delivery of the good from the warehouse.

  People trading in commodity futures need not necessarily possess such a receipt to strike a deal. Anyone can buy or sale a commodity future on an exchange based on his expectation of future prices realization.

  Futures have an expiry date; by when the buyer or seller either closes his account or gives/ takes delivery of the underlying commodity. The broker keeps an account of all parties dealing in the transaction, in which the routine transactional details, due to changes in the futures price is recorded. Closing off is done by taking an opposite contract so that the net outstanding is nil.

  For commodity futures to work, the seller must be able to deposit/handover the commodity at the nearest warehouse and collect the receipt. The buyer should be able to take physical delivery at a location of his choice on presenting the warehouse receipt. At present, very few warehouses provide delivery for specific commodities.

  Presently the system of commodity exchange is an online and physical visit to the market is not required for speculation.

The entire process involves three stages:

- Trading- Involves Order receiving/ matching/ reporting/ limit fixation/ Price Fixation is done at this stage
- Clearing- Involves Clearinghouse transactions/ Matching/ Registration/ Price limits/ position limits/ Notation/ margining function is done at this stage
- Settlement- Involves Settlement of the transactions is done at this stage.

4.9 COMMODITY EXCHANGE - A REFERENCE TO THE INDIAN SCENARIO

It is to be rightly said that India is a commodity based economy since more than 70 % of the total population is engaged in primary sector directly or indirectly. Major industries of the economy like sugar, textile, metal, energy etc. are based on various commodities. So, far the financial returns are

Notes

concerned, this sector has also become a good spot for booking good returns comparatively besides hedging against the inflation, since the returns in precious metals segments can be observed more than that of in equity and debt markets as are negatively correlated. After gaining the considerable popularity, the major commodity exchanges in India had started the future contracts in various commodities years back, which can serve preferably to manage the risk that can arises due to adversity of expected prices of commodities besides the price discovery tool.

The future contracts dealing in major commodity exchanges are standardize in nature. This paper will explain the growth of contracts traded in various commodities in one of the major exchange besides the relationship of commodity contracts with other economic factors; moreover it will impart a comprehensive view of commodity futures as risk management tool. Introduction:

Global Perspective

An Exchange is an organized market wherein varied people gather to trade with various goods that may be measured under various units of measurement. Such exchanges are regulated and inspected by the respective country/ state. The history of such exchanges may be traced to 14th century to be precise 1200- 1500 BC, as per the writings available of Romans and Phoenicians.

The invention and usage of notes brought about a revolution in the trading and business and the faster growth of various markets or so-called exchanges. The humble beginning which started as fairs in small streets of Europe soon spread to various other regions. Thus Hamburg, Bremen, New York Exchanges were later set up, which are still treated as exchanges of significant importance.

In the recent past, the origin of organized trading evolved in Chicago, in 1848. But the origin may also be traced to Japan, wherein the trading originally started with rice receipts rather than a physical product.

Over a period, such exchanges practices became profitable and encouraged the entry of various other products in the market. This led to the evolution of various regulatory bodies for the regulation of such exchanges across various countries.

Status of Exchanges within our country:

The origin of organized trading may be traced to the 19th century, in 1875. Over a period, such exchanges practices started in many cities with multiproduct.

This led to the creation of Forward contract Regulation Act'1952 (FCRA) for the regulation of such transactions and markets all over India. Initial market operations had too many restrictions but the same were liberalized after Globalization in 1990 leading to opening the markets for multiple products with relaxed norms for trading.

The relaxed norms have led to a surge in the market, in terms of modern exchanges, commodities allowed for derivatives trading and value of futures trading in commodities.

Further development took place with the launch of online commodity exchanges to facilitate better risk coverage and delivery of commodities.

Regulation of Commodity Exchanges- The Legal Framework:

Forward Market Commission (FMC), a statutory body was set up under the Forward Contract Regulation Act'1952 (FCRA) to regulate the entire process of commodity exchanges initially. Later, the FMC was merged with the Security and Exchange Board of India (SEBI) for better and

effective management.

SEBI as a regulator has got immense powers and authority under the Securities Contracts Regulation Act (SCRA) and is thus treated as better regulator than FMC, which had very limited powers and authority. FMC only had the powers to regulate the exchanges whereas SEBI has the powers to regulate the brokers also.

The Present Scenario:

India is amongst the top five producers of most of the Commodities. Further, it is also a major consumer of bullion and energy products. Agriculture contributes about 22% GDP of the country's economy and employs around 57% of the labor force on a total of 163 million hectors of land. Agriculture is a very crucial factor in achieving the GDP growth of 8-10%. This depicts that India can be promoted as a major Centre for the trading of commodity derivatives.

Trends in volume contribution on the three National Exchanges: –

Trends on Multi Commodity Exchange (MCX):-

MCX is the largest commodity exchange in terms of volumes. It has become the third-largest in bullion and second-largest in silver futures trading in the world.

Though there are close to 100 commodities traded on MCX, only 3 / 4 commodities provide for more than 80 per cent of total business volume.

The majorly traded commodities are Gold, Silver, Energy and Base Metals. The futures' trends of these commodities are mainly pushed by international futures prices. Major volume contributors amongst Agro based commodities include Gur, Urad, Mentha Oil etc.

Trends on National Commodity & Derivatives Exchange (NCDEX):-

National Commodity & Derivative Exchange (NCDEX) is the second-largest commodity exchange platform in India after MCX. The significant volume contributors on NCDEX are Agro based commodities.

They have a fundamental challenge of small market size, which is making them susceptible to market manoeuvrings and over speculation. Almost 60 per cent trade on NCDEX is achieved from guar seed, Chana and Urad etc.

Trends on National Multi Commodity Exchange (NMCE):

National Multi Commodity Exchange (NMCE) is third national level, futures exchange commodity market platform, that has been majorly trading in Agro-based Commodities. Trading on NMCE had a significant proportion of commodities with large market size as jute rubber etc. Over a period of time, the trend has changed and gradually moved towards commodities with a little market size.

Major volume contributors:

Majorly trade has been focused in a few commodities such as:

- Non-Agro Commodities like (bullion, metals and energy etc)
- Agro-based commodities with an insignificant market share like guar, Urad, Mentha etc.

India has a promising future with regards to the commodities market. Prices of all commodities

Notes

are on a higher side due to the rapid increase in demand for commodities national as well as internationally.

Developing countries like China are avidly consuming commodities. International commodity market has become bigger than the stock market. India being one of top producers of large number of commodities coupled with the fact that it has a long history of trading in commodities has a promising market.

The management will assume substantial importance in future with the promotion of free trade and the removal of trade barriers. Bulk of Indian investors are not aware of the potential of the organized commodity market.

But overall the entire community of producers, traders, as well as consumers, will be benefited from it. For this step must be taken to regulate and popularize & showcase the Commodity Market.

SUMMARY

- A commodities Market is an organised market that functions under established rules and regulations.
- Commodities are hard assets ranging from wheat to gold to oil. The U.S. government defines commodities in the 1936 Commodity Exchange Act.1 The Act covers trading in agricultural and natural resource commodities. Although the Act treats financial products like commodities, it doesn't consider them to be commodities. The Act also bans trade in onions as a commodity.
- Commodity exchanges are specialised organised markets which provide a place where their members buy and sell commodities or contract for future delivery under established rules and regulations.
- The organised market represents a public organisation consisting of buyers, sellers, producers, traders and dealers dealing in one or more commodities which constitute the articles of trade in the market. The exchange for commodity is a private association of dealers and is not for making money or profit or for fixing prices.
- Its objectives are to provide an open platform for the interaction of free play of the forces of demand and supply. It only registers the prices reflecting the forces of demand and supply. Buying and selling, trading practices and actual working of the organised market are governed by a code of rules and regulations and these can ensure fair dealings, fair prices and equity.
- Every forward market has a clearing house organisation to facilitate clearing of all dealings and their settlement. The clearing house guarantees payment of dues and taking and giving of delivery of commodities or securities during the settlement period.
- An organised market acts as a clearing house of market information, i.e., collection of all facts and figures and regular publicity of all relevant statistical information which helps the traders to estimate and forecast price trends, changes in demand and supply. Constant price quotation services enable people to make their purchases and sales with certainty and confidence.
- The speculative trader is a necessary and vital part of any broad and stable commodity or securities market. Speculation is an integral part of market mechanism whether in stock exchange or in commodity exchange.

Notes

- A commodity exchange provides a convenient place where the members can meet at fixed hours and transact business in a commodity according to a certain well established rules and regulations. This type of facility is very important for trading in such commodities as are produced in abundance and cover a very wide field as far as trading therein is concerned.
- As organised markets commodity exchanges establish and enforce rules and regulations with a view to facilitating trade on sound lines. The rules define the duties of mem¬bers and lay down methods for business transaction.
- The buyers and sellers on the commodity exchange enter into deals for settlement in future after making an assessment the trends of price and the prospects of a rise or fall in prices of a commodity. The commodity exchange acts as an association of these traders collecting the necessary information and the relevant statistical data and publishing it for the benefit of traders all over the country.:
- Commodities which are traded on the commodity exchanges have, to be graded according to quality. In this manner, the dealers can quickly enter into agreements for

abc

KEY WORDS

- **Cash Contracts (Physical Market):** The cash contracts for the purchase or sale of commodities are those which call for payment of the full con¬tract price in cash on delivery. Such contracts are made in the cash or physical market. In fact they are also referred to physical contracts in the sense that they deal in actual or physical products.
- **Spot Transactions:** Spot transactions are those cash contracts which involve the payment for the price by buyer and the delivery of the specified grade of goods by sellers immediately. These contracts relate to the purchase or sale of com¬modities on spot. The essence of such contracts is the ready delivery and acceptance of the delivery of the goods sold.
- **Forward Contracts:** Forward dealings are those cash contracts made in the cash or physical market which call for the delivery of goods and payment of the price after a specified period on a fixed date. The basic feature common to both the spot contracts and the forward contracts is that they are made and settled not necessarily in the premises of the commodity exchange. That is to say, the cash contracts are generally made outside the exchange.
- **Futures Contracts:** A futures contract is a special type of agreement made strictly under the rules of a commodity which may or may not call for the actual delivery of goods and payment of price in cash on a future date.
- **Credit risk:** Credit risk on account of default by counter party: This is very low or almost zeros because the Exchange takes on the responsibility for the performance of contracts.
- **Market risk:** Market risk is the risk of loss on account of adverse movement of price.
- **Legal risk:** Legal risk is that legal objections might be raised; regulatory framework might disallow some activities.
- **Operational risk:** Operational risk is the risk arising out of some operational difficulties, like, failure of electricity or connectivity, due to which it becomes difficult to operate in the market.

Notes

REVIEW QUESTIONS

1. Define commodity market. State its functions.
2. Distinguish between Forwards and Futures Contract.
3. What are objectives of commodity market
4. Differentiate between physical and futures market
5. Discuss the organisation structure of a commodity market
6. Discuss about FMC – functions, powers
7. Discuss the conditions for a successful commodity exchange
8. Write notes on : MCX , NMCE, NCDEX , ICEX ?
9. Give explanatory notes on :

   (a) Major commodity exchanges in india

   (b) Depositories

   (c) Demat

   (d) Transactions

FURTHER READINGS

1. Mukund Sharma , H.R.Appanaiah Stock and Commodity Market-Himalayan Publication International Financial Management.
2. Dr.Preeti Singh ,Stock and Commodity Market- Himalayan Publication International Financial Management khan,Indian Financial System 6th edition ,Tata McGraw Hill
3. Garner, Carley. A Trader's First Book on Commodities. (New Jersey: FT Press, 2010): Futures Trading Act of 1921, Declared unconstitutional in Hill v. Wallace 259 U.S. 44 (1922), the Grain Futures Act of 1922 and Board of Trade of City of Chicago v. Olsen 262 U.S. 1 (1923).
4. Cronon, William. Pricing the Future: Grain. Nature's Metropolis: Chicago and the Great West. University of Chicago, 1991. pp.109-133

UNIT 5

TRADING IN COMMODITIES MARKET

Structure

5.0 Learning Objectives
5.1 Introduction
5.2 Commodity Market in India
5.3 Trading in Commodity Market
5.4. Types of Commodity Markets
5.5 Examples of Commodities Markets
5.6 Meaning of Forward Market Commission (FMC)
5.7 The Role of Forward Markets Commission in Indian Commodity Markets
5.8 System of Regulation of Forward/Futures Trading
5.9 Regulatory Frame Work of Commodity Markets in India
5.10 Trading and Settlement in Commodity Market
5.11 Margins for Trading in Commodity Derivatives
5.12 Challenges Faced by Commodity Markets
Summary
Key Words
Review Questions
Further Readings

5.0 LEARNING OBJECTIVES

After reading this chapter students will be able to:

- Understand the Meaning of Forward Market Commission (FMC)
- Know the The Role of Forward Market Commission in Indian Commodity Market
- Know the patterns of trading
- Discuss the Challenges faced by commodity markets
- Understand the concept of Trading and Settlement in Commodity Market

5.1 INTRODUCTION

Commodities are an important aspect of most American's daily life. A commodity is a basic good used in commerce that is interchangeable with other goods of the same type. Traditional examples

Notes

of commodities include grains, gold, beef, oil, and natural gas.

For investors, commodities can be an important way to diversify their portfolio beyond traditional securities. Because the prices of commodities tend to move in opposition to stocks, some investors also rely on commodities during periods of market volatility.

In the past, commodities trading required significant amounts of time, money, and expertise, and was primarily limited to professional traders. Today, there are more options for participating in the commodity markets.

Key Points:

- Commodities that are traded are typically sorted into four categories broad categories: metal, energy, livestock and meat, and agricultural.
- For investors, commodities can be an important way to diversify their portfolio beyond traditional securities.
- In the most basic sense, commodities are known to be risky investment propositions because their market (supply and demand) is impacted by uncertainties that are difficult or impossible to predict, such as unusual weather patterns, epidemics, and disasters both natural and man-made.
- There are a number of ways to invest in commodities, such as futures contracts, options, and exchange-traded funds (ETFs).

A History of Commodities Trading

Trading commodities is an ancient profession with a longer history than the trading of stocks and bonds. The rise of many empires can be directly linked to their ability to create complex trading systems and facilitate the exchange of commodities.

In modern times, commodities are still exchanged throughout the world. A commodities exchange refers both to a physical location where the trading of commodities takes place and to legal entities that have been formed in order to enforce the rules for the trading of standardized commodity contracts and related investment products.

Some commodities exchanges have merged or gone out of business in recent years. The majority of exchanges carry a few different commodities, although some specialize in a single group. In the U.S., there is the Chicago Mercantile Exchange (CME), the New York Mercantile Exchange (NYMEX), the Intercontinental Exchange (ICE) in Atlanta, Georgia, and the Kansas City Board of Trade. In Europe, there is the London Metal Exchange (LME). As its name implies, the London Metal Exchange only deals with metals.

Special Characteristics of the Commodities Market

In the broadest sense, the basic principles of supply and demand are what drive the commodities markets. Changes in supply impact the demand; low supply equals higher prices.

So, any major disruptions in the supply of a commodity, such as a widespread health issue that impacts cattle, can lead to a spike in the generally stable and predictable demand for livestock.

Global economic development and technological advances can also impact prices. For example, the emergence of China and India as significant manufacturing players (therefore demanding a higher volume of industrial metals) has contributed to the declining availability of metals, such as steel, for the rest of the world.

Notes

Types of Commodities

Commodities that are traded are typically sorted into four categories broad categories: metal, energy, livestock and meat, and agricultural.

Metals

Metals commodities include gold, silver, platinum, and copper. During periods of market volatility or bear markets, some investors may decide to invest in precious metals–particularly gold–because of its status as a reliable, dependable metal with real, conveyable value.

Investors may also decide to invest in precious metals as a hedge against periods of high inflation or currency devaluation.

Livestock and Meat

Livestock and meat commodities include lean hogs, pork bellies, live cattle, and feeder cattle.

Agriculture

Agricultural commodities include corn, soybeans, wheat, rice, cocoa, coffee, cotton, and sugar. In the agricultural sector, grains can be very volatile during the summer months or during any period of weather-related transitions.

For investors interested in the agricultural sector, population growth–combined with limited agricultural supply–can provide opportunities for profiting from rising agricultural commodity prices.

Using Futures to Invest in Commodities

One way to invest in commodities is through a futures contract. A futures contract is a legal agreement to buy or sell a particular commodity asset at a predetermined price at a specified time in the future. The buyer of a futures contract is taking on the obligation to buy and receive the underlying commodity when the futures contract expires.

The seller of the futures contract is taking on the obligation to provide and deliver the underlying commodity at the contract's expiration date. Futures contracts are available for every category of commodity. Typically, there are two types of investors that participate in the futures markets for commodities: commercial or institutional users of the commodities and speculative investors.

Energy

Energy commodities include crude oil, heating oil, natural gas, and gasoline. Global economic developments and reduced oil outputs from established oil wells around the world have historically led to rising oil prices, as demand for energy-related products has gone up at the same time that oil supplies have dwindled.

Investors who are interested in entering the commodities market in the energy sector should also be aware of how economic downturns, any shifts in production enforced by the Organization of the Petroleum Exporting Countries (OPEC), and new technological advances in alternative energy sources (wind power, solar energy, biofuel, etc.) that aim to replace crude oil as a primary source of energy, can all have a huge impact on the market prices for commodities in the energy sector.

Notes

Manufacturers and service providers use futures contracts as part of their budgeting process to normalize expenses and reduce cash flow-related headaches. Manufacturers and service providers that rely on commodities for their production process may take a position in the commodities markets as a way of reducing their risk of financial loss due to a change in price.

The airline sector is an example of a large industry that must secure massive amounts of fuel at stable prices for planning purposes. Because of this need, airline companies engage in hedging with futures contracts.

Future contracts allow airline companies to purchase fuel at fixed rates for a specified period of time. This way, they can avoid any volatility in the market for crude oil and gasoline.

Farming cooperatives also utilize futures contracts. Without the ability to hedge with futures contracts, any volatility in the commodities market has the potential to bankrupt businesses that require a relative level of predictability in the prices of goods in order to manage their operating expenses.

Speculative investors also participate in the futures markets for commodities. Speculators are sophisticated investors or traders who purchase assets for short periods of time and employ certain strategies as a way of profiting from changes in the asset's price. Speculative investors hope to profit from changes in the price of the futures contract.

Because they do not rely on the actual goods they are speculating on in order to maintain their business operations (like an airline company actually relies on fuel), speculators typically close out their positions before the futures contract is due. As a result, they may never take actual delivery of the commodity itself.

If you do not have a broker that also trades futures contracts, you may be required to open a new brokerage account. Investors are also typically required to fill out a form that acknowledges that they understand the risks associated with futures trading.

Futures contracts will require a different minimum deposit depending on the broker, and the value of your account will increase or decrease with the value of the contract. If the value of the contract decreases, you may be subject to a margin call and required to deposit more money into your account in order to keep the position open.

Due to the high level of leverage, small price movements in commodities can result in either large returns or large losses; a futures account can be wiped out or doubled in a matter of minutes.

There are many advantages of futures contracts as one method of participating in the commodities market. Analysis can be easier because it's a pure play on the underlying commodity. There's also the potential for huge profits, and if you are able to open a minimum-deposit account, you can control full-size contracts (that otherwise may be difficult to afford). Finally, it easy to take long or short positions on futures contracts.

Because the markets can be very volatile, direct investment in commodity futures contracts can be very risky, especially for inexperienced investors. The downside of there being a huge potential for profit is that losses also have the potential to be magnified; if a trade goes against you, you could lose your initial deposit (and more) before you have time to close your position.

Most futures contracts offer the possibility of purchasing options. Futures options can be a lower-risk way to enter the futures markets. One way of thinking about buying options is that it is similar to putting a deposit on something instead of purchasing it outright. With an option, you have the right–but not the obligation–to follow through on the transaction when the contract expires.

Therefore, if the price of the futures contract doesn't move in the direction you anticipated, you have limited your loss to the cost of the option you purchased.

Using Stocks to Invest in Commodities

Many investors who are interested in entering the market for a particular commodity will invest in stocks of companies that are related to a commodity in some way. For example, investors interested in the oil industry can invest in oil drilling companies, refineries, tanker companies, or diversified oil companies. For those interested in the gold sector, some options are purchasing stocks of mining companies, smelters, refineries, or any firm that deals with bullion.

Stocks are typically thought to be less prone to volatile price swings than futures contracts. Stocks can be easier to buy, hold, trade, and track. Plus, it is possible to narrow investments to a particular sector. Of course, investors need to do some research to help ensure that a particular company is both a good investment and commodity play.

Investors can also purchase options on stocks. Similar to options on futures contracts, options on stocks require a smaller investment than buying stocks directly.

So, while your risk when investing in a stock option may be limited to the cost of the option, the price movement of a commodity may not directly mirror the price movement of the stock of a company with a related investment.

An advantage of investing in stocks in order to enter the commodities market is that trading is easier because most investors already have a brokerage account. Public information about a company's financial situation is readily available for investors to access, and stocks are often highly liquid.

There are some relative disadvantages to investing in stocks as a way of gaining access to the commodities market. Stocks are never a pure play on commodity prices. In addition, the price of a stock may be influenced by company-related factors that have nothing to do with the value of the related commodity that the investor is trying to track.

Using ETFs and Notes to Invest in Commodities

Exchange-traded funds (ETFs) and exchange-traded notes (ETNs) are an additional option for investors who are interested in entering the commodities market. ETFs and ETNs trade like stocks and allow investors to potentially profit from fluctuations in commodity prices without investing directly in futures contracts.

Commodity ETFs usually track the price of a particular commodity–or group of commodities that comprise an index–by using futures contracts. Sometimes investors will back the ETF with the actual commodity held in storage. ETNs are unsecured debt securities designed to mimic the price fluctuation of a particular commodity or commodity index.

ETNs are backed by the issuer. ETFs and ETNs allow investors to participate in the price fluctuation of a commodity or basket of commodities, but they typically do not require a special brokerage account. There are also no management or redemption fees with ETFs and ETNs because they trade like stocks. However, not all commodities have ETFs or ETNs that are associated with them.

BAL: iPath Bloomberg Cotton Subindex Total Return ETN; CAFE: iPath Pure Beta Coffee ETN; NIB: iPath Bloomberg Cocoa Subindex Total Return ETN

Another downside for investors is that a big move in the price of the commodity may not be reflected point-for-point by the underlying ETF or ETN. In addition, ETNs specifically have credit risk associated with them since they are backed by the issuer.

Notes

Using Mutual and Index Funds to Invest in Commodities

While you cannot use mutual funds to invest directly in commodities, mutual funds can be invested in stocks of companies involved in commodity-related industries, such as energy, agriculture, or mining. Like the stocks they invest in, the shares of the mutual fund may be impacted by factors other than the fluctuating prices of the commodity, including general stock market fluctuations and company-specific factors.

However, there are a small number of commodity index mutual funds that invest in futures contracts and commodity-linked derivative investments, and therefore provide investors with more direct exposure to commodity prices.

By investing in mutual funds, investors get the benefit of professional money management, added diversification, and liquidity. Unfortunately, sometimes management fees are high, and some of the funds may have sale charges.

Using Commodity Pools and Managed Futures to Invest in Commodities

A commodity pool operator (CPO) is a person (or limited partnership) that gathers money from investors and then combines it into one pool in order to invest that money in futures contracts and options. CPOs distribute periodic account statements, as well as annual financial reports. They are also required to keep strict records of all investors, transactions, and any additional pools they may be operating.1

CPOs will usually employ a commodity trading advisor (CTA) to advise them on trading decisions for the pool. CTAs must be registered with the Commodity Futures Trading Commission (CFTC) and are usually required to get a background check before they can provide investment advice.23

Investors may decide to participate in a CPO because they have the added benefit of receiving professional advice from a CTA. In addition, a pooled structure provides more money and more opportunities for the manager to invest. If investors choose a closed fund, all investors will be required to contribute the same amount of money.

The Bottom Line

Both novice and experienced traders have a variety of different options for investing in financial instruments that give them access to the commodity markets. While commodity futures contracts provide the most direct way to participate in the price movements of the industry, there are additional types of investments with less risk that also provide sufficient opportunities for commodities exposure.

In the most basic sense, commodities are known to be risky investment propositions because they can be affected by uncertainties that are difficult, if not impossible, to predict, such as unusual weather patterns, epidemics, and disasters both natural and man-made.

5.2 COMMODITY MARKET IN INDIA

There are several commodities available. Energy products include crude oil, natural gas, and gasoline. Precious metals include gold, silver, and platinum. Agricultural products include wheat, corn, soybeans, and livestock. Other commodities you can trade are coffee, sugar, cotton, and

Notes

frozen orange juice.

Although they are often confused and may be used interchangeably, the terms commodity and product are very different. A commodity is a raw material used to manufacture finished goods. A product, on the other hand, is the finished good sold to consumers.

Both commodities and products are part of the production and manufacturing process; the main difference being where they are in the chain. Commodities are typically in the early stages of production, while products fall at the final stage.

Key features

- A commodity is a raw material used in the production process to manufacture finished goods, while a product is a finished good sold to consumers.
- No value is added to a commodity, which can be grown, extracted, or mined.
- Commodities are traded on exchanges through futures contracts, stocks, and ETFs, and can also be bought and sold in their physical states.
- Products are sold on the market for consumption by the average consumer and can also be found in investment portfolios.

History of the Commodity Futures Market in India

The Commodity Futures market in India dates back to more than a century. The first organized futures market was established in 1875, under the name of 'Bombay Cotton Trade Association'. to trade in cotton derivative contracts. This was followed by institutions for futures trading in oilseeds, food grains, etc.

The futures market in India underwent rapid growth between the period of First and Second World War. As a result, before the outbreak of the Second World War, a large numberof commodity exchanges trading futures contracts in several commodities like cotton, groundnut, groundnut oil, raw jute, jute goods, castor seed, wheat, rice, sugar, precious metals like gold and silver were flourishing throughout the country.

In view of the delicate supply situation of major commodities in the backdrop of war efforts mobilization, futures trading came to be prohibited during the Second World War under the Defence of India Act. After Independence, especially in the second half of the 1950s and first half of 1960s, the commodity futures trading again picked up and there were thriving commodity markets. However, in mid-1960s, commodity futures trading in most of the commodities was banned and futures trading continued in two minor commodities, pepper and turmeric.

Current Scenario

Currently 5 national exchanges, viz. Multi Commodity Exchange, Mumbai; National Commodity and Derivatives Exchange, Mumbai and National Multi Commodity Exchange, Ahmedabad, Indian Commodity Exchange Ltd., Mumbai (ICEX) and ACE Derivatives and Commodity Exchange, regulate forward trading in 113 commodities. Besides, there are 16 Commodity specific exchanges recognized for regulating trading in various commodities approved by the Commission under the Forward Contracts (Regulation) Act, 1952.

The commodities traded at these exchanges comprise the following:

- Edible oilseeds complexes like Groundnut, Mustard seed, Cottonseed, Sunflower, Rice bran oil, Soy oil etc.

Notes

- Food grains – Wheat, Gram, Dals, Bajra, Maize etc.
- Metals – Gold, Silver, Copper, Zinc etc.
- Spices – Turmeric, Pepper, Jeera etc.
- Fibres – Cotton, Jute etc.
- Others – Gur, Rubber, Natural Gas, Crude Oil etc.

5.3 TRADING IN COMMODITY MARKET

Commodities markets allow producers and consumers of commodity products to gain access to them in a centralized and liquid marketplace. These market actors can also use commodities derivatives to hedge future consumption or production.

Speculators, investors, and arbitrageurs also play an active role in these markets. Certain commodities, such as precious metals, have been thought of to be a good hedge against inflation, and a broad set of commodities as an alternative asset class can help diversify a portfolio.

Because the prices of commodities tend to move in opposition to stocks, some investors also rely on commodities during periods of market volatility.

In the past, commodities trading required significant amounts of time, money, and expertise, and was primarily limited to professional traders.

Today, there are more options for participating in the commodity markets.

Brief History of Commodity Markets

Trading commodities goes back to the dawn of human civilization as tribal clans and newly established kingdoms would barter and trade with one another for food, supplies, and other items. Trading commodities indeed predates that of stocks and bonds by many centuries.

- The rise of empires such as ancient Greece and Rome can be directly linked to their ability to create complex trading systems and facilitate the exchange of commodities across vast swaths.
- Today, commodities are still exchanged throughout the world and on a massive scale. Things have also become more sophisticated with the advent of exchanges and derivatives markets, Exchanges regulate and standardized commodity trading, allowing for liquid and efficient markets.
- Perhaps the most influential modern commodities market is the Chicago Board of Trade (CBOT), established in 1848, where it originally traded only agricultural commodities such as wheat, corn, and soybeans in order to help farmers and commodity consumers manage risks by removing price uncertainty from agricultural products such as wheat and corn.
- Today, it lists options and futures contracts on a wide range of products including gold, silver, U.S. Treasury bonds, and energy products. The Chicago Mercantile Exchange (CME) Group merged with the Chicago Board of Trade (CBOT) in 2007, adding interest rates and equity index products to the group's existing product agricultural offerings.

Some commodities exchanges have merged or gone out of business in recent years. The majority of exchanges carry a few different commodities, although some specialize in a single group. In the U.S., the Chicago Mercantile Exchange (CME), the New York Mercantile Exchange

(NYMEX), the Intercontinental Exchange (ICE) dominate the space. Each exchange offers a wide range of global benchmarks across major asset classes

Notes

5.4. TYPES OF COMMODITY MARKETS

Generally speaking, commodities trade either in spot markets or derivatives markets. Spot markets are also referred to as "physical markets" or "cash markets" where buyers and sellers exchange physical commodities for immediate delivery.

Derivatives markets involve forwards, futures, and options. Forwards and futures are derivatives contracts that use the spot market as the underlying asset.

These are contracts that give the owner control of the underlying at some point in the future, for a price agreed upon today.

Only when the contracts expire would physical delivery of the commodity or other asset take place, and often traders will roll over or close out their contracts in order to avoid making or taking delivery altogether.

Forwards and futures are generically the same, except that forwards are customizable and trade over-the-counter (OTC), whereas futures are standardized and traded on exchanges.

5.5 EXAMPLES OF COMMODITIES MARKETS

The major exchanges in the U.S., which trade commodities, are domiciled in Chicago and New York with several exchanges in other locations within the country. The Chicago Board of Trade (CBOT) was established in Chicago in 1848.

Commodities traded on the CBOT include corn, gold, silver, soybeans, wheat, oats, rice, and ethanol. The Chicago Mercantile Exchange (CME) trades commodities such as milk, butter, feeder cattle, cattle, pork bellies, lumber, and lean hogs.

The New York Board of Trade (NYBOT) commodities include coffee, cocoa, orange juice, sugar, and ethanol trading on its exchange. The New York Mercantile Exchange (NYMEX) trades commodities on its exchange such as oil, gold, silver, copper, aluminum, palladium, platinum, heating oil, propane, and electricity.

Key commodity markets in regional centers include the Kansas City Board of Trade (KCBT) and the Minneapolis Grain Exchange (MGE). These exchanges are primarily focused on agriculture commodities. The London Metal Exchange and Tokyo Commodity Exchange are prominent international commodity exchanges.

Commodities are predominantly traded electronically; however, several U.S. exchanges still use the open outcry method. Commodity trading conducted outside the operation of the exchanges is referred to as the over-the-counter (OTC) market.

Commodity Market Regulation

In the U.S., the Commodity Futures Trading Commission (CFTC) regulates commodity futures and options markets. The CFTC's objective is to promote competitive, efficient, and transparent markets that help protect consumers from fraud and unscrupulous practices.

The CFTC and related regulations were designed to prevent and remove obstructions on interstate commerce in commodities by regulating transactions on commodity exchanges. For

Notes

example, regulations look to limit, or abolish, short selling and eliminate the possibility of market and price manipulation, such as cornering markets.

The law that established the CFTC has been updated several times since it was created, most notably in the wake of the 2007-2008 financial crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act gave the CFTC authority over the swaps market, which was previously unregulated.

Regulation of commodity markets has continued to remain in the spotlight after four leading investment banks were caught up in a precious metals manipulation probe in 2014.

Commodity Market Trading vs. Stock Trading

For most individual investors, accessing commodities markets, whether spot or derivatives, is untenable. Direct access to these markets typically requires a special brokerage account and/or certain permissions. Because commodities are considered an alternative asset class, pooled funds that traded commodities futures, such as CTAs, typically only allow accredited investors.

Still, ordinary investors can gain indirect access to commodities via the stock market itself. Stocks on mining or materials companies tend to be correlated with commodities prices, and there are various ETFs now that track various commodities or commodities indexes.

Investors looking to diversify their portfolio can look to these ETFs, but for most long-term investors stocks and bonds will make up the core of their holdings.

Moreover, because commodity prices tend by more volatile than stocks and bonds, commodities trading is often most-suited for those with a higher risk tolerance and/or longer time horizon.

5.6 MEANING OF FORWARD MARKET COMMISSION (FMC)

Forward Market Commission is a regulatory authority which is overseen by the Ministry of Consumer Affairs and Public Distribution, Government of India. It is a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952. This is the regulating authority for all Commodity Derivatives Exchanges in India. Forward Markets Commission (FMC) headquartered at Mumbai, is a regulatory authority for commodity futures market in India.

Forward Markets

Indian Agricultural Commodity Futures Markets

A large number of agricultural commodities and their byproducts are being traded in several exchanges. Six of these commodities have been traded long enough to enable an assessment of their performance. This unit examines the performance of these six commodity futures. The results indicate that most of these markets are yet to develop fully as efficient mechanisms of risk management and price discovery.

Sagging Agricultural Commodity Exchanges

Commodity derivatives have a crucial role to play in managing price risk especially in agriculture dominated economies. However, as long as prices of many commodities are restrained to a certain extent by government intervention in production, supply and

distribution, forward and futures markets for hedging price risk in those commodities have only limited practical relevance.

A review of the nature of institutional and policy level constraints facing this segment calls for more focused and pragmatic approach from the government, the regulator and the exchanges for making the agricultural futures market a vibrant segment for risk management.

Functions of FMC

(a) To advise the Central Government in respect of the recognition or the withdrawal of recognition from any association or in respect of any other matter arising out of the administration of the Forward Contracts (Regulation) Act 1952.

(b) To keep forward markets under observation and to take such action in relation to them, as it may consider necessary, in exercise of the powers assigned to it by or under the Act.

(c) To collect and whenever the Commission thinks it necessary, to publish information regarding the trading conditions in respect of goods to which any of the provisions of the Act is made applicable, including information regarding supply, demand and prices, and to submit to the Central Government, periodical reports on the working of forward markets relating to such goods;

(d) To make recommendations generally with a view to improving the organization and working of forward markets;

(e) To undertake the inspection of the accounts and other documents of any recognized association or registered association or any member of such association whenever it considers it necessary.

5.7 THE ROLE OF FORWARD MARKETS COMMISSION IN INDIAN COMMODITY MARKETS

Commodity trading in India has a long and rich history. The history of commodity Futures market in India dates back to the ancient times citied in Kautialya's 'Arthasastra', Words like, "Teji", "Mandi", "Gali", and "Phatak" have been commonly heard in Indian markets for centuries which seems to be coined in 320 BC and also referred in Forward Contracts (Regulation) Act, 1952 ;The first organized futures market in India was however established in 1875 under the aegis of the "Bombay Cotton Trade Association" to trade in cotton contracts.

This was followed by establishment of futures markets in edible oilseeds complex, raw jute and jute goods and bullion. Post-independence, in the 1950s, India continued to struggle with feeding its population and the government increasingly restricting trading in food commodities.

In independent India, the Forward Contracts (Regulation) Act was enacted in 1952 to regulate the commodity trading in forward and futures contracts. Just as SEBI regulates the stock exchanges, commodity exchanges are regulated by Forward Markets Commission (FMC); Forwards Market Commission works under the purview of the Ministry of Finance, Department of Economic Affairs.

Forward Markets Commission is a regulatory body for commodity futures/forward trade in India. This was set up under the Forward Contracts (Regulation) Act of 1952. It is responsible for regulating and promoting futures/forward trade in commodities. At present, there are three tiers of regulations of forward/futures trading system exists in India, namely, Government of India, Forward Markets Commission (FMC) and Commodity Exchanges.

Notes

Government of India, in 2002-03, has demonstrated its commitment to revive the Indian agriculture sector and commodity futures markets. Prime Minister's Independence Day address to the nation on August 15, 2002, which enlisted nation-building initiatives, included setting-up of national commodity exchange among the important initiatives.

The year 2002-03, certainly, was an eventful year in terms of regulatory changes and market developments that could set the agenda for development for the years to come. In 2003, a prohibition on futures trading in all commodities was lifted and recognition was granted to three national commodity electronic exchanges, the MCX, NCDEX and NMCE. The only financial product currently traded on commodity exchanges in India is futures.

Forward contracts are traded in the Over-the-Counter (OTC) market. There are six national commodity exchanges: the Multi Commodity Exchange (MCX); the National Commodity and Derivatives Exchange (NCDEX); the National Multi Commodity Exchange (NMCE); the Indian Commodity Exchange; ACE Derivatives & Commodity Exchange Limited (ACE); and the Universal Commodity Exchange Ltd. (UCX). Apart from these, there are 16 regional exchanges.

The Forward Markets Commission (FMC) is an independent body involved with the regulation of all commodity exchanges. Futures' trading is organized in such goods or commodities as are permitted by the government. Trading in commodity futures contracts can be done between, with and through the members of the recognized Exchanges. At present, 113 commodities are allowed for futures trading under the auspices of the commodity exchanges recognized under the F C (R) Act.

5.8 SYSTEM OF REGULATION OF FORWARD/FUTURES TRADING

At present, there are three tiers of regulations of forward/futures trading system in India, namely, government of India (Ministry of Finance), Forward Markets Commission (FMC) and commodity exchanges. The FC (R) Act, 1952 prohibits options in commodities.

For the purpose of forward contracts in certain commodities can be regulated by notifying those commodities u/s 15 of the Act; forward trading in certain other commodities can be prohibited by notifying these commodities u/s 17 of the Act.

The need for regulation arises on account of the fact that the benefits of futures markets accrue in competitive conditions. Proper regulation is needed to create competitive conditions. In the absence of regulation, unscrupulous participants could use these leveraged contracts for manipulating prices. This could have undesirable influence on the spot prices, thereby affecting interests of society at large.

Regulation is also needed to ensure that the market has appropriate risk management system. In the absence of such a system, a major default could create a chain reaction. The resultant financial crisis in a futures market could create systematic risk.

Regulation is also needed to ensure fairness and transparency in trading, clearing, settlement and management of the exchange so as to protect and promote the interest of various stakeholders, particularly non-member users of the market.

1. **Government of India:** The central government makes policy regarding the forward trading in commodities. At present, the Ministry of Finance, (Department of Economic Affairs) government is dealing with commodity futures trading.

   The Central Government broadly determines the policy relating to areas such as identification of commodities as well as the territorial area in which futures/forward trading can be permitted and giving recognition to the Exchange/ Association through which such trading is to be permitted.

Notes

2. **Forward Markets Commission (FMC):** The commission came into existence in 1953 under the provisions of Forward Contract (Regulation) Act, 1952. As a statutory body it functions under the administrative control of the Ministry of Finance.

   Administration headquarters of Forward Markets Commission is at Mumbai and regional office at Kolkata. The Forward Markets Commission performs the role of approving the Rules and Regulations of the Exchange in accordance to which trading is to be conducted, accords permission for commencement of trading in different contracts, monitors market conditions continuously and takes remedial measures wherever necessary.

3. **Commodity Exchanges:** The Recognized Exchanges/Associations provide the framework of Rules and Regulations for conduct of trading, indicate the place where the trading can be conducted, report, record, execute and settle contracts, provide forum for exchange of documents and payments, etc. Commodity Exchange works under the provisions of Forward Markets Commission.

   FMC is the regulatory body to control the activities of commodity exchanges just like SEBI regulates the functions of Capital Market. The Forward Markets Commission is a regulatory authority of commodity derivatives/futures market in India.

   FMC is the chief regulator of forward and futures markets in India. The Commission allows commodity futures/forward trading in 22 exchanges in India, of which 6 are national.

The major national exchanges are :

(i) Multi-commodity Exchange of India Ltd. (MCX), Mumbai,

(ii) National Commodity and Derivatives Exchange Ltd. (NCDEX), Mumbai

(iii) National Multi-commodity Exchange of India Ltd. (NMCE), Ahemadabad,

(iv) Indian Commodity Exchange Ltd. (ICEX) Mumbai,

(v) Ace Derivatives & Commodity Exchange Ltd. (ACE) Ahemadabad, and

(vi) Universal Commodity Exchange Ltd. (UCX). These exchanges are recognized to regulate trading in a variety of commodities approved by Forward Markets Commission under the Forward Contracts (Regulation) Act, 1952.

These on-line national commodity exchanges have been organized for conducting forward/futures trading activities in all commodities, to which section 15 of the Forward Contracts (Regulation) Act, 1952 is applicable, and other commodities subject to the approval of the Forward Markets Commission.

5.9 REGULATORY FRAME WORK OF COMMODITY MARKETS IN INDIA

1. **Forward Contract (Regulation) Act**

   The Commodity Derivatives and Futures Markets are regulated according to the provisions of Forward Contract (Regulation) Act 1952. The Act broadly divides commodities into 3 categories, i.e. commodities in which forward trading is prohibited, commodities in which forward trading is regulated and residuary commodities.

   Under Section 17 of the F.C (R) Act, 1952, the Government has powers to notify commodities, forward trading in which is prohibited in whole or part of India. Any forward trading in

Notes

such commodities in the notified area is illegal and liable to penal action. Under Section 15, Government has powers to notify commodities in which forward trading is regulated as also the area in which such regulation will be in force.

Once a commodity is notified under section 15, the forward trading in such contracts (other than Nontransferable Specific Delivery Contracts) has to be necessarily between members of the recognized association or through or with any such member.

Contracts other than these are illegal. Section 6 of the Act provides for powers to the Central Government to grant recognition to an association for organizing forward contracts in the commodity which is notified under Section 15.

Such recognition may be for a specified period or may remain in force till revoked under Section 7 of the Act. Section 18 (1) exempts the Non-Transferable Specific Delivery Contracts from the purview of regulation.

However, under Section 18 (3) of the Act, the Government has powers to prohibit or regulate the non-transferable specific delivery contracts in commodities also by issue of a notification. Such notifications may apply for the whole of the country or the specified part of the country. Trading in commodities where non-transferable specific delivery contracts are prohibited is illegal and liable to penal action.

Trading in non-transferable specific delivery contracts in respect of regulated commodities has to be through recognized associations just as in the case of other forward contracts. The commodities that are notified neither under section 15 nor under section 17 of the Act is in common parlance referred to as free commodities.

For organized forward trading in such commodities, the concerned Association or Exchange has to get a certificate of registration under Section 14B of the Act from the Forward Markets Commission.

2. **Forward Markets Commission (FMC)**

   The Forward Markets Commission (FMC) is a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952. Forward Markets Commission (FMC), is a regulatory authority for commodity futures and derivatives market in India.

   It functions under the administrative control of the Department of Economic Affairs, Ministry of Finance; with it's headquartered at Mumbai and a regional office at Kolkata. The Act provides that the Commission shall consist of not less than two but not exceeding four members appointed by the Central Government, out of them one being nominated by the Central Government to be the Chairman of the Commission.

Patterns pf Trading in Commodity market

- The basis of how commodity trading works the concept of supply and demand.
- When the supply goes low, the demand goes up and so do the prices and when the supply goes high, the demand goes down along with the prices. The traders take advantage of these price fluctuations to reap profits for themselves or to protect themselves from related risks.
- Commodity Trading is one of the most upcoming forms of trading in India. After equity, real estate and precious metals like gold and silver, people have started investing in some of the top commodities too. It is the new avenue for the retail investors and traders to participate in.
- Although commodity trading has its own risks and challenges, it is also a rewarding

Notes

platform that helps the traders to make good profits in the process of buying and selling commodities online. But just like other forms of trading, commodity trading also requires a lot of hard work, knowledge, experience and dedication. Just like some traders trade in stocks, some trade in commodities. These commodities can be energy, metals, agricultural products or livestock.

- In order to understand how commodity trading works, it is of absolute importance for the traders to understand how the demand and supply work. The supply of a commodity may get affected by various factors like the government policies regarding that commodity, economy of the country which is a big producer of the commodity, economic policies, political policies, health of the country, price of the raw materials, expected future price of the raw
- materials, cost of production, natural conditions, transport conditions etc. Similarly, the demand is also affected by causes like weather, preferences of the customers, the income of the people, the priceof the related goods like substitutes or complementary goods etc.

  For example, the price of oil futures is affected by the political situation in the Middle East and the price of gold futures is affected by wedding season or the situation of gold mining companies.

  Thus, the background to understand how commodity trading works is actually how demand and supply work. With inelastic demand and supply in the commodity markets, the prices become volatile and give the traders the opportunity to bank on the price fluctuations and earn money.

  For example, a trader bought a Gold Futures contract with a minimum contract size of 100 gm at 372,000 on MCX. He pays the margin amount of, say, 3.5% which is equal to 32,520. If the next day price of gold goes up to 373,000, the difference of 1000 will be credited to the trader's account, and the next day if gold trades at 372,500, the difference of 500 will be debited from the account. So, even by investing less money, the traders get an opportunity to make more profits using commodity trading.

With reference to the step by step process of how commodity trading works, it is more or less similar to all other forms of trading.

1. **Opening A Commodity Trading Account And Getting It Approved:**

   The first step in understanding how commodity trading works is to open a commodity trading account with a broker. The choice of broker is a crucial decision as because it is the broking company and its stockbrokers that hold your account and execute your trades. The brokers also help in educating traders on commodity trading and in making sound financial decisions through their recommendations.

   When the broker has been decided upon after due consideration, the paperwork is done. Application form which contains all the information like age, financial status, the trading experience of the trader is filled and submitted along with the required documents. The broker then analyses the documents and the form and upon satisfaction, the account is opened.

2. **Margin Money:**

   The trader also has to deposit the initial margin amount into the account as soon as the account is open. Initial margin amount is generally 5-10% of the contract value. In addition to the initial margin, maintenance margin also needs to be maintained by the trader in his account, which will ensure that the trader is able to pay off in case he suffers any huge loss due to adverse price movements.

Notes

3. **Order Processing:**

Once the account is opened, it is good to go for placing orders on commodity trades. The trader studies the market using fundamental and technical indicators and decides to invest in a commodity. The trader informs the broker about the number of lots and contract value and deposits the margin money accordingly. As soon as the order is filled by the broker, the contract is owned by the trader and is marked to market at the end of each trading day.

4. **Mark-To-Market Settlement:**

At the end of each trading day, the clearinghouse determines the settlement price of each commodity. The settlement price is then compared to the price at which the order was placed and according to the movement in price, the difference is either credited to or debited from the trader's account.

From the third day onwards, the comparison is made between the settlement price of that day and the previous day.

5. **Termination Of The Contract:**

The termination of a commodity contract can happen in many ways. This is important to understand how commodity trading works differently from other forms of trading. The contract can either be terminated by taking and giving delivery of the goods, which is actually a rare form of termination in the commodity market.

The most used method of termination of the contract is cash settlement; the difference in the expectation of the buying and selling parties is settled in cash. The commodity trade can also be closed by entering into a reverse trade by taking exact opposite position to the current position and thus netting the position.

As a bottom line, how commodity trading works is determined by how the prices of thecommodities move, driven by the demand and supply. The process of trading is simple and uncomplicated, but it does involve high risks due to volatility and high leverage.

So, the traders must be cautious and well- informed before entering into the commodity trading market.

After the process of opening account is done the investor may want to trade in commodity. IT is important to understand the process after the trade is placed.

An investor places a trade order with the broker (at the dealing desk) on phone. The dealer puts the order in exchange trading system. At the initiation of the trade, a price is set and initial margin money is deposited in the account.

At the end of the day, a settlement price is determined by the clearing house (Exchange). Depending on if the markets have moved in favor or against the investors' position the funds are either being drawn from or added to the client's account. The amount is the difference in the traded price and the settlement price.

On next day, the settlement price is used as the base price. As the spot market prices changes every day, a new settlement price is determined at the end of every day. Again, the account will be adjusted by the difference in the new settlement price and the previous night's price in the appropriate manner.

5.10 TRADING AND SETTLEMENT IN COMMODITY MARKET

Notes

Every market transaction consists of three components. Trading, clearing and settlement. This section provides a brief overview of how transaction happen on the commodity market/commodity exchanges.

1. **Trading**

   The trading system on the commodity exchanges, provides a fully automated screen basedtrading for futures on commodities on a nationwide basis as well as an online monitoring and surveillance mechanism.

   It supports an order driver market and provides complete transparency of trading operations. The trade timings of the commodity exchanges are 10.00 am to 4.00 p.m. After hours trading has also been proposed for implementation at a later stage.

   The commodity exchanges system supports an order driven market, where orders match automatically. Order matching is essentially on the basis of commodity, its price, time and quantity. All quantity fields are in units and price in rupees.

   The exchange specifies the unit of trading and the delivery unit for futures contracts on various commodities. The exchange notifies the regular lot size and tick size for each of the contracts traded from time to time.

   When any order enters the trading system, it is an active order. It tries to find a match on the other side of the book. If it finds a match, a trade is generated.

   If it does not find a match, the order becomes passive and gets queued in the respective outstanding order book in the system. Time stamping is done for each trade and provides a possibility for a complete audit trail if required.

   Commodity exchanges trades commodity futures contracts having one, month, two month and three month expiry cycles.

   All contracts expire on the 20th of the expiry month. Thus a January expiration contract would expire on the 20th of January and a February expiry contract would cease trading on the 20th February.

   If the 20th of the expiry month is a trading holiday, the contracts shall expiry on the previous trading day. New contracts will be introduced on the trading day following the expiry of the near month contract.

2. **Clearing**

   National securities clearing corporation limited (NSCCL) under takes clearing of trades executed on the commodity exchanges. The settlement guarantee fund is maintained and managed by commodity exchanges.

   Only clearing members including professional clearing members (PCMs) only are entitled to clear and settled contracts through the clearing house.

   At commodity exchanges, after the trading hours on the expiry date, based on the available information, the matching for deliveries takes place firstly, on the basis of location and then randomly keeping view the factors such as available capacity of the vault/ warehouse, commodities, already deposited and dematerialized and offered for delivery etc. matching done by this process binding on the clearing members.

   After completion of the matching process, clearing members are informed of the deliverable / receivable positions and unmatched positions. Unmatched positions have to be settled in cash. The cash settlement is only for the incremental gain/ loss as determined on the basis of final settlement price.

Notes

3. **Settlement.**

Futures contracts have two types of settlements, the MTM settlement which happens on a continuous basis at the end of each day, and the final settlement which happens on the last trading day of the futures contracts.

On the commodity exchanges, daily MTM settlement and final MTM settlement in respect of admitted deals in futures contracts are cash settled by debiting/ crediting the clearing accounts of CMs with the respective clearing bank.

All positions of a CM, either brought forward, credited during the day or closed out during the day, are market to market at the daily settlement price or final settlement price at the close of trading hours on a day.

On the date of expiry, the final settlement price is the spot price on the expiry day. The responsibility of settlement is on a trading cum clearing members for all traders done on his own account and his client's trades.

A professional clearing member is responsible for selling all the participants traders trades which he has confirmed to the exchange.

On the expiry date of a futures contracts members submit delivery information through delivery request window on the traders workstations provided by commodity exchanges for all open positions for a commodity for all constituents individually commodity exchanges on receipt of such information, matches the information and arrives at a delivery positions for a member for a commodity .

The seller intending to make delivery takes the commodities to the designated warehouse. These commodities have to be assayed by the exchange specified assayed. The commodities have to meet the contracts specifications with allowed variances.

If the commodities meet the specifications, the warehouse accepts them. Warehouse then ensures that the receipts get updated in the depository system giving a credit in the depositors' electronic account.

The seller then gives the invoice to his clearing member, who would courier the same to the buyer's clearing member. On an appointed date, the buyer goes to the warehouse and takes physical possession of the commodities.

Trading System of Commodity Exchanges.

The trading system at commodity exchange is as follows

a) The entire trading operation at commodity exchange shall be conducted under the automated screen based Trading system, which is called as 'commodity exchanges Trading system'. The Exchange will provide such Automated Trading Facility in all contracts permitted to commodity exchange by FMC

b) Trading on the exchange shall be allowed only through approved workstation (s) located at approved locations for the office (s) of a Members. If an approved workstation of a Trading Members is connected by LAN or any other way to other workstations at any place it shall be in advance.

c) Each members shall have a unique identification number which shall be provided by the Exchange and which shall be used to log on (sign on) to the system

Notes

d) A member shall have a non-exclusive permission to use the Trading system as provided by the exchange in the ordinary course of business as Trading member/Participant.

e) A member shall not any title, rights or interested with respect to Trading System, its facilities, software and information provided by MCX. The permission to use the Trading System shall be subject to payment of such charges as the Exchange may from time to Time prescribe in this regard.

f) A member shall not, permit itself or any other person(s) to: use the software provided by exchange for any purpose other than the purpose as approved and specified by the Exchange.

Use the software provide by exchange on any equipment other than the workstation approved by the exchange copy, alter, modify or make available to any other person the software provided by the exchange use the software in any manner other than the manner as specified by the exchange.

Attempt directly or indirectly to decompile, dissemble or reverse engineer the same.

g) A Member shall not, by itself or through any other person on his behalf, publish, supply, show or make available to any other person or reprocess, retransmit, store or use the facilities of the Trading System or the information provided by the Trading System except with the explicit approval of the Exchange

h) The exchange will provide the application software for installation of TWS. However, the member has to arrange at his own cost the system software required for installation of trading application. Besides, he has to arrange for installation of trading applications software at his TWS at his own cost.

5.11 MARGINS FOR TRADING IN COMMODITY DERIVATIVES

Margin is the deposit money that needs to be paid to buy or sell contract. The margin required for a futures contract is better describe as performance bond or good faith money. The margin levels are set by the exchanges based on volatility (market conditions) and can be changed at any time.

The margin requirements for most futures contracts range from 2% to 15% of the value of the contract. In the futures market, there are different types of margins which are discussed as follows:

1 **Initial margin:** The amount that must be deposited by a customer at the time of entering into a contract is called initial margin. This margin is meant to cover the largest potential loss in one day. The margin is a mandatory requirement for parties who are entering into the contract.

2 **Maintenance margin:** A trader is entitled to withdraw any balance in the margin account in excess of the initial margin. To ensure that the balance in the margin account never becomes negative, a maintenance margin, which is somewhat lower than the initial margin, is set.

If the balance in the margin account falls below the maintenance margins the traders receives a margin call and is requested to deposit extra funds to bring it to the initial margin level within a very short period of time. The extra funds deposited are known as a variation margin. If the traders does not provide the variation margin, the broker closes out the positions by offsetting the contract.

3 **Additional margin:** In case of sudden higher than expected volatility the exchange for an additional margin, which is a pre-emptive move to prevent breakdown. This is imposed

Notes

when the exchange fears that the markets have become too volatile and may results in some payment crisis etc.

4 **Mark-to-Market margin (MTM):** At the end of each trading day, the margin account is adjusted to reflect the trader's gain or loss. This is known as marking to market the account of each trader. All futures contracts are settled daily reducing the credit exposure to one day's movement.

Based on the settlement price. The value of all positions is marked-to-market each day after the official close i.e. the accounts are either debited or credited based on how well the positions are fared in the day's trading session.

If the account falls below the maintenance margin level the trader need s to replenish the account by giving additional funds can be withdrawn (those funds above the required initial margin) or can be used to fund additional trades.

5.12 CHALLENGES FACED BY COMMODITY MARKETS

Efficiency of commodity markets.

Despite a long history of commodity markets, the Indian commodity markets remained under developed, partially due to intermediate ban on commodity trading and more due to the policy interventions by the government.

Being agriculture-based economy, commodity markets plat vital role in the economic development of the country. Well the agricultural liberalization as provide way for commodity trading, India as to still go on long way in achieving the benefits of commodity markets.

Towards the development of the commodity markets, it is improved to understand the growth constraints and address those issues in the right perspective. Commodity markets play an important role in the development of an economic, especially those economics that are depended to a large extent on the agriculture sector. Owing to its dependence on agriculture sector, Indian economy to a large extent would benefit from commodity markets.

Despite the fact, that Indian economic as witnessed robust growth in the last decade on account of service sector; agricultural sector still remain the back bone of Indian economic. Roughly around 60% of the Indian population is dependent on agriculture. Vibrant commodity markets in India well not only benefit the farmers but also the manufacturing sectors that is dependent on it to gain significant price gains.

The following are challenges faced by Indian commodity markets currently. These are the explained and also conclusion is provided at the end of it:

- Legal challenges
- Regulatory Challenge
- Infrastructural challenges
- Awareness among investors and producers.

1 **Legal Challenges**

Right from the beginning of commodity markets there has been several bottlenecks regarding the products being in the essential commodities list because of which the often got banned. Also there were times when because of hoarding and black marketing there were famine for a very long time, so the market needed an efficient regulator which led to the formation of PMC.

Notes

Moreover, many efficient in commodity markets. Also weather and rainfall indexes are also banned from trading on the commodity exchanges because of the clauses of the banking regulations act, which defines that anything that could be obtained in physical form only can be traded at the exchange.

These inefficiencies must be eradicated by amending these acts. Several amendments have been introduced in these acts and also accepted by the government but only some of them has been passed. Rests are in the queue.

2 **Regulatory challenges**

As the market activity pick -up and the volumes rise, the market will definitely need a strong and independent regulatory body, similar to the Securities And Exchange Board of India (SEBI) that regulates the securities markets unlike SEBI which is an independent body, the forwards markets commission (FMC) is under the department of consumer Affairs (Ministry of consumers Affairs, food and Public Distribution) and depends on it for funds, it is imperative that the government should grant more power to the FMC to ensure that there is orderly development of the commodity markets.

The SEBI and FMC also need to work closely with each other due to interrelationship between the two markets.

3. **Infrastructural Challenge: The main Infrastructural Challenges includes**

a) The Warehousing and Standardization

For commodity derivatives market to work efficiently, it is necessary to have sophisticated, cost effective, reliable and convenient warehousing system in the country .A Sophisticated warehousing industry has yet to come in India further, independent labs are quality testing centers should be set up in each region to certify the quality, grade quantity and commodities so that they are appropriately standardized and there are no shocks waiting for the unlimited buyers who takes the physical delivery. Warehouse also need to beconveniently located.

b) Cash versus Physical Settlement

It is probably due to the inefficiencies in the present ware housing system that only about 1% to 5% of the total commodity derivatives trade in country is settled in physical delivery. Therefore warehousing problem obviously has to be handled on a war footing, as a good delivery system is the backbone of any commodity trade.

A particularly difficult problem in cash settlement of commodity derivative contracts is that at present, under the forward contracts (regulation) act 195, cash settlement of outstanding contacts at maturity is not allowed.

In other words, all outstanding contracts at maturity should be settled in physical delivery. To avoid these, participants square off their positions before maturity.

So, in practice, most contract are settled in cash but before maturity. There is a need to modify the laws to bring it closer to the widespread practice and save the participants from unnecessary hassles.

c) Lack of Economy of scale

There are too many (5 national level and 22 regional) commodity exchanges, though over 113 commodities are allowed for derivatives trading, in practice derivatives are popular only for few commodities. Again, most of the trade take place only on a few exchanges. With so much of volume of trade makes some exchanges unviable. This problem can possibly be addressed by consolidating some more exchanges.

Notes

Also, the questions of convergence of securities and commodities derivatives markets has been debited for a long time known. The government of India has announced its intention to integrate the two markets.

It is felt that convergence of these derivative markets would bring in economies of scale and scope without having to duplicate the efforts, thereby giving a boost to the growth of commodity derivatives market. It would also help in resolving some of the issues concerning withthe regulation of the derivative markets.

However, this would necessitate complete co-ordination among various regulating authorities such as reserve bank of India, forward markets commission, the securities and exchange board of India, and the department of company affairs etc.

d) **Tax and legal Bottlenecks**

There are at present restrictions on the movement of certain goods from one state to another. These need to remove such restrictions so that a true national market could develop for commodities and derivatives..

Also, regulatory changes are required to bring about uniformity in octroi and sale taxes act. VAT has been introduced in the country 2005, but has not yet been uniformly implemented by all states.

4. **Awareness among investors and producers**

Creation of awareness amongst the farmers, related bodies and organizations including the once which could be potential hedgers/aggregators and other market constituents has been one of major activities of the commission.

During 2010-11, 829 awareness programs were organized for various stockholders of the commodity features market. Of this, 486 programs were held exclusively for farmers. In the previous year 515 awarenessprograms were held, of which 423 were exclusively for the farmers. The programs were conducted at different locations all over the country.

These awareness programs were attended by different category of market participants from farmers, traders and member s of commodity exchanges to bankers, co-operative personnel staff and students of university, government functionaries ware house professional agricultural extensions workers, makers etc.

These awareness programs have resulted in creating awareness among the various constituents about commodity futures trading and benefits thereof. The programs were organized in associate with various organization/ university having connectivitywith the farmers,via agricultural universities, NABCONS farmer's cooperatives and federations GSKs national & Regional Base commodity exchanges.

Benefits of Commodity Markets

1. **A safe investment during crisis** – Investing in precious metals like silver, gold & platinum offer a clear protection during inflation and times of economic uncertainty.
2. **Diversified investment portfolio** – An ideal asset allocation plan means having a diversified portfolio. Thus an investor who has invested in stocks is suggested to invest in commodities so that in case of a stock crash he has some safety from commodity sector.
3. **Transparencies in the process** – Trading in commodity is a transparent process. The course of action leads to fair price discovery which is controlled by large scale participation.

Notes

4. **Profitable returns** – Commodities have huge swing in prices which can provide profitable returns in investments are planned correctly and calculated risks are taken.

5. **Protection against inflation** – the price of commodities usually go up during high inflation, accordingly price of raw materials also sees an upward trend , which will help those who have invested in such commodities.

6. **Trading on lower margin** – Commodity traders need to deposit a margin with broker which can be close to 5-10% of the total value of the contract , which is much lower considering other asset classes. Such low margins allow traders to take larger positions at a lesser capital.

7. **Managing the risk** – Exchanges have well structured settlement procedures and prudent risk management practices , which reassures an investor. The absence of counter party risk and existence of clearing house as a legal counter party increases the faith of investors and risk is manged well.

8. **Beneficial to farmers** – India is a traditionally agricultural economy and price fluctuations during harvest season has always been a major concern for the farming community.

Thus, futures trading has emerged as a beneficial option for providing a greater degree of assurance on the price front. Also, using the futures platform farmers can store their produce in the exchange provided warehouse till the time that their produce fetches reasonable returns.

SUMMARY

- The Commodity Futures market in India dates back to more than a century. The first organized futures market was established in 1875, under the name of 'Bombay Cotton Trade Association' to trade in cotton derivative contracts. This was followed by institutions for futures trading in oilseeds, food grains, etc.
- FMC is a regulatory authority which is overseen by the Ministry of Consumer Affairs and Public Distribution, Government of India. It is a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952. This is the regulating authority for all Commodity Derivatives Exchanges in India. Forward Markets Commission (FMC) headquartered at Mumbai, is a regulatory authority for commodity futures market in India.
- Efficiency of commodity markets. Despite a long history of commodity markets, the Indian commodity markets remained under developed, partially due to intermediate ban on commodity trading and more due to the policy interventions by the government. Being agriculture–based economy, commodity markets plat vital role in the economic development of the country.
- Towards the development of the commodity markets, it is improved to understand the growth constraints and address those issues in the right perspective.
- Commodity markets play an important role in the development of an economic, especially those economics that are depended to a large extent on the agriculture sector. Owing to its dependence on agriculture sector, Indian economy to a large extent would benefit from commodity markets.

Notes

KEY WORDS

- **Trade settlement:** is a two-way process which comes in the final stage of the transaction. Once the buyer receives the securities and the seller gets the payment for the same, the trade is said to be settled.
- **Financial Market:** It is a market for creation and exchange of financial assets. It helps in mobilisation and channelising the savings into most productive uses. Financial markets also helps in price discovery and provide liquidity to financial assets.
- **Money Market:** It is a market for short-term funds. It deals in monetory assets whose period of maturity is less than one year. The instruments of money market includes treasury bills, commercial paper, call money, Certificate of deposit, commercial bills, participation certificates and money market mutual funds.
- **Capital Market:** It is a place where long-term funds are mobilised by the corporate undertakings and Government. Capital Market may be devided into primary market and secondary market. Primary market deals with new securities which were not previously tradable to the public. Secondary market is a place where existing securities are bought and sold.
- **Stock Exchanges:** They are the organisations which provide a platform for buying and selling of existing securities. Stock exchanges provide continuous market for securities, helps in price discovery, widening share ownership and provide scope for speculation.

REVIEW QUESTIONS

1. State the types of margins in commodity market
2. What are the benefits of commodity market
3. Explain trading and clearing process
4. Challenges of commodity market or Efficiency of commodity markets.

FURTHER READINGS

1. Mukund Sharma , H.R.Appanaiah Stock and Commodity Market-Himalayan Publication International Financial Management.
2. Dr.Preeti Singh ,Stock and Commodity Market- Himalayan Publication International Financial Management khan,Indian Financial System 6th edition ,Tata McGraw Hill
3. Garner, Carley. A Trader's First Book on Commodities. (New Jersey: FT Press, 2010): Futures Trading Act of 1921, Declared unconstitutional in Hill v. Wallace 259 U.S. 44 (1922), the Grain Futures Act of 1922 and Board of Trade of City of Chicago v. Olsen 262 U.S. 1 (1923).
4. Cronon, William. Pricing the Future: Grain. Nature's Metropolis: Chicago and the Great West. University of Chicago, 1991. pp.109-133