



# **Module-D Unit-3**

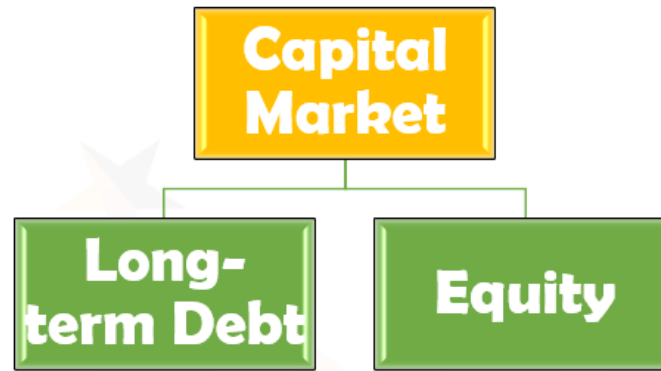
## **JAIIB PAPER-1**

**Indian Economy and Indian  
Financial System (IE & IFS)**



## JAIIB Paper 1 IE & IFS Unit 3: Capital Markets and Stock Exchanges

### Capital Market



Also includes private placement sources of debt and equity as well as organised forums like stock exchanges.



### Primary Market

- In the primary market, securities (shares/bonds/debentures) are offered to the public for subscription, for the purpose of raising capital or fund.



### Intermediaries

- Merchant banker,
- Issue manager,
- Lead arranger, etc.

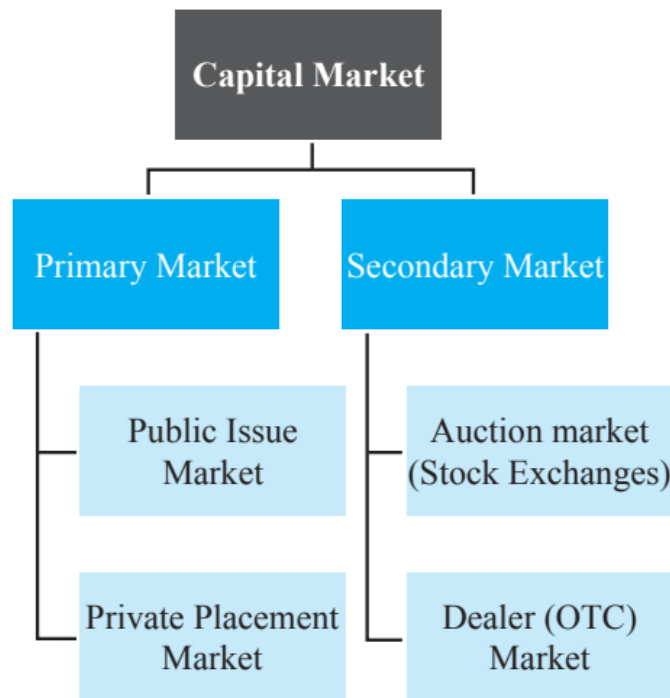
Banks participate in the capital market as bankers to the **issue, arrangers, underwriters, etc.**

### **Secondary Market**

Secondary 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



- **Secondary market is the trading avenue**, in which, already existing/pre-issued securities are traded, amongst investors. Secondary market could be either an auction or a dealer market. While stock exchange is a part of an auction market, Over the Counter (OTC) market, is a part of the dealer market.
- For the general investors, the secondary market provides an efficient platform for trading of securities, & for price discovery.
- **For managers 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.
- **Banks facilitate secondary market transactions** by opening direct trading and demat accounts to individuals and companies. Banks also extend credit against securities. They can also function as clearing house banks.



### Stock Exchanges In India

*At present following are the stock exchanges in India:*

#### **BSE Ltd. (Erstwhile Bombay Stock Exchange) (BSE) -**

- It is the oldest stock exchange of India
- set up in 1875
- First stock exchange to be granted permanent recognition from SEBI.
- It is one of the two major stock exchanges in the country today.

#### **National Stock Exchange of India Ltd. (NSE) -**

- **Established:** 1992 and is the other major stock exchange in the country today.
- **Permanent recognition from SEBI.**

#### **The Calcutta Stock Exchange Ltd. (CSE) -**

- One of the oldest stock exchanges of India.
- Set up as an Association in 1908.
- It has permanent recognition as stock exchange.

#### **Metropolitan Stock Exchange of India Ltd. -**

- Formed in December 2012, and commenced trading in February 2013.

#### **India International Exchange (India INX) -**

- A subsidiary of BSE and

- Set up in the International Financial Services Centre (IFSC), Gandhinagar.

#### NSE IFSC Ltd. –

- This stock exchange is a subsidiary of NSE and has been set up in the International Financial Services Centre (IFSC), Gift City, Gandhinagar.

#### Over the Counter Exchange of India Ltd. (OTCEI) –

- Set up in 1990 to aid enterprising promoters in raising finance for their projects in cost effective manner.

#### Demutualisation of Stock Exchanges

- **Demutualisation refers** to the transition process of an exchange from a 'mutually owned' association to a '**shareholders-owned**' company.

### **Financial Products/Instruments Dealt With In The Secondary Market**

*The following are the main financial products/instruments dealt with in the secondary market:*

- **Equity:** Equity is the ownership interest in a company of holders of its common and preferred stocks. The different types of equity shares are as follows:
- **Equity Shares:** An equity share is commonly referred to as an ordinary share. It represents the form of fractional ownership, in which, a shareholder, as a fractional owner, undertakes the entrepreneurial risk, associated with a business venture. The holders of equity shares are members of the company and have voting rights. A company may issue such shares with differential rights for voting, payment of dividend, etc.
- **Rights Issue/Rights Shares:** This refers to the issue of new securities to the existing shareholders, at a ratio to those shares already held.
- **Bonus Shares:** These are issued by the companies to their shareholders free of cost by capitalisation of accumulated reserves from the profits earned in the earlier years or out of the share premium account.
- **Preferred Stock/Preference Shares:** These shares do not offer voting rights. Owners of these shares are entitled to a fixed dividend or a dividend calculated at a fixed rate to be paid regularly before any dividend can be paid in respect of equity share. These shareholders also enjoy priority over the equity shareholders in the payment of surplus, during the process of liquidation of the company.
- **Cumulative Preference Shares:** This is a type of preference share on which dividend accumulates, if it remains unpaid. All arrears of preference dividend have to be paid out, before paying dividend on equity shares.
- **Cumulative Convertible Preference Shares:** This is a type of preference share where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.
- **Participating Preference Share:** This refers to the right of certain preference shareholders to participate in profits, after a specified fixed dividend, contracted

for, is paid. Participation right is linked with the quantum of dividend paid on the equity shares, over and above a particular specified level. Other instruments that form part of the capital market are given below:

- **Security Receipts:** Security receipts mean receipts or other securities, issued by a securitisation company or a reconstruction company, to any qualified institutional buyer, pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial assets involved in securitisation.
- **Government Securities (G-Secs):** These are sovereign (credit risk free) coupon-bearing instruments, which are issued by the Reserve Bank of India, on behalf of the Government of India, in lieu of the Central Government's market borrowing programme. These securities have a fixed coupon that is paid on specific dates, on a half-yearly basis.
- **Debentures:** Debentures are bonds issued by a company bearing a fixed rate of interest usually payable half-yearly, on specific dates and the principal amount repayable on a particular date, on redemption of the debentures. Debentures are normally secured/charged against the asset of the company in favour of the debenture holder.
- **Bond:** A bond is a negotiable certificate evidencing indebtedness. It is normally unsecured. A Bond (debt security) security is generally issued by a company, municipality or a government agency. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date.
- **Coupon Bonds:** These are normal bonds, on which, the issuer pays the investor/holder, interest at the pre-determined rate (known as coupon), at agreed intervals, normally, twice a year. The maturity of the bond is known by the period for which, **it is issued.**
- **Zero-Coupon Bond:** A bond issued at a discount and repaid at a face value is called a Zero-Coupon Bond. No periodic interest is paid in this case. The difference between the issue price and redemption price (face value) represents the return to the holder. The buyer of these bonds receives only one payment, at the maturity of the bond (known as a bullet payment).
- **Convertible Bond:** A bond giving the investor the option to convert the bond into equity, at a fixed conversion price, is referred to as a Convertible Bond.
- **Commercial Paper:** Commercial papers are borrowings of a company from the market. They take the shape of short-term promises to repay fixed amounts. They are placed on the market, either directly or through specialised intermediaries. Commercial papers are money market instruments issued, minimum of **7 days and maximum of one year.**
- **Treasury Bills:** These are short-term bearer discount security, issued by the Government (through the Reserve Bank of India), as a means of meeting its cash requirements.

### **Commonly Used Terms In The Capital Market**

#### **Securities Transaction Tax (STT):**

- Securities Transaction Tax (STT) is a tax, being levied on all transactions done on the stock exchanges, at rates prescribed by the Central Government, from time to time.
- Pursuant to the enactment of the Finance (No. 2) Act, 2004, the Government of India notified the Securities Transaction Tax Rules, 2004 and
- came into effect from October 1, 2004.
- In order to reduce transaction costs in the capital markets, the STT was reduced to 0.1% on cash delivery transactions in the annual budget 2013-14.

### Rolling Settlement:

- In a Rolling Settlement, trades executed during the day are settled, based on the net obligations for the day.
- Presently, the trades pertaining to the rolling settlement are **settled on a T+2 days basis**.
- Trades executed on a Monday, hence, are typically settled on Wednesday (considering 2 working days from the trade day).
- The funds and securities pay-in and pay-out **are carried out on T+2 day**.
- A Stock Exchange may choose to offer T+1 settlement cycle on any of the scrips with effect from January 01, 2022, after giving an advance notice of at least one month subject to applicable terms and conditions as per SEBI guidelines dated 7th September 2021.

### Pay-in Day and Pay-out Day:

- **Pay-in day is the day when the brokers** make payments or delivery of securities to the exchange.
- Pay-out day is the day when the exchange makes payment or delivery of securities to the broker.
- **Settlement cycle is on a T+2 rolling** settlement basis, with effect from April 1, 2003.
- The exchanges have to ensure that the pay-out of funds and securities to the clients is done by the broker, within 24 hours of the pay-out.
- The exchanges will have to issue a press release immediately after the pay-out

### Securities Lending Scheme:

- Securities Lending and Borrowing is a scheme which enables lending of idle securities by the investors to the clearing corporation and earning a return through the same.
- For securities borrowing and lending system, clearing corporations of the stock exchange would be the nodal agency and be registered as the **'Approved Intermediaries' (AIs)**.

- The clearing corporation can borrow, on behalf of the members, securities for the purpose of meeting shortfalls.
- The defaulting selling broker may make the delivery within the period specified by the clearing corporation.
- In the event of the defaulted selling broker, failing to make the delivery within the specified period, the clearing corporation has to buy the **securities from the open market and return the same to the lender, within 7 trading days.**
- In case of an inability to purchase the securities from the market, the transaction shall be closed out.

### **Types Of Capital Issues In The Primary Market**

#### **PUBLIC ISSUE**

- Classified into Initial Public Offerings (IPO) & Further/Follow on Public Offerings (FPOs).
- In a public offering, the issuer makes an offer to new investors to enter its shareholding family.
- The issuer company makes detailed disclosures, as per the Disclosure and Investor Protection (DIP) guidelines, in its offer document and offers it, for subscription.

#### **IPO:**

- An IPO is the offering that is made when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public.
- This paves way for listing and trading of the issuer's securities.

#### **FPO:**

- FPO is made when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document.
- An offer for sale in such a scenario is allowed only if it is made to satisfy listing or continuous listing obligations.

#### **RIGHT ISSUE:**

- Rights Issue (RI) is when a listed company proposes to issue fresh securities to its existing shareholders, as on a recorded date.
- The rights are normally offered in a particular ratio to the number of securities held prior to the issue.
- Best suited for companies who would like to raise capital, without diluting the stake of its existing shareholders, unless they do not intend to subscribe to their entitlements.

#### **PRIVATE PLACEMENT:**

- A private placement is an issue of shares or of convertible securities by a company to a select group of persons under Section 81 of the Companies Act, 1956, which is neither a rights issue nor a public issue.
- This is a faster way for a company to raise equity capital.
- A Qualified Institutional Placement (QIP) is a private placement of equity shares or securities convertible into equity shares by a listed company to Qualified Institutional Buyers (QIB) only, in terms of provisions of Chapter XIII A of SEBI (DIP) guidelines.

### **Eligibility Norms For Making Capital Issues**

- SEBI has laid down eligibility norms for entities accessing the primary market through public issues.
- There are no eligibility norms for a listed company that is making a rights issue, as it is an offer made to for a listed company making a preferential issue.
- However, for a QIP, only those companies whose shares are listed in NSE or BSE and those who are having a minimum public float, as required in terms of the listing agreement, are eligible.
- For making any public issue of securities, a draft Prospectus has to be filed by the issuer, with **the SEBI, through a Merchant Banker**.
- No listed issuer company shall make any rights issue of securities, where the aggregate value of such securities, including premium, **if any, exceeds Rs. 50 lakhs**, unless a draft letter of offer has been filed with the Board, through a Merchant Banker, at **least 30 days prior to the filing of the letter of offer with the Designated Stock Exchange**.
- In QIP, the merchant banker handling the issue has to file a copy of the placement document with SEBI, post-allotment, for record purposes.
- Merchant banks are the specialised intermediaries who are required to display due diligence and ensure that all the requirements of DIP (Disclosure and Investor Protection) guidelines are complied with, while submitting the draft offer document to SEBI.
- The draft offer document filed by the merchant banker is also placed on the website for public comments.

#### Offer Document means

- Prospectus in case of a public issue,
- Offer for sale and Letter of Offer, in case of a rights issue, which are filed with the Registrar of Companies (ROC) and stock exchanges.
- SEBI may specify changes, if any, in the draft offer document and the issuer or the lead merchant banker (LM) shall carry out such changes **in the draft offer document, before filing the offer document with ROC/SEs**.
- The draft offer document will be available on the SEBI website, for public comments, for a **period of 21 days, from the filing of the draft offer document with SEBI**.

#### Red Herring Prospectus (RHP)

- **Red Herring Prospectus (RHP) is a prospectus** which does not have details of either price or number of shares being offered or the amount of issue.
- This means that in case the price is not disclosed, the number of shares and the upper and lower price bands are disclosed.

- An issuer can state the issue size and the number of shares is determined later.
- An RHP for an FPO can be filed with the ROC, without the price band. In such a case, the floor price or the price band will be notified by way of an advertisement, one day prior to the opening of the issue.
- In the case of issues for book building, it is a process of price discovery and the price cannot be determined, until the bidding process is completed.
- Such details are thus not shown in the RHP filed with ROC, **in terms of the provisions of the Companies Act.**
- Only on completion of the bidding process, the details of the final price are included in the offer document.
- The offer document filed thereafter with **ROC is called a prospectus.**

### What is a Draft Red Herring Prospectus?

- A Red Herring Prospectus, or offer document, is filed by a company to SEBI (Securities and Exchange Board of India), when it intends to raise money from the public by selling shares of the company to investors.
- The document is very useful to investors because, it provides detailed information about the company's business operations, financials, promoters and the company's objective for raising funds by filing an IPOs.
- It also elaborates on how the company intends to use the money that will be raised and the possible risks for investors.

### Contents of RHP:

*The Red Herring Prospectus contains some of the following information*

#### Business Description:

- This segment talks about a company's core operations and how it conducts business.
- A prospective shareholder, should pay attention to this part, as the investment will be utilised by the company, in its core business.

#### Financial information:

- contains the company's audit reports and financial statements.
- For an investor, the financial statement will help him to get an idea of future dividends, based on the profits disclosed.
- The investor can gauge the safety and profitability of his future investment, based on the financial information.

#### Risk Factors:

- Companies list out the potential risks that could impact their business and operations under a section titled '**Risk Factors**'.
- While many are routinely listed risks, some risks need to be scrutinised. For instance, if the investor finds that the company has a number of pending legal cases, it may be a good idea to avoid the IPO.

#### **Use of Proceeds:**

- The investor should find out what the company intends to do with the capital it raises, through the IPO.
- Also, the capital structure of the company should be scrutinised in order to see if any big private investors have put money into the company.

#### **Industry overview:**

- A red herring prospectus carries information about the position of the company, relative to its competitors. The performance trends of the industry to which the company belongs to, is also included in the document.

#### **Management:**

- A company's prospects have a lot to do with the people who run it.
- The management is responsible for planning strategies on varied fronts like driving growth, pushing expansions, renovation, marketing, etc.
- This section has details such as names, qualifications, designations about directors, promoters and key management personnel.
- It may also have information about any criminal cases or that of financial delinquency or pending litigations against these people.
- It is important for an investor to check this section because all these can be a risk factor.

#### **Pricing of the Issue**

- **There is no price formula stipulated by SEBI.**
- The company and merchant banker are however required to give full disclosures of the parameters, which they had considered, while deciding on the issue price.

#### **There are two types of issues,**

- One where company and LM fix a price (called fixed price)
- Other, where the company and LM stipulate a floor price or a price band and leave it to market forces to determine the final price (price discovery through book building process).
- An issuer company is allowed to freely price the issue.
- The basis of issue price is disclosed in the offer document

- Book Building means a process by which, a demand for the securities proposed to be issued by a corporate body is elicited and built-up and the price for the securities is assessed, on the basis of the bids obtained for **the quantum of securities offered for subscription by the issuer.**

In a 100% of net offer to public through voluntary book-built issue, allotments to different *categories of investors are required to be ensured in the following proportions:*

- **Retail Individual Investors (RIIs):** Not less than 35% of the net offer to the public
- **Non-Institutional Investors (NIIs):** Not less than 15% of the net offer to the public
- **Qualified Institutional Buyers (QIBs):** Not more than 50% of the net offer to the public (5% of which should go to Mutual funds)

*In case of compulsory Book-Built Issues, the proportion of allotments shall be as under:*

- **QIBs:** At least 75% of the net offer to the public (failing which full subscription monies to be refunded)
- **NIIs:** Not more than 15% of the net offer to the public
- **RIIs:** Not more than 10% of the net offer to the public

*In case of Fixed Price Issues, the proportion of allotments shall be as under:*

(a) A **minimum 50%** of the net offer of securities to the public shall initially be made available for allotment to RIIs.

(b) **The balance net offer of securities to the public shall be made available for allotment to:**

- Individual applicants other than RIIs, and
- Other investors including corporate bodies/institutions irrespective of the number of securities applied for.

### **Retail Individual Investor**

- Means an investor who applies or bids for securities of or **for a value not more than `2,00,000.**

### **Qualified Institutional Buyer**

- Is an institutional investor who is perceived to possess expertise and the financial strength to evaluate and invest in the capital markets.
- SEBI has specified certain categories of investors which are considered as QIB, for example mutual funds, scheduled commercial banks, etc.

## Non-Institutional Investor

- Is an investor other than a QIB or a RII. Typically, this category includes High Net Worth Individuals (HNIs) and corporate bodies.
- **“Anchor investor”** means a qualified institutional buyer who makes an application for a value of at least ten crore rupees in a public issue on the main board made through the book building process in accordance with these regulations or makes an application for a value of at least two crore rupees for an issue made in accordance with Chapter IX of these regulations.
- **“Green shoe-option”** means an option of allotting equity shares in excess of the equity shares offered in the public issue as a post-listing price stabilizing mechanism.
- **“Self-certified Syndicate Bank”** means a banker to an issue registered with the Board, which offers the facility of ASBA

### **Intermediaries In An Issue In The Primary Market**

- Merchant bankers to the issue or Book Running Lead Managers (BRLM), syndicate members, registrars to the issue, bankers to the issue, auditors of the company, underwriters to the issue, solicitors, etc., are the intermediaries to an issue, in the primary market.

### **Book Running Lead Managers (BRLM):**

- A merchant banker possessing a valid SEBI registration, in accordance with the **SEBI (Merchant Bankers) Regulations, 1992**, is eligible to act as a BRLM to an issue.

### **Safety Net:**

- Any safety net scheme or buy-back arrangements of the shares proposed in any public issue shall be finalised by an issuer company, with the lead merchant banker in advance and disclosed in the prospectus.
- Such a buy-back or safety net arrangement shall be made available only to original resident individual allottees, **limited to a maximum of 1,000 shares per allottee and the offer is kept open for a period of six months, from the last date of dispatch of securities.**

### **Cut-Off Price**

- In a book-building issue, the issuer is required to indicate either the price band or a floor price in the RHP.
- The actual discovered issue price can be any price, in the price band or any price above the floor price.
- **This issue price is called the Cut- Off Price.** This is decided by the issuer and LM, after considering the **‘book and investors’** appetite, for the stock.

- SEBI (DIP) guidelines permit only retail individual investors to have an option of applying at the cut off price.

### **Applications Supported By Blocked Amount (ASBA)**

- ASBA means “Applications Supported by Blocked Amount”.** ASBA is an application containing an authorisation to block the application money in the bank account, for subscribing to an issue.
- If an investor is applying through ASBA, the application money shall be debited from the bank account, only, if his/her application is selected for allotment, after the basis of allotment is finalised, or the issue is withdrawn/failed.
- Under ASBA facility**, investors can apply in any public/rights issues, by using their bank accounts.
- The investors submit the ASBA forms (available at the designated branches of the banks acting as SCSB), after filling the details like name of the applicant, PAN number, dematerialised account number, bid quantity, bid price and other relevant details, to their banking branch, by giving instructions to block the amount in their account.
- In turn, the bank will upload the details of the application in the bidding platform.
- Investors shall ensure that the details that are filled in the ASBA form are correct, otherwise the form is liable to be rejected.
- In case of public issues with effect **from May 1, 2010, all the investors could apply through ASBA.**

In rights issues, all shareholders of the company as on record date were permitted to use ASBA *for making applications provided the applicant shareholder:*

- Is holding shares in dematerialised form and has applied for entitlements or additional shares in the issue, in dematerialised form;
- Has not renounced his/her entitlements in full or in part;
- Is not a renouncee;
- Is applying through blocking of funds in a bank account with the Self Certified Syndicate Bank. (SCSB is a bank which is specialised as a bank capable of providing ASBA services to its customers. Names of such banks would appear in the list available on the website of SEBI).

### **Qualified Institutional Placement (QIP)**

- SEBI instituted the guidelines for Qualified Institutional Placement (QIP) relatively **new Indian financing avenue on May 8, 2006.**
- QIP is a capital raising tool, whereby, a listed company can issue equity shares, fully and partly convertible debentures, or any securities other than warrants, which are convertible into equity shares, to a qualified institutional buyer (QIB).

- Apart from preferential allotment, this is the only other speedy method of private placement for companies to raise money
- To enable the listed companies, raise money from domestic markets in a short span of time, market regulator- SEBI introduced the concept of QIP.
- Prior to introduction of QIPs, the complications associated with raising capital in the domestic markets had led many companies to look at tapping overseas markets via foreign currency convertible bonds (FCCBs) and global depository receipts (GDRs). This has also helped issuing companies price their issues closer to the prevailing market price.
- The specified securities can be issued only to QIBs, who shall not be promoters or related to promoters of the issuer.
- The issue is managed by a SEBI-registered merchant banker.
- There is no pre-issue filing of the placement document with SEBI.
- The placement document is placed on the websites of the stock exchanges and the issuer, with appropriate disclaimer to the effect that the placement is meant only for QIBs on private placement basis and is not an offer to the public.

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