After going through the chapter student shall be able to understand:

- Introduction to Secondary Market
- Development of the stock market in India
- Stock market Organization in India
- Demutualization of Stock Exchanges
- Share Trading in Secondary Market
- Stock Market and Its Operations
- Risk Management in Secondary Market
  - (1) Trading Rules and Regulations
  - (2) Circuit Breakers
  - (3) Trading and Settlement
  - (4) National Securities Clearing Corporation Limited
  - (5) Market Making System
  - (6) Securities Lending and Borrowing
  - (7) Straight Through Processing
  - (8) Margin Trading
  - (9) Short Selling
- Indian Debt Market
1. INTRODUCTION TO SECONDARY MARKET

Secondary market is a market where shares initially issued are traded. Trading of securities takes place when securities are purchased or sold. This market is also known as stock market. In India, secondary market consists of recognized stock exchanges operating under rules, regulations and guidelines approved by the government. The stock exchanges are organized market where securities issued by the Companies, Central and State Government, and public bodies are traded. As per section 2(j) of the Securities Contract 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, selling or dealing in securities.

Therefore, in nutshell, securities issued by a company for the first time are offered to the public in the primary market. Once the IPO is done and the stock is listed, they are traded in the secondary market. The main difference between the two is that in the primary market, an investor gets securities directly from the company through IPOs, while in the secondary market, one purchase securities from other investors willing to sell the same.

Equity shares, bonds, preference shares, debentures, etc. are some of the key products available in a secondary market.

Functions of Secondary Market

(i) Economic Indicator – Every major change in the economy either due to government policy or any major international event has a bearing on the secondary/stock market. So, if the stock market is doing well, it is an indicator that economy is more or less in a stable position.

(ii) Valuation of Securities – Secondary market helps in the valuation of securities through its demand and supply. The securities of those companies which are growth oriented and doing well will surely have higher demand in comparison to securities of companies which are not doing well. Consequently, the share prices of growth oriented companies will be high.

(iii) Transaction in securities is safe in the secondary market – Transactions executed in the secondary market are safe because all the trading taking place in an electronic system which is highly secure.

(iv) Contributes to economic growth – It contributes to economic growth through allocation of funds to the most efficient sector through the process of disinvestment to reinvestment. This leads to capital formation and economic growth.

(v) Motivating people to invest in equity shares – Efficient secondary market motivate people to invest in the securities market. The reason is that the people would be less apprehensive about the riskiness of the stock market.

(vi) It ensures safety and measure of fair dealing to protect investor’ interest.
It induces companies to improve their performance since market price of shares showing at the stock exchanges is the indicator that reflects a company's performance and is easily available to the investors.

2. DEVELOPMENT OF THE STOCK MARKET IN INDIA

The stock market originated in India at the end of the eighteenth century when lots of new negotiable instruments were introduced. However, the real beginning was made in the middle of nineteenth century when Companies Act, 1860 was enacted where the concept of limited liability was introduced.

The Bombay Stock Exchange was formed in 1875. This was followed by formation of exchanges in Ahmedabad in 1894, Calcutta (Kolkata) in 1908, and Madras (now Chennai) in 1937. Calcutta Stock Exchange (CSE) was the largest stock exchange in India till 1960’s. In 1961, there were 1203 listed companies. Of these, 576 were listed on the CSE and 297 on the BSE. However, the latter part 1960’s saw significant decline in the share of CSE. But, the share of BSE gained during that period.

<table>
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<th>Pattern of Growth of Stock Exchanges</th>
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<tr>
<td>No of Stock exchanges</td>
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<td>Market Capitalization (₹ in crores)</td>
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<td>Market Capitalisation</td>
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<td>Turnover(₹ in crores)</td>
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Source: SEBI Annual Report, Various issues

Till 1990’s, the Indian Stock Market was suffering from many drawbacks which are enumerated as below:

- Uncertainty of execution prices.
- Uncertain delivery and settlement periods.
- Lack of transparency.
4.4  FINANCIAL SERVICES AND CAPITAL MARKETS

- High transaction costs.
- Absence of risk management.
- Systematic failure of market due to market failure.
- Partiality of brokers to certain client only.

Market Reforms after 1991

After the initiation of reforms in 1991, the secondary market has adopted the following system:

- Regional stock exchanges
- The National Stock Exchanges (BSE and NSE)
- The Over the Counter Exchange of India (OTCEI)
- The Interconnected Stock Exchange of India (ISE)

The NSE was set up in 1994. It was the first stock exchange in India to bring new technology, new trading practices, new institutions and new products. The OTCEI was established in 1992 providing small and medium sized enterprises the means to generate capital. Metropolitan Stock Exchange of India Ltd. (MSEI), formerly known as MCX Stock Exchange Ltd. (MCX-SX), is recognized by country’s securities market regulator - Securities and Exchange Board of India (SEBI). It offers an electronic platform for trading in Capital Market, Futures & Options, Currency Derivatives, Interest Rate Futures (IRF) and Debt Market segments. MSEI’s current shareholders include Indian public sector banks, private sector banks, investors and domestic financial institutions.

3. STOCK MARKET ORGANIZATION IN INDIA

The organization of stock exchanges has been depicted in the following figure:
The stock market organization (highlighting the capital market intermediaries) in India as shown in the above diagram is discussed as below:

(i) **Stock Broking** – Brokers are members of stock exchange. They enter into share trading transactions either on their own account or on behalf of their clients. They have to get registration from SEBI before starting their operations and have to comply with the prescribed code of conduct. Till recently, most of the brokers work as proprietary or partnership concerns. However, now many top broking firms are company form of organizations. Recent examples are:

- Sharekhan Limited
- India Bulls
- Angel Broking Limited
- India Infoline Limited
- Reliance Money
- Kotak Securities Limited
- ICICI Direct
- Motilal Oswal Securities
- HDFC Securities
- Bajaj Capital

Brokers are important intermediaries in the stock market as they bring buyers and sellers together. However, the brokerage on transactions varies from broker to broker. The maximum allowable brokerage is 2.5% of the contract price.

Further, every stock broker should appoint a compliance officer to monitor the compliance of SEBI Act and its various rules, regulations and guidelines and also for redressal of investor grievances. The compliance officer should immediately report any non-compliance observed by him to the SEBI.

SEBI is also empowered to appoint one or more persons as inspectors to inspect the books of accounts, other records and documents of the stockbroker. Also, a stock broker shall only deal with any person as a sub-broker only if he has obtained a certificate of registration from the SEBI. Further, a stock broker or a sub-broker who has contravened any provisions of SEBI Act, rules and regulations are liable for penal actions.

(ii) **Custodial Services** – The custodians play a critical role in the secondary market. SEBI Custodian of Securities Regulation, 1996 was framed for the proper conduct of their business. According to SEBI regulations, custodial services in relation to securities of a client or gold/gold related instrument held by a mutual fund or title deeds of real estate assets held by a real estate
mutual fund mean safekeeping of such securities or gold/gold related instruments or title deeds of real estate assets and providing related services.

The related services provided by them are as follows:

- Maintaining accounts of the securities of a client.
- Collecting the benefits/rights accruing to the client in respect of securities.
- Keeping the client informed of the actions taken by issuer of securities.
- Maintaining and reconciling records of the services as referred above.

SEBI can also ask for information from the custodian in regard to his activities. Such information has to be given within a reasonable period as laid down by SEBI. Further, SEBI is also empowered to conduct inspection/investigation including audit of books of account, records etc. of custodians to ensure that they are being properly maintained. SEBI's task is also to ascertain that compliance of provisions of SEBI Act and its regulations have been duly complied with. Moreover, his job is also to investigate into complaints received from the investors or clients.

(iii) Depository System – A major reform of the Indian stock markets has been the introduction of the depository system and scripless trading mechanism. The Depository Act was passed in 1996 to provide further fillip to the process.

The issuers should enter into an agreement with the depository to enable the investors to dematerialize the securities.

Before the depository system came into being, the market suffered from various drawbacks including thefts and forgeries of share certificates. Moreover, dealing in the physical mode had its own limitations which inhibited the growth of the capital market in India. These shortcomings were acutely felt more so after the liberalization of the economy. To address all such issues the Central Government enacted the Depositories Act, 1996, with retrospective effect from September 20, 1995.

Is it compulsory for every investor to hold securities in the demat form or can he also hold shares in the physical form? The Depositories Act provides that every person subscribing to securities offered by an issuer has the option to receive the security certificates or hold securities with a depository. However, investors need to note that while securities can be held by way of certificates, dealing in the market is permitted only if the securities are in the demat mode.

When an investor holds securities in the physical form, the certificates bear serial numbers, the distinctive numbers, etc. However, when the securities are held in demat mode, they are akin to money lying in the bank account. Therefore, there is no question of certificate numbers or distinctive numbers, though the quantity will remain the same.

As in the case of certificates, holders of securities in demat mode (called beneficial owners) can create a pledge or hypothecation in respect of the securities held by them. In such cases, it is
necessary for the beneficial owner to inform the depository of the pledge or hypothecation created by him. The depository concerned has to make a noting in its records to that effect.

Can the investor, who has opted for holding the securities in demat form, ask for certificates on opting out of the depository. A beneficial owner has a right to opt out of the depository at any time he or she may desire. In fact, the depository has to note the request in its records and also convey the same to the company. The company is obliged to issue the certificates in respect of the securities within 30 days of the receipt of the intimation from the depository.

What can an investor do if a depository or any participant or an issuer fails to redress his grievances? A complaint should be lodged with Sebi giving the necessary particulars in the prescribed form. Sebi would write to the concerned party asking it to redress the grievances of the investors within a specified time. In exceptional circumstances Sebi may grant further time for redressing the grievances. However, if the depository or the participant indulges in dilatory tactics or neglects to redress the grievances, Sebi has power to proceed against such defaulting party and impose penalty. In fact, Sebi has come down heavily on various market intermediaries as also the defaulting companies which ignore the investors and fail to redress their grievances. The heavy penalties that Sebi can impose and in many cases it has done so have come as an eye opener for various market players.  
(Source: Financial Express)

Secondary Market Structure

SEBI Registered Market Intermediaries

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Source: SEBI handbook of statistics
4. DEMUTUALIZATION OF STOCK EXCHANGES

Demutualization is the process by which any member owned organization can become a shareholder owned company. Such a company can either be listed on a stock exchange or be established as a closely held company. In simple words, a demutualized stock exchange is basically a company form of organization in which the company goes public and owners will be given equity shares.

Earlier (i.e. prior to 1991), all stock exchanges in India are broker owned and broker controlled. In other words, it is the brokers who collectively owned, controlled and managed these exchanges. However, the ownership and managership of these stock exchanges led to a conflict of interest where the interest of these brokers was given prominence than the investors.

These led to price rigging, frequent payment crises on stock exchanges and misuse of official position by office bearers. Therefore, demutualization of stock exchange was resorted to instill confidence in the minds of the investors.

So, through the demutualization process, a stock exchange becomes a profit making company and a tax paying entity. Demutualization separates the ownership and control of stock exchange from the trading rights of members. This reduces the conflict of interest and also the chances of brokers using the trading mechanism for personal gains.

In November 2002, SEBI approved the uniform model of corporatization and demutualization of stock exchanges, recommended by the Kania Committee. Further, Securities Contract Regulation Act was amended on October 12, 2004, through an ordinance, making it compulsory for the exchanges to convert into corporate entities and delink their broker members from the management. The ordinance restricts brokers’ representation in the governing body of stock exchanges to 25%. It also reduces their shareholding from 100% to 49%. Moreover, 51% of the stake of the stock exchange should be held by the public. This segregation was initiated to safeguard the interest of shareholders, bring greater transparency and efficiency of stock exchanges.

Advantages of Demutualization

(i) Enable stock exchanges to have more access to funds for investment in technology.
(ii) Facilitate merger and acquisition of other exchanges.
(iii) Facilitate alliances with other stock exchanges.
(iv) Benefit to members of the stock exchange as their asset becomes liquid.
(v) Members get share of the profits made by exchanges through dividends.
(vi) Makes operations of the stock exchanges transparent.
(vii) Transparency brings better governance.
5. SHARE TRADING IN SECONDARY MARKET

Secondary Market or Stock Exchange Market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets. For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, secondary equity markets serve as a monitoring and control conduit—by facilitating value-enhancing control activities, enabling implementation of incentive-based management contracts, and aggregating information (via price discovery) that guides management decisions. [Source: moneycontrol.com]

5.1 Share Trading by a Retail Investor

One can either choose to trade online or via a stockbroker or investment firm or an agent. One needs to take following steps to conduct trade in secondary market in India:

(i) **Open a Bank Account:** The first step towards investing in Indian stock market is to open a bank account. A bank account is required to hold the funds which would be investing in secondary market.

(ii) **Open a Demat Account:** Just as a bank account is required to hold the funds, a Demat Account is required to hold and trade the securities i.e. Shares, debentures and mutual funds electronically.

(iii) **Open a trading account:** After opening a Demat account, a trading account is required to trade in securities market. A trading/brokerage account allows you to purchase stocks, bonds, mutual funds, and other units by paying the broker to do the trading on your behalf. A retail investor would not be able to do trading without a trading account. Now, many banks have started providing all these services in a single unified account. The trading platform of a stock exchange is accessible only to trading members. The brokers would give buy/sell orders either on their own account or for their clients.

(iv) **Trading Mechanism:** With the advent of technology, trading at stock exchanges are now taking place through an open electronic limit order book, in which order matching is done by the trading computer. The buy or sell orders placed by the investors are matched automatically with the order which is best for them. Because of these, the buyers and sellers do not come to the picture. In other words, they remain anonymous. The market driven by order as stated above eliminates opaqueness. It brings transparency by highlighting all buy and sell orders in the trading system. But, the presence of market makers is very important. In their absence, there might by a possibility of non-execution of any order.

Investors buy/sell securities on stock exchange platform by placing buy/sell orders through their stock brokers with whom they are registered as client. On successful execution of order (buy/sell), securities will be bought/sold on behalf for the client. This activity is known as buying/selling of securities on the stock exchange platform on specific days which is known as trading day. This activity is referred to as trading and is carried out by stock exchanges for a specific period called trading hours. After the trading activity is completed, the process of delivering securities by the seller and payment of funds by the buyer is called securities pay-in/funds pay-in respectively. This
activity also has to be conducted within a stipulated time period. After the pay-in process is completed successfully, the buyer will get shares and the seller will get money. The above mentioned activities of, pay-in and, payout are collectively referred to as settlement process. Each settlement is identified by a unique number called settlement id/Settlement number.

(v) Payment to Broker for purchase of shares/securities: The payment for the shares purchased is required to be done prior to the pay-in date for the relevant settlement or as otherwise provided in the Rules and Regulations of the Exchange.

(vi) Delivery of shares to the broker for sale: The delivery of shares has to be done prior to the pay-in date for the relevant settlement or as otherwise provided in the Rules and Regulations of the Exchange and agreed with the broker/sub broker in writing.

(vii) Receipt of money for a sale transaction and receipt of shares for a buy transaction: Brokers were required to make payment or give delivery within two working days of the pay-out day. However, as settlement cycle has been reduced from T+3 rolling settlement to T+2, the pay out of funds and securities to the clients by the broker will be within 24 hours of the payout.

5.2 Buy Back of Shares

What is a buyback?

The buyback is a process in which a company uses its surplus cash to buy shares from the public. It is almost the opposite of initial public offer in which shares are issued to the public for the first time. In buyback, shares which have already been issued are bought back from the public. And, once the shares are bought back, they get absorbed and cease to exist.

For example, a company has one crore outstanding shares and having a huge cash pile of ₹ 5 crores. Since, the company has very limited investment options it decides to buyback some of its outstanding shares from the shareholders, by utilizing some portion of its surplus cash. Accordingly, it purchases 10 lakh shares from the existing shareholders by paying ₹ 20 per share, i.e. total cash of say, ₹ 2 crore.

The concept of buyback can be cleared with the help of the following diagram:
4.12  FINANCIAL SERVICES AND CAPITAL MARKETS

Effects of Buyback

There are several effects or consequences of buyback, some of which are as follows:

(i)  It increases the proportion of shares owned by controlling shareholders as the number of outstanding shares decreases after the buyback.

(ii)  Earning Per Share (EPS) escalates as the number of shares reduces leading the market price of shares to step up.

(iii) A share repurchase also effects a company’s financial statements as follows:

   (a) In balance sheet, a share buyback will reduce the company’s total assets position as cash holdings will be reduced and consequently as shareholders’ equity get reduced it results in reduction on the liabilities side by the same amount.

   (b) Amount spent on share buybacks shall be shown in Statement of Cash Flows in the “Financing Activities” section, as well as from the Statement of Changes in Equity or Statement of Retained Earnings.

(iv) Ratios based on performance indicators such as Return on Assets (ROA) and Return on Equity (ROE) typically improve after a share buyback. This can be understood with the help of following Statement showing Buyback Effect of a hypothetical company using ₹ 1.50 crore of cash out of total cash of ₹ 2.00 crore for buyback.

<table>
<thead>
<tr>
<th></th>
<th>Before Buyback</th>
<th>After Buyback (₹ )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (₹ )</td>
<td>2,00,00,000</td>
<td>50,00,000</td>
</tr>
<tr>
<td>Assets (₹ )</td>
<td>5,00,00,000</td>
<td>3,50,00,000</td>
</tr>
<tr>
<td>Earnings (₹ )</td>
<td>20,00,000</td>
<td>20,00,000</td>
</tr>
<tr>
<td>No. of Shares outstanding (Nos.)</td>
<td>10,00,000</td>
<td>9,00,000</td>
</tr>
<tr>
<td>Return on Assets (%)</td>
<td>4.00%</td>
<td>5.71%</td>
</tr>
<tr>
<td>Earnings Per Share (EPS) (₹ )</td>
<td>2</td>
<td>2.22</td>
</tr>
</tbody>
</table>

As visible from the above figure, the company’s cash pile has been reduced from ₹ 2 crore to ₹ 50 lakh after the buyback. Because cash is an asset, this will lower the total assets of the company from ₹ 5 crore to ₹ 3.5 crore. Now, this leads to an increase in the company’s ROA, even though earnings have not changed. Prior to the buyback, its ROA was 4% but after the repurchase, ROA increases to 5.71%. A similar effect can be seen in the EPS number, which increases from ₹ 2 to ₹ 2.22.

Why buybacks are being favoured by companies?

There are several reasons why a company chooses buyback, some of which are as follows:

(i)  A business organization needs cash to either expand its operations through acquisition of other businesses or grow its capacity by purchasing machinery, plant, furniture or other
kinds of assets. Therefore, too much cash is not considered good as it shows that cash is lying idle without being utilized in any manner.

(ii) A company may reduce some of its dividend liability by buying back shares thereby providing cash in the hands of shareholders and reducing cost.

(iii) Also, company will save on the dividend distribution tax @15% if they opt for buy back instead of declaring dividend to shareholders.

(iv) Further, a company's earnings per share (EPS) increases as the numbers of shares reduce because EPS is PAT (Profit after Tax) divided by total outstanding shares. This leads to spurt in the market price of shares.

(v) Moreover, by going for buyback, the company may give a signal to the investors that there are not any worthwhile investment opportunities for the company to increase capacity or through acquisitions.

(vi) Another reason to opt for buyback is when a company feels that the current market value of its shares is underpriced and is confident of its business and potential future value to investors.

When investors should opt for buyback?

The investors may opt for buyback of shares if the price offered to them is at a premium on the market price. In such a scenario, the buyback may be an attractive proposition. For example in case of Tata Consultancy Services (TCS) buyback, the offer price is ₹ 2850 per share while the current market price is around ₹ 2505. So, in case of TCS, offer price is at about 14% premium.

Further, if a shareholder goes by the famous quote, “a bird in the hand is worth two in the bush”, he may be inclined to accept the buyback offer, if buyback premium is more than the market price. However, if the investors can make out that management is continuously putting its effort to improve shareholder value, then the long term investor may not go for the buyback offer. The reason is that may be, in the next few years, market price of shares may upstaged the premium price of buyback offer.

On the other hand, opting for a buyback makes sense if the share price in the market is overvalued (i.e. there is very little chance that share price may increase any further in near future), or if there is firm belief that there are not enough opportunities for a firm to grow earnings.

Also, High Net Worth Individuals (HNI) having large shareholdings will not have to pay 10% tax on dividend income had they opted for the company’s buy back scheme because if their dividend income crosses ₹ 10 lakh, they would have to pay an additional dividend tax on the excess income.

Factors to be considered in buy back option by the investor

Acceptance ratio is also a very important factor in buy back. Acceptance ratio is the proportion of shares accepted by the company from the shareholders for buyback out of the shares tendered by
the shareholders. In case of the buyback offer of TCS, only 3% of total shares tendered by each of shareholders are accepted by the company. So, if we go by the TCS example, if a shareholder is holding e.g. 1000 shares, it doesn’t mean that TCS will buyback all the 1000 shares. In this case, it will buyback only 30 shares.

Another factor which is to be considered by investors while buying back the shares of a particular company is that whether promoters are participating in buyback or not. If there is promoter participation, the buyback is likely to be positive for the shares in the long run.

**Delisting versus Buyback**

Generally delisting is confused with buyback which is wrong since it is the process by which a listed security is removed from the exchange on which it trades. The major differences between buyback and delisting of shares are as follows:

1. In case of delisting, buyback of shares compulsorily happens while buyback offer does not lead to delisting of shares.
2. Delisting can happen in case of two circumstances. One, a company may delist its shares voluntarily. Two, a company’s stock may be compulsorily removed from an exchange if the company does not comply with the listing requirements of the exchange. However, there is no compulsion upon a company to execute buyback.
3. In case of delisting, entire share capital of the company is extinguished. But, in case of buyback, only some portion of the total capital is offered to the shareholders for buyback.
4. Delisting can happen in case of a listed company only. While buyback can take place in case of both listed and unlisted company.

**Legal implications of Buyback**

As per the Companies Act, the buyback is allowed to a company, if it is meeting the prescribed requirements and that too from permitted resources such as Free Reserves, Securities Premium etc. Further company can buyback upto 25% of its total paid up capital and free reserves.

**6. STOCK MARKET AND ITS OPERATIONS**

The stock exchanges are meant to facilitate mobilization of resources by companies. Their effective regulation is required for protecting the interests of investors and safeguarding their developmental role.

The Securities Contracts (Regulation) Act 1956 along with the Securities Contracts (Regulation) Rules 1957 has been the main laws to regulate the securities market in India. As per the Securities Contracts Regulations Act, 1956, a stock exchange is defined as “an association, organization 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”. A look at the powers given to
stock exchanges in India to make and enforce by laws under the Act and the rules reveals that Indian Stock Exchanges have been envisaged as self-regulatory organizations.

6.1 Growth of Stock Exchanges

The stock exchange in India came into existence in the eighteenth century. At that time, securities of East India Co. were transacted. And, there were at the most 50-60 brokers led by Premchand Roychand. They provided the much needed impetus to the shares issued by East India Company and a few commercial banks. The issuance of shares of a company made their beginning in the 1830s and gained importance with the passage of Companies Act in 1850s. The stock exchange in India, the Bombay Stock Exchange was established in 1875. It's name at that time was "Share and Stockbrokers Association."

The stock exchanges are tightly regulated as self-regulatory organizations (SROs) under the Act. In addition to ordinary regulatory powers over the stock exchanges, the Central Government and/or SEBI may nominate up to three members to the board of each stock exchange [Section 4(2)(iii) of the SC(R) Act, 1956 and Section 10 of SC(R) Rules, 1957]. The government and/or the agency have the authority to make, approve and amend the byelaws of the stock exchanges [Section 4(1)(a) & 8 of the SC(R) Act, 1956]. In return, the stock exchanges have been granted a strong disciplinary authority (as well as obligations) over their member stockbrokers.

6.2 Characteristics of Stock Exchanges in India

A stock exchange is an association of brokers, who are its members, established with the objective of regulating and helping the buying and selling of securities by the organizations. Recognition to a stock exchange in India is provided by the Central Government after making such inquiry as may be necessary after satisfying the provisions of the Securities Contract (Regulation) Act, 1956.

The governance of a stock exchange is done by the Board of Directors. Some board members are nominated by the Government. And, Govt. nominees include people representing Ministry of Finance. There, are some public representatives also whose job is to protect the interest of investors.

Further, the Board is presided by a President, who is nominated by the government from among the elected members. The Executive Director (ED) is the operational chief of stock exchange. He is appointed by the Stock Exchange with government's approval. The duty of ED is to make sure that day to day operations of the stock exchange are carried out in accordance with the rules and regulations.

The office of SEBI has been set up in Mumbai to observe the proper functioning of stock exchanges in the country. Every company wishing to issue shares to public has to get its securities listed in at least one stock exchange. Stock exchanges also facilitate trading of shares listed in them.
6.3 Functions of Stock Exchanges

Various functions of stock exchanges are discussed as below:

(a) **Liquidity and Marketability of Securities:** The basic functions of the stock market are to provide liquidity to the securities of a company. This can be achieved when investors can sell their securities at the prevalent market price at that time and get the required amount. The stock exchanges also provide marketability to the securities of a company i.e. the securities can be bought and sold at any time at the convenience of investors.

(b) **Fair Price Determination:** Fair price is determined through the demand and supply forces. As the market is almost perfectly competitive, there are large number of buyers and sellers that ensures an honest and just determination of prices of securities.

(c) **Source for Long term Funds:** Stock exchanges provide a reliable long term sources of funds to the corporates, government and the public bodies. The advantages of the securities place in the stock exchanges are that they are negotiable and transferable. They are freely traded and changes hands from one investor to other without affecting the funds requirement of the issuing company.

(d) **Helps in Capital Formation:** It means the savings of the people are mobilized and channelized into those sectors which are in need of money. So, stock exchanges facilitate capital formation i.e. it helps in transfer of funds from those people who have surplus money to sectors which are in need of money.

(e) **Services provided by Stock Exchanges:** Stock exchanges ensure that the shares issued to the public are transparent and according to prescribed rules and regulations.

Shares are issued to the public by the companies by disclosing all the information through the prospectus. It ensures that various norms regarding listing, opening of subscription for a minimum number of days, availability of share applications at the prescribed centres etc.

Members of the stock exchanges provide useful services as brokers and underwriters. As brokers, they try to gain access to potential investors and encourage them to invest in the stock market. And, as underwriters, they provide the much needed services by subscribers to those securities of a company which remains unsubscribed.

Stock exchanges also provide a platform where right shares of a company are issued to the already existing shareholders of the company. New shareholders can also take part in the rights shares provided existing shareholders renounce a part of their shareholding.

(f) **Reflects the General State of Economy:** The stock market is a reflection of an economy. When economy is doing badly, the stock market also reflects the same negativity in the form of declining share prices. On the other hand, when the economy is doing well, the stock market also shows a boosting effect in the form of higher share prices.
6.4 Basics of Stock Market Indices

6.4.1 Stock Market Index

It represents the entire stock market. It shows the changes taking place in the stock market. Movement of index is also an indication of average returns received by the investors. With the help of an index, it is easy for an investor to compare performance as it can be used as a benchmark, for e.g. a simple comparison of the stock and the index can be undertaken to find out the feasibility of holding a particular stock.

Each stock exchange has an index. For instance, in India, it is Sensex of BSE and Nifty of NSE. On the other hand, in outside India, popular indexes are Dow Jones, NASDAQ, FTSE etc.

6.4.2 Concept behind Fluctuations of Index

Valuation of stocks is arrived at by discounting future earnings (i.e. dividend and capital gains) to arrive at the present value. So, the stock market is basically reflective of how a company will perform in the future. So, when the index goes up, the perception is that the future returns will goes up and vice-versa.

6.4.3 Computation of Index

Following steps are involved in calculation of index on a particular date:

- Calculate market capitalization of each individual company comprising the index.
- Calculate the total market capitalization by adding the individual market capitalization of all companies in the index.
- Computing index of next day requires the index value and the total market capitalization of the previous day and is computed as follows:

\[
\text{Index Value} = \text{Index on Previous Day} \times \frac{\text{Total market capitalisation for current day}}{\text{Total capitalisation of the previous day}}
\]

- It should also be noted that Indices may also be calculated using the price weighted method. Here, the share price of the constituent companies forms the weight. However, almost all equity indices world-wide are calculated using the market capitalization weighted method.

7. RISK MANAGEMENT IN SECONDARY MARKET

The stock exchanges have developed a comprehensive risk management mechanism to promote a safe and efficient capital market. These include:

- Laying down trading rules and regulations for broker members.
- Setting up market surveillance systems to curb excess volatility.
Creating trade/settlement guarantee fund to ensure timely settlements even if a member defaults to deliver securities or pay cash.

Setting up a clearing corporation to guarantee financial settlement of all trades and thereby reduce credit risk in the settlement system.

The Risk Management structure of Secondary Market (or stock exchanges) has been discussed in detail in the following paragraphs to enable students to have a good grasp over the nuances of secondary market.

I. Trading Rules and Regulations

Strict rules and regulations have been framed to prevent unfair trading practices and insider trading. Stock exchanges impose different types of margins on brokers for individual stocks, depending upon the exposures taken by these brokers in these stocks, both on ownership basis and on behalf of clients. These margins are collected to prevent brokers from taking market positions in excess of their buying capacity. They are also used to settle any amount due to the stock exchange, clearing corporation and traders, in case the broker faces any shortage of amount.

Further, there is a real-time monitoring of the intra-day trading limits and gross exposure limits by the stock exchanges. There is an automatic deactivation of trading terminals in case of breach of exposure limits. Also, SEBI stipulated that stock brokers and sub-brokers of one exchange cannot deal with the brokers and sub-brokers of the same exchange either for proprietary trading or for trading on behalf of their clients. However, they can deal with the brokers and sub-brokers of another exchange for proprietary trading only.

Moreover, to ensure fair trading practices, the SEBI has devised insider trading regulations by prohibiting insider trading and making it a criminal offence. To ensure transparency in the takeover process, SEBI takeover regulations have been made.

II. Circuit Breakers to curb excess volatility

Circuit Breaker is a temporary halt or suspension of trading in any particular stock or index for a certain period of time. The move is basically resorted to curb excess volatility in the stock market.

There are two methods by which circuit breakers are practiced:

1. Suspension of trade in a security or index for a certain period.
2. Suspension of trade in a security or index for the entire trading day.

In case of first option, trading activities are suspended for few hours to enable the market to settle down. This also allows market participants to make an informed decision by having a relook at the market. If the market is very volatile and it seems that it is going out of control, then the trading may be halted for the entire day.
Advantages of Circuit Breakers

(i) During the suspension period, circuit breakers allow participants to reassess the situation by gathering new information.

(ii) It helps in controlling panic among the investors.

(iii) It also helps exchange clearing houses to monitor their members.

(iv) It also helps investors to take a rational approach towards the security during the time the trading is suspended.

Disadvantages of Circuit Breakers

(i) Firstly, circuit breakers prevents true discovery of price for the period during which it is imposed.

(ii) Secondly, sometimes circuit breakers prove to be unfair to retail investors because well informed investors such as foreign institutional investors usually makes a move before the circuit breaker can be invoked leading to chaos and confusion among retail investors.

The extent of duration of the market halt and pre-open session is as given below:

<table>
<thead>
<tr>
<th>Circuit Breaker</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trigger limit</td>
</tr>
<tr>
<td>10%</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>15%</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>20%</td>
</tr>
</tbody>
</table>

III. Trading and Settlement

Rolling settlement is basically settlement of transaction in stock market in a certain number of days after the trade is agreed.

Rolling settlement can be explained with the help of following table:

<table>
<thead>
<tr>
<th>Rolling Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Activity</strong></td>
</tr>
<tr>
<td>Trading</td>
</tr>
<tr>
<td>Clearing</td>
</tr>
</tbody>
</table>
Corporation Ltd. (NSCCL) confirms the trade from stock exchange. Then, NSCCL process and download obligation files to brokers.

<table>
<thead>
<tr>
<th>Settlement</th>
<th>Pay-in of securities and funds to NSCCL. NSCCL gives pay out of securities and funds.</th>
<th>T + 2</th>
<th>By 10.30 A.M.</th>
</tr>
</thead>
</table>

Settlement explained
Suppose, an investor buys 100 shares @ ₹ 2000 each on Monday and sell those shares @ 2500 each on the same day. His net obligation in terms of funds and securities will be calculated on Tuesday. In terms of securities, his net obligation is nil as he has sold all the shares he bought. So, he will neither receive nor give any security. On the other hand, his net monetary obligations will be calculated taking into account his buying and selling amount. In this case, the net amount he is receiving is ₹ 50000 (100 shares x ₹ 2500 – 100 shares x ₹ 2000). This pay-in and pay-out of funds are calculated on T+2 day i.e. on Wednesday.

Settlement Activities (T+2 Day)
On the second working day i.e. T+2 day, all the brokers has to pay-in the required funds and securities to the NSCCL by 10.30 A.M. giving the required instructions to the respective clearing banks and members on the same day. Moreover, by 1.30 on the same day, brokers get the required funds through the NSCCL. This is called pay-out of funds.
Pay-in and pay-out of funds explained

Pay-in of funds take place when NSCCL gives the required funds to the clearing corporation by giving instructions to the clearing bank which credits the account of clearing corporation and debit the accounts of clearing bank. This is called pay-in of funds. After that, the NSCCL gives electronic instructions to the clearing banks to credit accounts of clearing members and debit accounts of the clearing corporation. This is called pay-out of funds and this completes the settlement cycle.

Pay-in and pay-out of securities explained

Pay-in of securities means that shares that the shareholder wants to sell are picked up from their Demat account and transferred to the broker's account. All these shares are then delivered to the clearing corporation. In pay-out of securities, the shares that the investor wants to buy are received from the clearing corporation and then transferred to the broker's account. After that, the shares are transferred from the broker's account to the buyer's Demat account.

IV. National Securities Clearing Corporation Limited

In April 1995, the NSE set up the National Securities Clearing Corporation Limited (NSCCL), its wholly owned subsidiary, to undertake clearing and settlement at the exchange. It started operations from April 1996. The NSCCL undertakes the counterparty risk of each member and guarantees settlement. Settlement guarantee is a guarantee provided by the clearing corporation for the settlement of all trading of products in the stock exchange. The organizations linked with Clearing Corporation in the clearing and settlement process are discussed as below:

(a) Custodians/Clearing Members: NSCCL takes trading information from the exchange and pass the trade details to custodians/clearing members. Custodians confirm the obligations of the parties by netting.

(b) Clearing Banks: They act as a link between clearing corporation and clearing member. Every clearing member is required to maintain a clearing account with one of the clearing banks. A clearing bank has to enter into an agreement with the NSCCL and clearing member and open clearing account with the depository.

(c) Depositories: They hold securities in dematerialized form for the investors in their beneficiary account. Every clearing member is required to maintain a clearing pool account with the depositories.

The clearing banks, on receiving electronic instructions from the NSCCL, debit accounts of clearing banks and credit accounts of the clearing corporation. This is termed as pay-in of funds and securities. The NSCCL, after providing for shortages of funds and securities, sends electronic instructions to the depositories and clearing banks to credit accounts of clearing members and debit accounts of the clearing corporation. Thus, the settlement cycle is completed once the pay out of funds and securities is done.
V. Market Making System

The job of the market maker is to provide liquidity to the stock market by providing a two way quote i.e. a buy and a sell quote. How do the market makers do this? And what is the purpose. Consider a situation, when you want to purchase shares and there is no one there to sell his share. What will happen? Such a person has to wait until he finds a person who can sell his shares at a price quoted by him. The market maker resolves this problem. He sells shares at the quoted price. This way, the person gets the shares he wants to sell. Conversely, if a person wants to sell his shares, market maker may come at his rescue and purchase shares at the price quoted by him. So, he gets the shares he was so willing to purchase. Hence, market maker has devised a system in which anyone can buy and sell shares anytime.

Market makers are basically large brokerage houses. But, how do they make money? And there is a chance that they may suffer loss. For e.g. if they buy shares at a particular price and are not able to sell them later at a higher price because of fall in market price of shares, they will incur loss. To offset this loss, they purchase shares at a particular price (ask price) say ₹ 100 and sell them at a slightly higher price say ₹ 100.10 (bid price). This profit margin of 0.10 seems to be very nominal. But, when trading of millions of shares takes place in a day, the market maker at the end of the day managed to pocket a significant amount.

The obligations and responsibilities of Market Makers (as per BSE website)

The Market Maker shall fulfill the following conditions to provide depth and continuity on this exchange:

(a) The Market Maker shall be required to provide a 2-way quote for 75% of the time in a day. The same shall be monitored by the stock exchange. Further, the Market Maker shall inform the exchange in advance for each and every black out period when the quotes are not being offered by the Market Maker.

(b) The minimum depth of the quote shall be ₹ 1,00,000/- . However, the investors with holdings of value less than ₹ 1,00,000 shall be allowed to offer their holding to the Market Maker in that scrip provided that he sells his entire holding in that scrip in one lot along with a declaration to the effect to the selling broker.

(c) Execution of the order at the quoted price and quantity must be guaranteed by the Market Maker, for the quotes given by him.

(d) There would not be more than five Market Makers for a scrip. These would be selected on the basis of objective criteria to be evolved by the Exchange which would include capital adequacy, networth, infrastructure, minimum volume of business etc.

(e) The Market Maker may compete with other Market Makers for better quotes to the investors;
(f) Once registered as a Market Maker, he has to start providing quotes from the day of the listing / the day when designated as the Market Maker for the respective scrip and shall be subject to the guidelines laid down for market making by the exchange. Once registered as a Market Maker, he has to act in that capacity for a period as mutually decided between the Merchant Banker and the market maker.

(g) Further, the Market Maker shall be allowed to deregister by giving one month notice to the exchange.

VI. Securities Lending and Borrowing (SLB)

Securities lending means lending of stocks, derivatives and other securities to investor or firm. Securities lending requires the borrower to pledge, whether cash, security or a letter of credit to the lender. When a security is lent, the title and the ownership are also transferred to the borrower.

Why securities lending and borrowing is important? The Securities lending and borrowing has its importance in short selling. Basically, short selling is a facility in which a person (short seller) can sell shares which he does not own or possess. What is the advantage of doing that? The short seller borrows security to immediately sell them. He generally does that when he has a firm belief that security prices will come down in the near future. So, he borrows security hoping to profit by selling the security and buying it back at a lower price. The borrower of securities pays the lender interest on the value of the securities borrowed.

*The concept of short selling has been discussed in detail later in this chapter.*

The borrower of securities are usually brokers, speculators, market makers, custodian banks, clearing banks, clearing corporation, and finance companies. The lenders are mutual funds, insurance companies, custodian banks, finance companies, brokers and high net worth individuals.

Further, the lender still remains the owner of stock after SLB and gets all beneficial rights such as dividend, rights or bonus shares in respect of the stock lent. The borrower, however, has the legal title of the borrowed securities and is eligible to trade and sell securities in any manner he thinks fit. Moreover, there is roll over facility also i.e. the lender and borrower can extend the period of their borrowing and lending respectively.

*Merits of Stock Lending and Borrowing*

(i) Provides facility to the borrowers who are anticipating fall in the market price of securities to sell securities which they don’t own.

(ii) Provides an incentive to institutional investors such as banks, mutual funds, financial institutions and insurance companies to earn income by lending their idle stock in the market and earn interest income from borrowers.

(iii) Increase liquidity of the stock as more and more people can sell or purchase stock inspite of shortage of money.

(iv) Providing stability to stock market movements.
(v) Helps to avoid delivery failures as it is routed through the clearing house and facilitates timely delivery.

(vi) And, lastly, manipulation of stock prices is difficult.

VII. Straight Through Processing (STP)

The concept of Straight Through Processing is designed to complete the transaction without human intervention. Straight through processing (STP) is an initiative that financial companies use to optimize the speed at which they process transactions. This is performed by allowing information that has been electronically entered to be transferred from one party to another in the settlement process without manually re-entering the same pieces of information repeatedly over the entire sequence of events.

The primary purpose of STP is to streamline the processing of transactions across multiple points. By allowing information to pass along electronically, this eliminates the need for a hands-on reentry of data that has already been completed at the source. Additionally, information could be sent to more than one party simultaneously if it is appropriate for the transaction type.

So, the purpose of STP is to eliminate costly delays during transaction processing period. Since manual assistance is not needed, there is no delay between one party receiving information and the other being able to proceed further.

In normal processing, information must be handled by the multiple persons involved. This requires taking the time to accept and review the information, rekeying data as required, and then sending it forward to the next part of the transaction process. STP eliminates the human factor, allowing an automated process to complete any steps needed for a transaction to proceed. By eliminating these delays, the transactions can be more cost-effective as they require less time to manage. This is particularly attractive to investors looking for lower fee options.

The benefit of STP can be explained with the help of an example. In a manual trade, the broker issues a contract note which is then passed on to the custodian or a depository participant. There are multiple data entries during the different stages of a manual trade which makes the process prone to errors, delays and manipulation. However, in STP, contract note is issued in electronic form and the trade is settled in computer leaving almost no scope for manipulation. Further, in comparison to manual trade, STP is quicker, risk free and eliminates any failure in trade. (Source: Investopedia)

VIII. Margin Trading

Margin Trading is a facility given to the investors in which they can invest in shares by part financing from the bank. In other words, investors can provide some amount of money from their pocket to invest in shares, and rest of the amount will be financed by the banks. Margin trading permits investors to buy shares by providing 40% of the total value as margin, while borrowing 60% from the banks.
For example, an investor wants to buy 20000 shares worth ₹ 2,00,000 (price of one share is ₹ 10). But, he can invest only ₹ 80000 from his own pocket. However, under margin trading, he can buy as many as 20000 shares worth ₹ 200000 from his broker by paying ₹ 80000 as margin and by borrowing the balance ₹ 120000 from a bank through his broker. The broker pledges 20000 shares with the bank. The bank has collateral of ₹ 200000 backing the loan of ₹ 120000.

Now, suppose, the market price of share moves upwards from ₹ 10 to ₹ 15. So, with the help of the facility of margin trading, the shareholder can sell his entire shareholding of 20000 shares and pocket a gain of ₹ 100000 (20000 shares x ₹ 15 – 20000 shares x ₹ 10). Conversely, if he hadn’t availed the facility of margin trading, he would have been able to sell only 8000 shares and pocketed a gain of ₹ 40000 only. The reason is that he would have purchased only 8000 shares because of paucity of funds.

On the other hand, if the market price of shares fall below ₹ 10, the bank will give a margin call under which the investors will have to furnish additional funds/securities for the broker to pass on to the bank.

Margin trading gives a unique opportunity to the bank to lend short term funds at a high rate of interest. However, banks have to evolve a suitable risk management mechanism to safeguard the loans given by them against collateral of securities. In the same way, it provides a facility to the investors to borrow to money from the bank and invest it in the stock market.

IX  Short Selling

Concept

Short Selling means selling shares without owning it. In other words, the task of short sellers is to borrow the shares (generally through the clearing corporation of an exchange) and sell them. The borrowed shares which have been sold are bought back when prices are lower. The shares are then returned back to the lender and the excess profit is pocketed by the short seller.

In India, short selling can only takes place on an intra-day basis. As per the SEBI’s revised guidelines, both retail and institutional investors can participate in short selling. These transactions are facilitated by the exchanges. So, if one wants to short sell, one has to undertake the transaction through a broker. If the profit is made, then the short seller has to shell out 15% short term Capital Gain tax.

Risk inherent in short selling

In short selling, there is a scope of making huge return. On the flipper side, risk is also high. If you are trading in shares, the losses can be limited to the amount which you have invested. For e.g. if you have purchased 1000 shares at ₹ 10 each, the maximum loss that can be borne is ₹ 10,000.

However, in case of short selling, the amount of loss which an investor can bear is unlimited. The reason is that the price of shares of a given company can rise to any amount. For instance you short 100 shares at ₹ 50 each, but the shares increases to ₹ 70 each. So, you end up losing
₹ 2000 because you cannot bought back the shares until it reaches below ₹ 50. And, short seller has to return the borrowed shares to the lender. Hence, in short selling, there is an inherent risk of losing a heavy amount if the shares prices do not fall as per the expectations.

However, on the positive side, short selling gives much needed liquidity to the market by keeping the valuation of stocks in check. Another advantage of short selling is that the short seller is not required to pay too much at the time of entering into the transaction. So, initially only a small fee to the broker is required to be paid. And, lastly, it is one of the easiest ways to make money in a bear market.

8. INDIAN DEBT MARKET

Debt market is one of the most important components of a financial system. In fact debt market in most of the developed countries is bigger than the equity market. The Indian Debt market has been a Wholesale market. The major participants are basically restricted to some financial institution only. The primary participants are banks.

So, basically debt market is a financial market where buying and selling of securities takes place. The debt market also facilitates efficient allocation of mobilized resources. It also helps in financing the various developmental projects of the government. Further, the fiscal deficit is often financed by the government borrowing from the market by tapping the debt market.

So, in India, most of the times, the debt market is used as a mechanism to finance the development activities of the government.

8.1 Indian debt market can mainly be classified into two categories

(i) Government Securities Market (G-Sec Market): It consists of central and state government securities. It means, loans are being taken by the central and state government. It is also the most dominant category in the India debt market.

(ii) Bond Market: It consists of Financial Institution bonds, corporate bonds and debentures and Public Sector Unit bonds. These bonds are issued to meet financial requirements at a fixed cost and hence remove uncertainty in financial costs.

Structurally, the debt market remains firmly skewed towards government securities (G-secs). And the corporate bond market remains largely about top-rated financial and public sector issuances. The good part is, the domestic corporate bond market has done fairly well, fuelled by higher demand as a larger share of financial savings get channeled into the capital market, and favourable supply conditions have emerged because of mounting pressure of non-performing assets (NPAs) at banks.

If India is to see rapid economic growth over the long term – which is an absolute social necessity – the corporate bond market will have to play a pivotal role as a funding source.
Over the five fiscals through 2023, CRISIL expects corporate bond outstanding to more than double to ₹ 55-60 lakh crore, compared with ₹ 27 lakh crore at the end of fiscal 2018, driven by large infrastructure investment requirements, growth of non-banking financial institutions, regulatory push, and the inability of banks to crank up corporate lending because of capital constraints.

However, demand is expected to be only for ₹ 52-56 lakh crore, driven by higher penetration of mutual funds (MFs) and insurance products, increasing retirement subscriptions, growth in corporate investments, and increasing wealth of high networth individuals (HNIs). As a result, there would be a substantial gap of ₹ 3-4 lakh crore between demand and supply of corporate bonds in the next five fiscals.

[Source: Crisil Year Book on the Indian Debt Market 2018]

Further, a comparative figure of outstanding amount of various types of fixed income securities as on March 31, 2018 has been given as follows:

**Outstanding amount of various fixed – income securities**

<table>
<thead>
<tr>
<th>Type of Security</th>
<th>Amount outstanding as on March 31, 2018 (₹ Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Bonds</td>
<td>2,742,259</td>
</tr>
<tr>
<td>Government Securities</td>
<td>5,323,090</td>
</tr>
<tr>
<td>SDLs</td>
<td>2,430,333</td>
</tr>
<tr>
<td>T – Bills</td>
<td>385,283</td>
</tr>
<tr>
<td>CDs</td>
<td>185,732</td>
</tr>
<tr>
<td>CPs</td>
<td>372,577</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>11,439,276</strong></td>
</tr>
</tbody>
</table>

Source: RBI, SEBI, CCIL

The secondary debt market in India can be broadly categorized into –

(a) **Wholesale Debt Market** – comprising of investors like Banks, financial institutions, RBI, insurance companies, Mutual funds, corporates and FIIs.

(b) **Retail Debt Market** – comprising of investors like individuals, pension funds, private trusts, NBFCs and other legal entities.

**8.2 Benefits of an efficient Debt Market to the financial system and the economy**

- The debt market allows government to raise money to finance the development activities of the government.
- It plays an important role in efficient mobilization and allocation of resources in the economy.
The Government securities are issued to meet the short term and long term financial needs of the government, they are not only used as instruments for raising debt, but have emerged as key instruments for internal debt management, monetary management and short term liquidity management.

The debt market also provides greater funding avenues to public-sector and private sector projects and reduces the pressure on institutional financing.

It also enhances mobilization of resources by unlocking illiquid retail investments like gold.

Reduction in the borrowing cost of the Government and enable mobilization of resources at a reasonable cost.

Development of heterogeneity of market participants.

Assist in development of a reliable yield curve and the term structure of interest rates.

[Source: BSE - FAQs on Debt Market]

### 8.3 Different types of risks with regard to debt securities

- **Default Risk**: This can be defined as the risk that an issuer of a bond may be unable to make timely payment of interest or principal on a debt security or to otherwise comply with the provisions of a bond indenture and is also referred to as credit risk.

- **Interest Rate Risk**: can be defined as the risk emerging from an adverse change in the interest rate prevalent in the market so as to affect the yield on the existing instruments. A good case would be an upswing in the prevailing interest rate scenario leading to a situation where the investors' money is locked at lower rates whereas if he had waited and invested in the changed interest rate scenario, he would have earned more.

- **Reinvestment Rate Risk**: can be defined as the probability of a fall in the interest rate resulting in a lack of options to invest the interest received at regular intervals at higher rates at comparable rates in the market.

  *The following are the risks associated with trading in debt securities:*

- **Counter Party Risk**: is the normal risk associated with any transaction and refers to the failure or inability of the opposite party to the contract to deliver either the promised security or the sale-value at the time of settlement.

- **Price Risk**: refers to the possibility of not being able to receive the expected price on any order due to an adverse movement in the prices.

[Source: BSE - FAQs on Debt Market]