UNIT - 4

Introduction to Stock Markets

Stock Exchange - Meaning:

Stock exchange or stock market is a market where old securities that have been already issued by the companies and other organizations to the public are bought and sold through authorized agents according to certain rules and regulations. It is a mechanism though which the holder of securities may find a buyer for his holdings at a fair price. Similarly buyer of securities may find an immediate seller who is willing to sell his holdings at a fair price. The securities are bought and sold continuously among the investors in these stock exchanges without the involvement of companies. Stock exchanges facilitate the free trade of only the securities that are listed.

The Securities Contracts (Regulations) Act, 1956 defines stock exchange as under:

"Stock Exchange is 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".

Characteristics of Stock Exchange:

The stock exchange is an organized market for the purchase and sale of listed securities. They facilitate, regulate and control the trade in securities. The following are the features of stock markets :

(1) Association: Stock market is an association of persons that may be incorporated or not.

(2) Mechanism: It provides a place or mechanism through which industrial and government securities may be bought and sold.

(3) Organized market: It is an organized market for securities. It allows trading in securities subject to certain regulations.

(4) Market for old securities: It provides the ready market for old securities that have been already issued by the companies to public. It does not deal in the fresh shares, debentures and bonds to be issued by the companies or government agencies to the public. In stock market transactions in old securities of companies are carried on without the involvement of companies.

(5) Deals with listed securities: It offers trading facilities only for those securities that are listed by the companies or issuing agencies with the exchange. It a company has not complied with the listing procedure of a stock market then its securities are not allowed to be traded on such stock market.

(6) Only the members allowed dealing: These stock markets allow only their members to transact the business in the market. Outsiders or nonmembers cannot purchase or sale the securities on these stock exchanges. Membership of a stock exchange is limited. New people are not allowed to be a member unless there is a vacancy. Membership of a particular stock exchange (say Bombay stock Exchange or National stock Exchange or Bangalore Stock Exchange) is acquired by individuals and firms only on payment of the membership fees prescribed by that stock exchange. Such fee is normally very high. Members of a stock exchange are known as *brokers*. They purchase and sell securities for and on behalf of their clients, buyers and sellers, investors and speculators. For these services they charge fees known as *brokerage.*

(7) ***It also deals in government securities:*** An independent section of stock markets deals with government and semi- government securities. It is called *gilt edged* market and government securities are called *gilt edged securities*.

(8) Ensures free transferability of securities and securities evaluation: Stock exchange provides a mechanism for free transfer of industrial securities and also makes continuous evaluation of securities traded in the market.

Functions (Services) of Stock Exchange:

Stock exchanges play an important role in the economic development of a nation. They serve as an economic barometer of a country. They perform several economic functions and render invaluable services to the investors, companies and to the economy as a whole. These are as follows:

(1) Marketability of securities: Stock exchange provides a market for the purchase and sale of securities. As a result, any person holding securities can get back his money invested in the securities (share, debentures, government bonds etc.) by selling them through the brokers of a stock exchange at the market price. Similarly a person willing to make investment in securities or conduct speculation in securities can do so with the help of these stock markets.

(2) Liquidity to investment: People readily invest in the industrial securities as the money blocked in these securities can be released by selling them in stock exchange. In absence of these stock exchanges, the public would not have freely invested in the industrial and government securities. As a result, the industry and government would have starved for the capital. Thus stock exchanges provide liquidity for the industrial securities and help the industrial development of a country.

(3) Supply of long term funds: The securities traded in stock market are negotiable. They can be transferred with minimum formalities from one person to another. As a result of this facility people readily invest in the industrial securities and companies receive a good response for their public issue of shares and debentures whenever they need funds. Thus they are assured a long-term availability of funds due to the existence of stock markets.

(4) Evaluation of Securities: Stock exchange keeps a record and makes a public declaration of prices at which securities are traded . On the basis of these prices for the securities quoted in the markets the investors and speculators can evaluate the values of securities held by them.

(5) Motivation for the companies for improvement in performance : The performance of a company is reflected through the prices quoted for their securities in the stock markets. With the improvement in the performance of a company the prices of its shares in the market increase enhancing the goodwill of the company. Thus stock markets indirectly motivate the companies to improve their financial performance through continual increase in productivity and profitability.

***(6) Assistance of capital formation**:* Stock market ensures liquidity of industrial securities; it also ensures the appreciation of funds invested in the securities with the improvement in the performance of companies and increase in the demand for their securities. Thus they motivate the public to invest their savings in the capital of companies. These savings are channelized in the productive activities of the companies resulting in the capital formation which is essential for the economic development of a nation.

(7) Protection of Investors: Stock markets conduct the trade in securities subject to certain rules and regulation. These rules prevent overtrading, illegitimate speculations and charging of excess commission on trading by the brokers in order to protect the interest of common investors. Thus stock exchanges safeguard the innocent investors from the malpractices of clever brokers dealing in securities. This strengthens the investors' confidence and promotes large investments.

(8) Encouragement of savings: Stock exchanges provide an attractive avenue for investors wherein they can invest their small savings in industrial securities and obtain a regular return on investment as well as capital appreciation. Thus they encourage savings habits among the public.

***(9) Listing of securities**:* Stock exchanges do the listing of securities of various companies. Only listed securities are traded on stock exchanges. Listing of a security means permission to the security to quote officially on trading floor of the stock exchange. Shares or debentures of a particular company can be listed and traded at stock exchange only if the company fulfils certain standard norms fixed by the exchange.

(10) Maintaining business information: Companies whose securities are listed on stock exchange are required to furnish the financial statements and other reports and statements. The stock exchange maintains a detail record of the various companies whose securities are traded on its floor. s Such information is regularly published and maintained on web site for public reference by the stock exchange.

Listing of securities:

Listing of securities means admitting the securities' trading on a recognized stock exchange. Purchase and sale of a security cannot be conducted on a stock exchange unless it is officially listed in that stock exchange. Trading in a particular security takes place on a stock exchange only after the company issuing that security accomplishes the listing procedure.

Listing is compulsory for the company that offers its shares and debentures to the public for subscription by issue of prospectus. Once the securities of a company are listed on recognized stock exchanges it has to follow the rules and regulations of the stock exchanges. It has to maintain necessary books; documents etc. and disclose any information which the stock exchanges call for.

Advantages of Listing:

Listing of securities result in the following advantages:

(1) Facilities marketing of securities: If a company does the listing of its shares on recognized stock exchanges its shareholders will be able to release their investment in the shares at market price whenever they want by selling these shares on stock exchanges. Similarly an investor who wants to purchase the shares of that company may buy those shares at market price in those stock exchange. Thus constant marketing facilities are availed to the securities that are listed on stock exchange.

(2) Assures finance to the companies : Whenever a company offers its shares to the public it receives proper response from the investors only if such shares are listed on recognized stock exchanges. Because listing enables the investor to release his money in the shares by selling those on stock exchange. Thus listing enables the companies to raise the necessary finance by the issue of its securities to the public.

(3) Ensures liquidity *:* The prices of listed securities are quoted daily in the share markets. Hence the listed securities can be readily converted into cash at the quoted price. Thus listing ensures liquidity of securities.

(4) Enables the investors to borrow the funds : Banks and other financial institutions accepted the listed securities as collateral securities against their loans and advances because these listed securities have a ready market. Thus the people holding the listed securities can raise loan against such securities without any difficulty.

(5) Protection to investors*:* The companies that have listed their securities on stock markets have to follow the rules and regulations of stock markets and Securities Exchange Board of India (SEBI). They have to maintain transparency in their working and have to disclose their financial information and policies. All these rules regulations and transparency aim at protection of interest of small investors who should not be deceived or put to loss.

(6) Offers wide publicity: Names of companies whose securities are listed on stock exchanges are mentioned regularly in stock market reports, T.V. , News papers, Radios etc. Thus listed securities offer wide advertising and publicity to the companies concerned.

Listing Procedure :

A company willing to list its securities in stock market should comply with the following formalities.

Important terms and concepts related to stock market:

(1) Group A or specified shares : These are the actively traded shares of reputed companies having a broad investor base. Naturally these shares attract a lot of speculative forces. In case of these shares transactions take place in market lots of trading or multiples thereof.

(2) Group B or Non-specified shares : These are the shares of companies that have narrow investor base. Hence they are not actively traded in stock exchanges. Transactions of these shares cannot be carried forward. They are settled on settlement day. Group B also includes shares of companies listed on other stock exchanges.

(3) Group C Shares : These are shares of good companies in *odd lots* and also *permitted shares*. A number of shares that are less than market lot are known as *odd lots. Market lot* means the minimum number of shares of a particular security that must be transacted on a stock exchange. Odd lots have settlement once in a fortnight or on Saturdays. *Permitted securities* are those securities that are not listed on stock exchange but are listed on other stock exchange in India. So they are permitted to be traded on this stock exchange.

(4) Bull or Tejiwallas : Bulls are those speculators of stock exchange who expect a rise in prices of certain securities. Hence they go on buying shares in expectation of selling them at higher prices later. They are also called *tejiwallas* because they are optimistic about price rise in securities. In bullish market there will be excess of purchase over sale.

(5) Bears / Mandiwallas : Bears are those speculators who are pessimistic and they expect a fall in the prices of securities. They are known as *Mandiwallas*. With a view to take advantage of an expected fall in price they agree to sell for delivery on the settlement day the security which they may or may not possess. On the date of delivery of settlement they purchase the security at a lower price in market if their expectation proves correct and fulfil the promise of sale at higher price. In this way they make a profit. But if their expectation of fall in price does not come true and if actually the prices rise on the date of delivery or settlement they have to purchase the security at higher price and sell it at agreed lower price or pay for the difference in price and thus incur a loss. The sale of a security which the bear speculator does not possess is called *short selling.*

(6) Stag : Stags are those members who neither buy or sell securities in the stock market. They simply apply for subscription to new issues expecting to sell them at a higher price later when such issues are quoted on the stock exchange. Generally, stags buy new issues and sell them on allotments or even before allotment for a profit. Since they act fast and are cautions they are called stags. Because stag is cautions by nature and runs fast.

(7) Gilt edged securities : These are the securities issued by government agencies that have a high liquidity and safety.

(8) Blue chips : Securities issued by the reputed companies that have ready market are called blue chips.

(9) Carry over or Badla System : The speculators like bulls and bears make money by anticipating the future trend of prices of securities. If their forecast comes true they make a money but if it fails they are likely to lose money on the settlement day. Forward trading is an arrangement that provides an opportunity for such speculators to avoid the loss by postponing of transactions to the next settlement day on payment of charge known as badla charge. Thus if a speculator carries forward his transactions from one settlement day to another, he has to pay *Badla charge*.

If securities were purchased and are required to be carried forward to the next settlement day, their value on the settlement day is credited to the account of the speculator and brought forward to the next period on the debit side of account of the speculator. On the other hand, if the securities were sold and remain unsettled on the settlement day, the value of the securities on the settlement day is debited to the account of the speculator and brought forward to the next period on credit side of the speculator's account. The difference in the account of the speculator after the carry forward is settled in cash.

(10) Arbitrager : Arbitragers are those brokers who buy securities in one stock market and sell them in another stock market to the take advantage of the price differences prevailing in different markets for the same scrips.

(11) Short selling : When bear speculators sell a large volume of securities without actually possessing them, they are said to be short selling.

Procedure for dealing at Stock Exchange

The following procedure is followed for dealings at a stock exchange :

1. *Selection of a Broker*. Persons who want to buy and sell securities cannot act directly on a stock exchange because trading in securities in a stock exchange is allowed through brokers. Therefore, the first thing to be done is the selection of a broker through whom buying or selling of securities it to be done. A broker of repute should be selected so that fair dealings may be expected from him.

2. *Placing an Order*. After making a choice of the broker, the intending buyer or seller places an order for purchase or sale of securities. Brokers open account for each of their clients. Before opening of account of a client, a broker may seek bank guarantee from his client. Client places an order to his broker of his requirement of purchasing or selling securities. In his order, the client tells about the quantity and tentative price of purchase or sale. The broker will try to make purchases or sale of securities as far as possible to the nearest price offered by the client.

3. *Making the Contract*. After getting an order from the client, the broker or his authorized clerk makes efforts to materialize the order on the floor of exchange. A deal is struck when the other party also agrees and this becomes a contract of purchase of securities on the part of one party and a contract of sale on the part of the other party. When a deal is struck it is announced by another party mentioning the price, name and number of security and bargain is noted by both the parties in their note books. After this the seller of securities is sent a selling note and the purchaser of securities is sent a buying note mentioning the details of securities traded.

4. *Settlement*. Settlement of account depends upon the type of transaction whether it is cash or forward. Cash transaction is a spot transaction and payment is made on the delivery of securities. This type of transaction is also known as investment transaction because it is based on bona fide intention or purchase and sale of securities. On the other hand, a forward transaction is of a speculative nature and reveals forward delivery contract. It can be settled in any of the following three ways:

(i) Securities are delivered and payment is received on fixed settlement day after cancelling all intermediate purchases and sales. Such type of settlement is known as *liquidation in full*.

(ii) On fixed settlement days, securities are not delivered but only the different between ruling price and agreed price is settled. This type of settlement is known as *liquidation by payment of differences*.

(iii) When settlement is not made on fixed settlement date and it is desired that settlement should be carried forward to the next settlement period, is known as carry over to the next settlement. For giving the facility of carry over the broker makes a charge known as *contango or backwardation*. The account of the client is debited with contango charge (i.e. a payment made by way of interest) if it is the purchase which is being carried forward. If the sale is being carried forward (i.e. delivery of securities is due), the amount to be debited by way of compensation is known as backwardation. Contango charge is also known as badla charge and it should be calculated on the amount carried forward and for the period of next settlement date from this settlement date. Settlement day falls after 15 days or one month according to the byelaws of the stock exchange.

EXERCISE

(1) Short Answer Type

1. What is a Stock Market?
2. Give any four characteristics of a stock exchange.
3. What is the difference between a bull speculator and a bear speculator ?
4. What do you mean by listing of securities ?
5. Explain the meaning of a jobber.
6. Explain the meaning of Badla System relation to stock market transactions.
7. What do you mean by blue chips ?
8. What is a gilt edged securities ?
9. What is Short Selling ?
10. Who is called Stag in the stock market ?
11. What is contango day ?
12. What do you mean by forward contracts ?

(2) Long Answer Type

1. Define stock exchange, Explain its functions.
2. Explain the procedure of dealings at a stock exchange.
3. Explain characteristics and functions of a stock exchange.
4. Explain various types of operators which operate at a stock exchange.
5. What is Listing of shares ? What are its merits and how it is done ?