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Investment:

The money which we earn is partly spent and the rest saved for meeting future expenses. Instead of keeping the savings idle we would like to use savings in order to get return on it in the future. This is called Investment. We invest because of many reasons. One important reason is that we want to meet the cost of Inflation.

- The Inflation which is the rate, at which the cost of living increases, indicates the rate at which the prices of the goods and services we need are increasing.
- If there is inflation, the money loses value, because it will not buy the same amount of a good or a service in the future as it does now or did in the past.

For example, we suppose that if there was a 6% inflation rate for the last 20 years, a Rs. 100 purchase in 1992 would cost Rs. 321 in 2012. So, whenever we make a long term investment strategy, we need to consider inflation. An investment's real return is that return which is after deducting the inflation. This means that if the annual inflation rate is 6%, what we invest should earn more than 6% annually so that we get a positive real return.

A person can invest in **Physical assets** like real estate, gold/jewellery, and commodities etc or **Financial assets** such as fixed deposits with banks, small saving instruments with post offices, insurance/provident/pension fund etc. Apart from that an investor can invest in **securities market related instruments** like shares, bonds, debentures etc.

When a person borrows money, he / she is expected to pay for using it. This is called interest. Interest is thus an amount charged from the borrower for the privilege of using the money of the lender. The interest is expressed as percentage of the principal balance. The interest rates may be of many kinds. There are rates that banks offer on their deposits. There are rates at which banks lend to their customers (borrowers). Then, the Government may also borrow in the market which is called G-sec or Government Securities or Guilt Edge market. Then, there are rates offered to investors in small saving schemes such as PPF.

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- Interest rates are affected by many factors. Most of these factors are related to macro economy such as Demand for money, Suply of Money, Level of Government borrowings, Inflation rate, the policies of RBI and Policies of the Government.

Short Term Investment Options

There are short term investment options such as savings bank account, money market/liquid funds and fixed deposits with banks.

- Out of them the **Savings Bank Account** is often the first banking product people use, which offers low interest, making them only marginally better than fixed deposits. In India, the interest rate on savings bank accounts is now deregulated and, the banks themselves decide the interest rates.
- The Money Market or **Liquid Funds** are a specialized form of mutual funds that invest in extremely short-term fixed income instruments and thereby provide easy liquidity.
    - Please note that there is a big difference between the **Mutual Funds** and **Liquid Funds.** Unlike most mutual funds, money market funds are primarily oriented towards protecting the investor's capital and then, aim to maximise returns.
    - Money market funds usually yield better returns than savings accounts, but lower than bank fixed deposits.
- Lastly, the **Fixed Deposits** with Banks can be long term as well as short term investment options as minimum investment period for bank FDs is 30 days. Fixed Deposits with banks are for investors with low risk appetite, and may be considered for 6-12 months investment period as normally interest on less than 6 months bank FDs is likely to be lower than money market fund returns.

Long Term Investment Options

The Long term investments typically comprise the **Post Office Savings Schemes**, **Public Provident Fund**, **Company Fixed Deposits**, **Bonds and Debentures**, **Mutual Funds** etc.

Post Office Investments:

Post Office Monthly Income Scheme is a low risk saving instrument, which can be availed through any post office.

- It generally provides an interest rate of around 8% per annum, which is paid monthly. Minimum amount, which can be invested, is Rs. 1,500/- and additional investment in multiples of 1,000/-.
- Maximum amount is Rs. 3,00,000/- (if Single) or Rs. 6,00,000/- (if held Jointly) during a year. It has a maturity period of 6 years. Premature withdrawal is permitted if deposit is more than one year old.
- Post office also provides time deposits for 1, 2, 3, 5 years. The monthly scheme and term deposits of Post offices don't provide any Tax benefits.

Public Provident Fund:

PPF is a long term savings instrument with a maturity of 15 years and interest payable at **8.25 % per annum** (2011-12, it was 9.5 per cent paid in 2010-11) compounded annually.

A PPF account can be opened through a nationalized bank at anytime during the year and is open all through the year for depositing money. Tax benefits can be availed for the amount invested and interest accrued is tax-free. A withdrawal is permissible every year from the seventh financial year of the date of opening of the account and the amount of withdrawal will be limited to 50% of the balance at credit at the end of the 4th year immediately preceding the year in which the amount is withdrawn or at the end of the preceding year whichever is lower the amount of loan if any.

Corporate FDs:

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Corporate FDs or Company Fixed deposits are short-term (six months) to medium-term (three to five years) borrowings by companies at a fixed rate of interest which is payable monthly, quarterly, semi-annually or annually. They can also be cumulative fixed deposits where the entire principal along with the interest is paid at the end of the loan period. The rate of interest varies between 6-9% per annum. The interest received is after deduction of taxes.

Bonds:

Bonds are fixed income instruments issued for a period of more than one year with the purpose of raising capital. The central or state government, corporations and similar institutions sell bonds. A bond is generally a promise to repay the principal along with a fixed rate of interest on a specified date, called the Maturity Date.

Mutual Funds:

The Mutual funds are operated by an investment company which raises money from the public and invests in a group of assets (shares, debentures etc.), in accordance with a stated set of objectives. Mutual Funds are for those who are unable to invest directly in equities or debt because of resource, time or knowledge constraints. Mutual Funds come with benefits such as professional money management, buying in small amounts and diversification.

- Mutual fund units are issued and redeemed by the **Fund Management Company** based on the fund's net asset value (NAV), which is determined at the end of each trading session.
- NAV is calculated as the value of all the shares held by the fund, minus expenses, divided by the number of units issued.
- Mutual Funds are usually long term investment vehicle though there some categories of mutual funds, such as money market mutual funds which are short term instruments.

Capital Markets

We all know that Land, Labour and Capital are three factors of production. Capital has many meanings in economy. Capital can be used for production of other goods (this is what makes it a factor of production). Here , what we are discussing is the **Equity Capital**.

- Equity capital is the owners' interest on the assets of the enterprise after deducting all its liabilities.
- It appears on the balance sheet / statement of financial position, one of the four primary financial statements.
- Ownership equity includes both tangible and intangible items (such as brand names and reputation / goodwill).
- Accounts listed under ownership equity include several components such as Share capital (common stock), Preferred stock, Capital surplus, Retained earnings, Treasury stock, Stock options & reserve.

To understand the basics, we take an example of a new start-up. We know that every business needs some capital to start up. Generally, the personal savings of an entrepreneur along with contributions from friends and relatives are the source of fund to start a new business. The entrepreneur in this case can also be called a **promoter**.

- This may not be feasible in case of large projects as the required contribution from the entrepreneur (promoter) would be very large even after availing term loan; the promoter may not be able to bring his / her share (equity capital).
- Thus availability of capital can be a major constraint in setting up or expanding business on a large scale, because of this limited pool of savings of small circle of friends and relatives.

However, instead of depending upon this small pool, the promoter has the option of raising money from the public across the country by selling (issuing) shares of the company. For this purpose, the promoter can invite investment to his or her venture by issuing offer document which gives full details about track record, the company, the nature of the project, the business model, the expected profitability etc. If an investor is comfortable with this proposed venture, he

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/ she may invest and thus become a shareholder of the company. This means that a shareholder is a owner of the company to the extent of his / her shareholding. The values of these shares are very small, but when the large number of shares aggregate, it makes substantial amount which is usable for large corporate.

- This mechanism by which corporate raise money from public is called the **primary markets**.
- When the shareholder needs the money back, he / she would not sell it back to the company except in some cases which we are going to discuss, but would sell them to other new investors. The trade of shares does not reduce or alter the company's capital. This trading of shares is facilitated by the Stock Exchanges, which bring such sellers and buyers together and facilitate trading. Therefore, companies raising money from public are required to list their shares on the stock exchange. This mechanism of buying and selling shares through stock exchange is known as the **secondary markets.**

Stock exchange

Stock exchanges are defined by the Securities Contract (Regulation) Act, 1956 [SCRA]. As per this act, 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, is called Stock Exchange. Stock exchange may be a regional stock exchange whose area of operation/jurisdiction is specified at the time of its recognition or national exchanges, which are permitted to have nationwide trading since inception. Examples are Delhi Stock Exchange and National Stock Exchange respectively.

Please note these points:

- As a shareholder, investor who invests in the shares of company is a part owner of the company and entitled to all the benefits of ownership, including dividend (company's profit distributed to owners).
- Over the years if the company performs well, other investors would like to become owners of this performing company by buying its shares. This increase in demand for shares leads to increase in its price.
- In this case, the investors have option of selling their shares at a higher price than at which they purchased it. Thus investor can increase their wealth, provided they make the right choice, as the reverse is also true.

But we should know that the shares are not the only instruments in share markets. Apart from the shares, there are many other financial instruments (securities) used for raising capital. **Debentures or bonds** are debt instruments which pay interest over their life time and are used by corporate to raise medium or long term debt capital. If an investor prefers fixed income, he / she may invest in these instruments which may give him / her higher rate of interest than bank fixed deposit.

Then, apart from equity and debt, a combination of these instruments, like convertible debentures, preference shares are also issued to raise capital. If the investor can not invest directly in share markets due to constraints like time, wherewithal, small amount etc., they can opt for Mutual Funds (MFs), which are regulated entities, provide an alternative avenue. They collect money from many investors and invest the aggregate amount in the markets in a professional and transparent manner. The returns from these investments net of management fees are available to investors as a MF unit holder.

Mutual Funds are of many kinds such as those investing only in equity or debt, index funds, gold funds, etc. to cater to risk appetite of big ranges of investors. Then, for those investors, who have very small amounts to invest, there are SIPs or **Systematic Investment Plans** which allow to invest in MF schemes through monthly investments.

The institutions, players and mechanism that bring suppliers and users of capital together, is known as **capital market.**

- The Capital Market allows people to do more with their savings by providing variety of assets thereby enhancing the wealth of investors who make the right choice.

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- Simultaneously, it enables entrepreneurs to do more with their ideas and talent, facilitating capital formation.
- Thus capital market mobilizes savings and channelizes it, through securities, into preferred entrepreneurs.

Equity

The shares which we discussed in the beginning of this module are Equity Shares. Equity is an instrument of ownership. Equity shares are instruments issued by companies to raise capital and it represents the title to the ownership of a company. An investor becomes an owner of a company by subscribing to its equity capital (whereby investor will be allotted shares) or by buying its shares from its existing owner(s). As a shareholder, investors bear the entrepreneurial risk of the business venture and are entitled to benefits of ownership like share in the distributed profit (dividend) etc. The returns earned in equity depend upon the profits made by the company, company's future growth etc.

- **Equity share** is initially issued to those who have contributed capital in setting up an enterprise. This would be called the **Public Issue.** The shares may also be issued to some limited number of people, which shall be called **Private Issue.** Apart from a Public Issue or Private Issue, equity shares may originate through an issue of Bonus Shares, Convertible securities etc. All of them are collectively called **Common Stock or Simply Stock**.

Please note that if the company fails or gets liquidated otherwise, the claim of equity shareholders on earnings and on assets in the event of liquidation, follows all others. Similarly, the dividend on equity shares is paid after meeting interest obligations and dividends to Preference shareholders. That is why the holders of the Equity shares are also known as **'residual owners'**. Since the equity shareholders bear such risks, they expect handsome returns by way of **DIVIDENDS** and price appreciation of the share, when their enterprise performs well.

Please note these points:

- The total equity capital of a company is divided into equal units of small denominations, each called a share.
- For example, in a company the total equity capital of Rs 2,00,00,000 is divided into 20,00,000 units of Rs 10 each. Each such unit of Rs 10 is called a Share.
- Thus, the company then is said to have 20,00,000 equity shares of Rs 10 each. The holders of such shares are members of the company and have voting rights.

Debt Instruments

Debt instrument represents a contract whereby one party lends money to another on pre-determined terms with regards to rate and periodicity of interest, repayment of principal amount by the borrower to the lender. In the Indian securities markets, the term **'bond'** is used for debt instruments issued by the Central and State governments and public sector organizations and the term **'debenture'** is used for instruments issued by private corporate sector. The Debt Instruments may be **Corporate Debt** or **Government Debt.** Corporate debt instruments are generally called Debentures while Government debt instruments are generally called Bonds, but Bonds can be issued by companies and local governance bodies too. The only difference between Debentures and Bonds is that Debentures are secured, while Bonds are unsecured.

Debentures:

The Corporate Debts includes Debentures. Debentures are instrument issued by companies to raise debt capital.

- This means that when a person invests in a debenture, he / she would lend money to the company in return for its promise to pay him / her an interest at a fixed rate (usually payable half yearly on specific dates) and to repay the loan amount on a specified maturity date say after 5/7/10 years.

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- This repayment of debenture is called **redemption**. Generally, the debentures are secured as specific assets of company are held (secured) in favour of debenture holders. If the company is unable to pay the principal amount to the investor as promised in a debenture, the assets can be liquidated.

The question is that if debentures are debt instruments, then how they are different from loans? Here you must note that the only major difference between loans & debentures is that the later can be sold and purchased in markets. Please note that Debentures may or may not be convertible into equity shares. Based upon this, the debentures are of following kinds.

- **Non convertible debentures (NCD)** – Total amount is redeemed by the issuer
- **Partially convertible debentures (PCD)** – Part of it is redeemed and the remaining is converted to equity shares as per the specified terms
- **Fully convertible debentures (FCD)** – Whole value is converted into equity at a specified price

Bonds

Bonds and Debentures, both are similar. Bonds can be issued by companies, financial institutions, municipalities or government companies and are normally not secured by any assets of the company (unsecured). The bonds may be **Regular Income Bonds**, which provide a stable source of income at regular, predetermined intervals or Tax-Saving Bonds, which offer tax exemption up to a specified amount of investment, depending on the scheme and the Government notification. There are varieties of Tax relief bonds available on the market.

Government Debts:

Government securities **(G-Secs)** are instruments issued by Government of India to raise money. **G Secs** pays interest at fixed rate on specific dates on half-yearly basis. It is available in wide range of maturity, from short dated (one year) to long dated (up to thirty years).

- Since it is sovereign borrowing, it is free from risk of default (credit risk). The investors can subscribe to these bonds through RBI or buy it in stock exchange.

Hybrid Instruments

The Hybrid Instruments are a combination of ownership and loan instruments or Equity and Debt Instruments. Examples are **Preference Shares, Cumulative Preference Shares** and **Cumulative Convertible Preference Shares**. **Preference shares** are also known as **Preferred Stock.**

- The Preference share entitles the investors to receive dividend at a fixed rate. This is the major difference between the equity share holder and preference share holder that the later gets dividend at a fixed rate.
- This dividend had to be paid to the investor before dividend can be paid to equity shareholders.
- In the event of liquidation of the company, the claim to the company's surplus will be higher pf the holders of Preference shares than that of the equity holders, but however, below the claims of the company's creditors, bondholders / debenture holders.

Now Kindly note this:

If a company is liquidated, the payment will be done in the following order:

- Creditors →Debenture / Bond Holders →Preference share holders → Equity Share Holders

Cumulative Preference Shares is a type of preference shares on which dividend accumulates if remains unpaid. All arrears of preference dividend have to be paid out before paying dividend on equity shares. **Cumulative Convertible Preference Shares** is type of preference shares 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.

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A share market Index shows how a specified portfolio of share prices are moving in order to give an indication of market trends. It is a basket of securities and the average price movement of the basket of securities indicates the index movement, whether upwards or downwards. BSE Sensex is one index. The BSE SENSEX is a free-float market capitalization-weighted stock market index of 30 well-established and financially sound companies listed on Bombay Stock Exchange. The 30 component companies which are some of the largest and most actively traded stocks, are representative of various industrial sectors of the Indian economy. Published since January 1, 1986, the SENSEX is regarded as the pulse of the domestic stock markets in India. The base value of the SENSEX is taken as 100 on April 1, 1979, and its base year as 1978-79. On 25 July, 2001 BSE launched DOLLEX-30, a dollar-linked version of SENSEX.

Depository

A depository is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form. We can compare a Depository with a bank, which holds the funds for depositors, as there are many similarities in Banks and Depositories.

- While the Bank holds funds in an account, depositories hold securities in an account.
- While Bank transfers funds between accounts on the instruction of the account holder, Depository transfers securities between accounts on the instruction of the account holder.
- While the bank facilitates transfers without having to handle money, Depository facilitates transfers of ownership without having to handle securities.
- Banks keep safe money, depositories keep safe securities.

In India, we have two depositories viz. National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL).

After depository, we have another entity called **Depository Participant**. Depository provides its services to investors through its agents called depository participants (DPs). These agents are appointed by the depository with the approval of SEBI. According to SEBI regulations, amongst others, three categories of entities, i.e. Banks, Financial Institutions and SEBI registered trading members can become DPs.

- Please note that accounts are always no frills at Depositories. This means an investor can have an account with depository without any balance.

There is one more entity about which you must know. It is called **Custodian**. A Custodian is basically an organisation, which helps register and safeguard the securities of its clients. Besides safeguarding securities, a custodian also keeps track of corporate actions on behalf of its clients. The functions of custodians are to maintain client's securities account, Collecting the benefits or rights accruing to the client in respect of securities, keeping the client informed of the actions taken or to be taken by the issue of securities, having a bearing on the benefits or rights accruing to the client.

Securities and Security Market

Security is a broader term in comparison to share market. The definition of 'Securities' as per the Securities Contracts Regulation Act (SCRA), 1956, includes instruments such as shares, bonds, scrips, stocks or other marketable securities of similar nature in or of any incorporate company or body corporate, government securities, derivatives of securities, units of collective investment scheme, interest and rights in securities, security receipt or any other instruments so declared by the Central Government.

- Securities Markets is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc.
- Further, it performs an important role of enabling corporate, entrepreneurs to raise resources for their companies and business ventures through public issues.

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- Transfer of resources from those having idle resources (investors) to others who have a need for them (corporate) is most efficiently achieved through the securities market.
- Stated formally, securities markets provide channels for reallocation of savings to investments and entrepreneurship. Savings are linked to investments by a variety of intermediaries, through a range of financial products, called 'Securities'.

Regulation of Security Market

The securities markets need regulation because there is absence of perfect competition and markets are prone to manipulation. It is the duty of the regulator to ensure that the market participants behave in a desired manner so that securities market continues to be a major source of finance for corporate and government and the interest of investors are protected. In India, the responsibility for regulating the securities market is shared by Department of Economic Affairs (DEA), Department of Company Affairs (DCA), Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI). The Securities and Exchange Board of India (SEBI) is the regulatory statutory authority in India established under Section 3 of SEBI Act, 1992. SEBI Act, 1992 .The statutory powers of SEBI are:

1. Protecting the interests of investors in securities
2. Promoting the development of the securities market
3. Regulating the securities market.
4. Regulating the business in stock exchanges and any other securities markets
5. Registering and regulating the working of stock brokers, sub–brokers etc.
6. Promoting and regulating self-regulatory organizations
7. Prohibiting fraudulent and unfair trade practices
8. Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self – regulatory organizations, mutual funds and other persons associated with the securities market.

Face Value

Face Value is the nominal or stated amount (in Rs.) assigned to a security by the issuer. For shares, it is the original cost of the stock shown on the certificate; for bonds, it is the amount paid to the holder at maturity. **Face Value** is also known as the **par value** or **simply par**. For an equity share, the face value is usually a very small amount (Rs. 5, Rs. 10) and does not have much bearing on the price of the share, which may quote higher in the market, at Rs. 100 or Rs. 1000 or any other price. For a debt security, face value is the amount repaid to the investor when the bond matures (usually, Government securities and corporate bonds have a face value of Rs. 100).

- The price at which the security trades depends on the fluctuations in the interest rates in the economy.

Premium and Discount

Securities are generally issued in denominations of 5, 10 or 100. This is known as the Face Value or Par Value of the security as discussed earlier.

- When a security is sold above its face value, it is said to be issued at a Premium and if it is sold at less than its face value, then it is said to be issued at a Discount.

Public Issue & Private Issue

Most companies are usually started privately by their promoter(s). However, the promoters' capital and the borrowings from banks and financial institutions may not be sufficient for setting up or running the business over a long term. So companies invite the public to contribute towards the equity and issue shares to individual investors. The way to invite share capital from the public is through a 'Public Issue'. Simply stated, a public issue is an offer to the

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public to subscribe to the share capital of a company. Once this is done, the company allots shares to the applicants as per the prescribed rules and regulations laid down by SEBI.

- Primarily, issues can be classified as a Public, Rights or Preferential issues (also known as private placements). While public and rights issues involve a detailed procedure, private placements or preferential issues are relatively simpler.
- Please note that when an issue is not made to only a select set of people but is open to the general public and any other investor at large, it is a public issue. But if the issue is made to a select set of people, it is called private placement.
- As per Companies Act, 1956, an issue becomes public if it results in allotment to 50 persons or more. This means an issue can be privately placed where an allotment is made to less than 50 persons.

Initial Public Offering IPO

IPO as we all know is Initial Public Offering (IPO). 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, it is called IPO. An IPO paves way for listing and trading of the issuer's securities.

- When a company makes an IPO, the prior requirement would be to decide a price of the Issue / share.

The question is -who will decide what should be the price? In India, there is a system of free pricing since 1992. However, there are guidelines that the company (Issuer) will decide the price in consultation with Merchant Banker. Still there is no formula for deciding the price of an IPO. Please note that SEBI does not play any role on pricing of shares, but the company and merchant banker are required to give full disclosures of the parameters which they had considered while deciding the issue price. While deciding the prices, there are two possibilities,

1. Where company and Lead Merchant Banker fix a price. This is called **Fixed Price**.
2. Where the company and the Lead Manager (LM) stipulate a floor price or a price band and leave it to market forces to determine the final price. This is called the **Price discovery through book building process**.

Here we need to know more about **Book Building**. Book Building is basically a process used in IPOs for efficient price discovery. It is a mechanism where, during the period for which the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The offer price is determined after the bid closing date.

- Please note that in our country, the Price discovery through book building process is more popular than a normal issue.
- In the case of Price discovery through book building process, the price at which securities will be allotted is not known, while in case of offer of shares through normal public issue, price is known in advance to investor.
- Under Book Building, investors bid for shares at the floor price or above and after the closure of the book building process the price is determined for allotment of shares.

Prospectus

We know that many companies float public issues in market everyday. They also advertise the IPO and often when we read such advertisements in newspapers and we come across such lines printed in small font.

Please read the prospectus carefully prior to investing.

Question is what is a prospectus? We know that most of the companies are genuine, but there are also few who may want to exploit the investors. Therefore, it is very important that an investor before applying for any issue to judge and identify the future potential of a company. SEBI guidelines stipulate that the company must provide "disclosure of information to the public". This disclosure would include the information such as what is the reason for raising money,

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how this money will be spent, what are possible returns on expected money. All this contained in a document which is called "Prospectus".

- Apart from the above, the Prospectus would also cover information regarding the size of the issue, the current status of the company, its equity capital, its current and past performance, the promoters, the project, cost of the project, means of financing, product and capacity etc.
- It also contains lot of mandatory information regarding underwriting and statutory compliances. The sole objective of the Prospectus is to provide investors an opportunity to evaluate short term and long term prospects of the company.

Draft Offer Document

Now, we understand that Prospectus gives information to the public about the potential of an IPO and its issuer company. But what if the company shows the people a rosy picture in its prospectus?

It is not possible, because before a prospectus is available to the general public, the company has to make a "**Draft Offer document**' , which is a "Prospectus" in case of a public issue or offer for sale and "Letter of Offer" in case of a rights issue which is filed with the Registrar of Companies (ROC) and Stock Exchanges (SEs).

A Draft offer document is thus a "Draft Prospectus", which covers all the relevant information to help an investor to make his/her investment decision. The draft offer documents are filed with SEBI, at least 30 days prior to the registration of **Red Herring Prospectus**. Since it's a draft, SEBI may specify changes, if any, in the draft Offer Document and the issuer or the lead merchant banker shall carry out such changes in the draft offer document before filing the Offer Document with ROC (Registrar of Companies). The Draft Offer Document is made available on the SEBI website for public comments for a period of 21 days from the filing of the Draft Offer Document with SEBI.

Draft Red Herring Prospectus

A company making a public issue of securities has to file a Draft Red Herring Prospectus (DRHP) with capital market regulator Securities and Exchange Board of India, or Sebi, through an eligible merchant banker prior to the filing of prospectus with the Registrar of Companies (RoCs). The issuer company engages a Sebi registered merchant banker to prepare the offer document. Besides due diligence in preparing the offer document, the merchant banker is also responsible for ensuring legal compliance. The merchant banker facilitates the issue in reaching the prospective investors by marketing the same.

The offer documents of public issues are available on the websites of merchant bankers and stock exchanges. It is also available on the Sebi website under' Offer Documents' section along with its status of processing. The company is also required to make a public announcement about the filing in English, Hindi and in regional language newspapers. In case, investors notice any inaccurate or incomplete information in the offer document, they may send their complaint to the merchant banker and / or to Sebi.

What SEBI does with DRHP?

The Indian regulatory framework is based on a disclosure regime. Sebi reviews the draft offer document and may issue observations with a view to ensure that adequate disclosures are made by the issuer company/merchant bankers in the offer document to enable investors to make an informed investment decision in the issue. It must be clearly understood that Sebi does not 'vet' and 'approve' the offer document. Also, Sebi does not recommend the shares or guarantee the accuracy or adequacy of DRHP. Sebi's observations on the draft offer document are forwarded to the merchant banker, who incorporates the necessary changes and files the final offer document with Sebi, Registrar of Companies (ROC) and stock exchanges. After reviewing the DRHP, the market regulator gives its observations which

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need to be implemented by the company. Once the observations are implemented, it gets final approval & the document then becomes RHP (Red Herring Prospectus).

FPO

FPO refers to follow on public offering. It is also known as **Further Issue**. A Further Issue is s 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.

Rights Issue

Rights Issue is when a listed company which proposes to issue fresh securities to its existing shareholders as on a record date. The rights are normally offered in a particular ratio to the number of securities held prior to the issue. This route is best suited for companies who would like to raise capital without diluting stake of its existing shareholders.

Preference Issue

A Preferential issue is an issue of shares or of convertible securities by listed companies 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. The issuer company has to comply with the Companies Act and the requirements contained in the Chapter pertaining to preferential allotment in SEBI guidelines which inter-alia include pricing, disclosures in notice etc.

Issue Price & Market Price

The price at which a company's shares are offered initially in the primary market is called as the Issue price. When they begin to be traded, the market price may be above or below the issue price.

Market Capitalisation

The market value of a quoted company, which is calculated by multiplying its current share price (market price) by the number of shares in issue is called as market capitalization. For example, if a company A has 150 million shares in issue and current market price is Rs. 100. The market capitalisation of company A is Rs. 15000 million.

Listing & Delisting of Securities

Listing means admission of securities of an issuer to trading privileges (dealings) on a stock exchange through a formal agreement. The prime objective of admission to dealings on the exchange is to provide liquidity and marketability to securities, as also to provide a mechanism for effective control and supervision of trading. The term 'Delisting of securities' means permanent removal of securities of a listed company from a stock exchange. As a consequence of delisting, the securities of that company would no longer be traded at that stock exchange.

Auction Market & Dealer Market

In the primary market, securities are offered to public for subscription for the purpose of raising capital or fund. Secondary market is an equity trading venue in which already existing/pre-issued securities are traded among investors. Secondary market could be either **auction or dealer market.** While stock exchange is the part of an auction market, Over-the-Counter (OTC) is a part of the dealer market. In India, all the stock exchanges form the secondary market.

The stock exchanges are under the overall supervision of SEBI and provide a trading platform, where buyers and sellers can meet to transact in securities. The trading platform provided by most exchanges in India is an electronic one and there is no need for buyers and sellers to meet at a physical location to trade. They can trade through the computerized trading screens available with the Stock Exchange trading members or the internet based trading facility provided by the trading members of Exchanges.

The next question is **- Who owns the Stock Markets?**

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Please note that broker members of the exchange are both the owners and the traders on the exchange and they further manage the exchange as well. However, there can be two cases viz. Mutualized and demutualized exchanges. In a mutual exchange, the three functions of ownership, management and trading are concentrated into a single Group. This at times can lead to conflicts of interest in decision making. A demutualised exchange, on the other hand, has all these three functions clearly segregated, i.e. the ownership, management and trading are in separate hands.

Factors that influence the price of a stock

Factors that influence the price of a stock can be stock specific or market specific. The stock-specific factor is related to people's expectations about the company, its future earnings capacity, financial health and management, level of technology and marketing skills. The market specific factor is influenced by the investor's sentiment towards the stock market as a whole. This factor depends on the environment rather than the performance of any partic ular company. Events favourable to an economy, political or regulatory environment like high economic growth, friendly budget, stable government etc. can fuel euphoria in the investors, resulting in a boom in the market. On the other hand, unfavourable events like war, economic crisis, communal riots, minority government etc. depress the market irrespective of certain companies performing well. However, the effect of market-specific factor is generally short-term. Despite ups and downs, price of a stock in the long run gets stabilized based on the stockspecific factors. Therefore, a prudent advice to all investors is to analyse and invest and not speculate in shares.

Bid and Ask price

The 'Bid' is the buyer's price. It is this price that you need to know when you have to sell a stock. Bid is the rate/price at which there is a ready buyer for the stock, which you intend to sell. The 'Ask' (or offer) is what you need to know when you're buying i.e. this is the rate/ price at which there is seller ready to sell his stock. The seller will sell his stock if he gets the quoted "Ask' price.

Derivatives Market

Derivatives are products whose value is derived from the value of one or more basic variables, which are called Underlying. The underlying asset can be equity, index, foreign exchange (forex), commodity or any other asset. This means that any instrument that derives its value on its underlying quity, index, foreign exchange (forex), commodity or any other asset.

- Please note that derivative products initially emerged as hedging devices against fluctuations in commodity prices and commodity-linked derivatives remained the sole form of such products for almost three hundred years.
- But after 1970s, the financial derivatives came into spotlight thanks to the growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two thirds of total transactions in derivative products.

The derivatives can be **Forwards** or **Futures** or **Options** or **Warrants**. A **forward contract** is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price. A **futures contract** is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts, such as futures of the Nifty index. An **Option** is a contract which **gives the right, but not an obligation**, to buy or sell the underlying at a stated date and at a stated price. While a buyer of an option pays the premium and buys the right to exercise his option, the writer of an option is the one who receives the option premium and therefore obliged to sell/buy the asset if the buyer exercises it on him.

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Options are of two types **- Calls and Puts options.** 'Calls' give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. 'Puts' give the buyer the right, but not the obligation to sell a given quantity of underlying asset at a given price on or before a given future date.

- Please note that options generally have lives of up to one year. The majority of options traded on exchanges have maximum maturity of nine months. Longer dated options are called Warrants and are generally traded over-thecounter.

Option Premium

At the time of buying an option contract, the buyer has to pay premium. The premium is the price for acquiring the right to buy or sell. It is price paid by the option buyer to the option seller for acquiring the right to buy or sell. Option premiums are always paid upfront.

Commodity

FCRA Forward Contracts (Regulation) Act, 1952 defines "goods" as "every kind of movable property other than actionable claims, money and securities". Futures' trading is organized in such goods or commodities as are permitted by the Central Government. At present, all goods and products of agricultural (including plantation), mineral and fossil origin are allowed for futures trading under the auspices of the commodity exchanges recognized under the FCRA.

Commodity derivatives market trade contracts for which the underlying asset is commodity. It can be an agricultural commodity like wheat, soybeans, rapeseed, cotton, etc or precious metals like gold, silver, etc.

Commodity Exchange

Commodity Exchange is an association, or a company of any other body corporate organizing futures trading in commodities. In a wider sense, it is taken to include any organized market place where trade is routed through one mechanism, allowing effective competition among buyers and among sellers – this would include auction-type exchanges, but not wholesale markets, where trade is localized, but effectively takes place through many non-related individual transactions between different permutations of buyers and sellers.

Difference between Commodity and Financial derivatives

The basic concept of a derivative contract remains the same whether the underlying happens to be a commodity or a financial asset. However there are some features which are very peculiar to commodity derivative markets. In the case of financial derivatives, most of these contracts are cash settled. Even in the case of physical settlement, financial assets are not bulky and do not need special facility for storage. Due to the bulky nature of the underlying assets, physical settlement in commodity derivatives creates the need for warehousing. Similarly, the concept of varying quality of asset does not really exist as far as financial underlying are concerned. However in the case of commodities, the quality of the asset underlying a contract can vary at times.

Badla System

Badla System is an outdated Indian term for a trading system with a mechanism for deferring either payment for shares purchased or delivery of shares sold. The system, discontinued by the Securities and Exchange Board of India (SEBI), from March 1994, was applicable to A group or 'Specified' shares. For carrying forward a purchase transaction from one settlement period to the next, the buyer normally paid the seller a charge termed badla or 'Contango'. This consideration would be fixed in the badla session. When buyers could not take delivery, badla financiers would step in and help out the buyers. In the reverse but abnormal situation, when the market was in an oversold position and a buyer demanded delivery but the seller could not respond even by borrowing shares, the buyer would be paid a 'Backwardation charge', also known as undha badla. However the buyer could insist on delivery, instead of accepting deferment charges, leading to an auction of the shares in question. The contango or backwardation charge depended on

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various factors including the extent of outstanding position, short sales, floating stocks, and the prevailing interest rate. The criticism against the badla system has essentially been on two counts: equity and transparency. The system was slanted in favour of short sellers who could, in a normal market situation, earn interest even without owning the shares sold (it has been argued though, that such short selling helps to check speculative and frenzied buying). Also, it was suspected that the contango and backwardation charges reportedly decided at the badla sessions were often untrue. Besides, it appears that the limit of 90 days within which the carryovers were to be settled, was often exceeded. The new system was CARRY FORWARD (CF), introduced at the Bombay Stock Exchange in January 1996. In this system, Sale or purchase of transactions may be carried forward up to 75 days.Then, the Brokers are to classify the transactions, as to whether for delivery or CF, and report daily. A more liberal Modified Carry Forward System based on the recommendations of the J. S. Varma committee was introduced in 1997. Salient features of the new system include an increase in the overall carry forward limit per broker, reduction in daily margin and removal of the limit on financiers.

Bonus Shares

Bonus Shares refers to the issue of shares to the shareholders of a company, by capitalizing a part of the company's reserves. Following a bonus issue, though the number of total shares increases, the proportional ownership of shareholders does not change. The magnitude of a bonus issue is determined by taking into account certain rules, laid down for the purpose. For example, the issue can be made out of free reserves created by genuine profits or by share PREMIUM collected in cash only. Also, the residual reserves, after the proposed capitalization, must be at least 40 percent of the increased PAID-UP CAPITAL. These and other guidelines must be satisfied by a company that is considering a bonus issue.

Legislations that control the securities market

Major legislations that control the securities market are the SEBI Act, 1992, the Companies Act, 1956, Securities Contracts (Regulation) Act, 1956, Depositories Act, 1996 & Prevention of Money Laundering Act, 2002. Please note that previously we had a British Era legislation Capital Issues (Control) Act, 1947, which has been repealed now. Here are some important points about these legislations.

Capital Issues (Control) Act, 1947:

- Origin of the act from war situation in 1943 when the objective was to channel resources to support the war effort.
- Later the act was retained with some modifications as a means of controlling the raising of capital by companies and to ensure that national resources were channelled into proper lines, i.e. for desirable purposes to serve goals and priorities of the government, and to protect the interests of investors.
- As per this act, any firm wishing to issue securities had to obtain approval from the Central Government, which also determined the amount, type and price of the issue. As a part of the liberalisation process, the Act was repealed in 1992.

SEBI Act, 1992:

SEBI was established and empowered statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market.

Jurisdiction of SEBI extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and

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also to penalise them in case of violations of the provisions of the Act, Rules and Regulations made there under. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

Securities Contracts (Regulation) Act, 1956

This act provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities. It gives Central Government regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition of recognition, a stock exchange complies with conditions prescribed by Central Government. Organised trading activity in securities takes place on a specified recognised stock exchange. The stock exchanges determine their own listing regulations which have to conform to the minimum listing criteria set out in the Rules.

Depositories Act, 1996

Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of ownership of securities electronically by book entry without making the securities move from person to person. The Act has made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with.

Companies Act, 1956

It deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standard of disclosures in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, payment of interest and dividends, supply of annual report and other information.

Prevention of Money Laundering Act, 2002:

The primary objective of the Act is to prevent money-laundering and to provide for confiscation of property derived from or involved in money-laundering. The term money-laundering is defined as whoever acquires, owns, possess or transfers any proceeds of crime; or knowingly enters into any transaction which is related to proceeds of crime either directly or indirectly or conceals or aids in the concealment of the proceeds or gains of crime within India or outside India commits the offence of moneylaundering. Besides providing punishment for the offence of money-laundering, the Act also provides other measures for prevention of Money Laundering. The Act also casts an obligation on the intermediaries, banking companies etc to furnish information, of such prescribed transactions to the Financial Intelligence Unit- India, to appoint a principal officer, to maintain certain records etc.

Apart from the above legislations, government has framed rules under the SCRA, SEBI Act and the Depositories Act. SEBI has framed regulations under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, and for prevention of unfair trade practices, insider trading, etc. Under these Acts, Government and SEBI issue notifications, guidelines, and circulars which need to be complied with by market participants.

{Document prepared with the help of SEBI, National Stock Exchange & Bombay Stock Exchange Documents}

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