2nd SEMESTER (FYUGP)

MDC (PERSONAL FINANCIAL MANAGEMENT)

UNIT 2: FINANCIAL MARKETS AND INSTRUMENTS

Q9. Explain the methods of floatation of New Issue in Primary Market.

Answer - A company can raise share capital from the primary market also called New Issue Market (NIM) through various methods. The methods are:

(a) Public issue through prospectus

(b) Offer for Sale (OFS)

(c) Private Placement

(d) Right Issue

(e) Preferential Allotment

(f) e-IPOs

They are briefly explained below -

(a) **Public issue through prospectus** – Under this method, a company invites public to apply for its securities through the issue of prospectus. A company desiring to raise funds from the public may issue a prospectus inviting subscription to its offer. The prospectus carries detailed information about the company, the nature of business already undertaken and the projects to be taken up in the future, the background and experience of promoters, the purpose for which the funds are being raised, past financial performance of the company. This detailed information will help the investor in making up his mind whether to subscribe for the issue or not. Since company has to reach the public at large it will require the services of intermediaries such as brokers, underwriters, bankers, etc.

Types of Public Issues

There are two types of Public Issues:

i) Initial Public Offer (IPO)

ii) Follow- on Public Offer (FPO)

i) ***Initial Public Offer(IPO)*** : Initial public offer is an offering of either a fresh issue of securities or an offer for sale of existing securities or both by an unlisted company for the first time in its life to the public. In short, it is a method of raising securities in which a company sells shares or stock to the general public for the first time. An IPO refers to simply as an “offering” or “floatation”, when a company (called the issuer) issues common stock or shares to the public for the first time.

ii) ***Follow- on Public Offer (FPO)*** : Follow – on public offer is an offer of sale of securities by a listed company. This is an offering of either a fresh issue of securities or an offer for sale to the public by an already listed company through an offer document.

(b) **Offer for Sale (OFS)** – Under this method the company sells the shares to an intermediary, who in turn sells them to the public. Brokers sometimes purchase all the shares of the company at a specified price. The company is relieved of the botheration of making efforts to sell the shares and also of the uncertainty of the outcome of the issue. The brokers then sell these shares to the public at a higher price and earning profit out of sale.

(c) **Private Placement -** Private placement is the issue of securities of a company direct to one investor or a small group of investors. Generally the investors are the financial institutions or other existing companies or selected private persons such as friends and relatives of promoters. A private company cannot issue a prospectus. Hence it usually raises its capital by private placement. A public limited company can also raise its capital by placing the shares privately and without inviting the public for subscription of its shares. Company law defines a privately placed issue to be the one seeking subscription from 50 members. In a private placement, no prospectus is issued. In this case the elaborate procedure required in the case of public issue is avoided. Therefore, the cost of the issue is minimal. The process of raising funds is also very simple. But the number of shares that can be issued in a private placement is generally limited.

(d) **Right Issue** – When an already existing company wants to raise additional capital then it has to offer these shares to existing shareholders. They are offered shares in proportion of shares held by them. The shareholders may subscribe to the right shares themselves or may transfer their right to anybody else. The price offered for right shares is generally lower than the market price of those shares. This is the least expensive method of raising share capital because limited persons are to be contacted in the process. This method will be useful if the amount to be raised is moderate. 'Right Issue' as a method of marketing of securities is popularly known as 'privileged subscription'.

(e) **Preferential Allotment** - It is an issue of equity by a listed company to selected investors at a price which may or may not be related to prevailing market price. It is not a public issue of shares. This kind of preferential allotment is made mainly to promoters or friends and relatives. The shares allotted under preferential allotment process will attract a lock in period. If it is allotted to a promoter, the lock in period will be 3 years and to others, it is 1 year.

f) **e-IPOs** - Under this system the company issues capital to public through online system of stock exchange. A company proposing to issue capital to the public through this method has to enter into an agreement with the stock exchange. SEBI registered brokers are appointed for the purpose of accepting applications and placing orders with the company. The company also appoints a Registrar to the Issue having electronic connectivity with the stock exchange.

Q10. What is a Secondary Market?

Answer - Secondary market also known as stock market represents the market where existing securities (shares and debentures) are traded. Stock exchange provides an organized mechanism for purchase and sale of existing securities. The investors want liquidity for their investments. The securities which they hold should easily be sold when they need cash. Similarly, there are others who want to invest in securities. The risk in a security investment is transferred from one investor (seller) to another (buyer) in the secondary markets. The primary market creates financial assets, and the secondary market makes them marketable.

Q11. Distinguish between primary and secondary market.

Answer -

Basis	Primary Market	Secondary Market
Meaning	A market in which securities are sold for the first time is known as a Primary Market.	A market in which the sale and purchase of newly issued securities and second-hand securities are made is known as a Secondary Market.
Types of Securities	In the primary market, the sale of new securities takes place.	In the secondary market, the sale and purchase of existing or second-hand securities take place.
Issued by	In the primary market, the securities are directly issued by companies.	In the secondary market, the securities are transferred between the investors only.
Entry	The companies enter a primary market for raising capital for their operations.	The securities of listed companies only are bought and sold in this market.
	Major intermediaries in	Main intermediaries in

Intermediaries	primary market are registrar to the issue, merchant bankers, underwriters, collection banks, debentures trustees, etc.	secondary market are brokers, sub-brokers, jobbers, etc.
Price	The price of securities in a primary market is fixed by the management of the company issuing them.	The price of securities in a secondary market is fixed by the demand and supply of the stock exchange market.

Q12. What is Equity Share? State its features.

Answer - Equity Shares are also known as ordinary shares. The holders of equity shares are members of the company. Equity shares are the vital source for raising long-term capital of a company. Each holder of equity shares in a company, as a fractional owner of the share capital of a company, takes the maximum business risk. It represents the ownership of a company and capital raised by the issue of such shares is known as Equity Share Capital.

The following are the important features of equity shares:

1) **Permanent Finance** – The equity share capital is held permanently by the company and cannot be redeemed during the life time of the company. Hence equity shares are an important source of long term finance for the company.

2) **Ownership Right** – Equity shareholders are the actual owners of the company and they bear the highest risk.

3) **Transferability** – Equity shares are transferable in nature. They can be transferred from one person to another with or without any consideration.

4) **Liability** – The liability of equity shareholders is limited to the extent of the face value of the shares held by them.

5) **Right to Control** – Equity shareholders have the right to control the affairs of the company. This right is exercised through their voting power.

Q13. What is Debenture? State its features.

Answer - Debenture is a debt instrument that may or may not be secured by any collateral. Governments or companies use them for raising capital by borrowing money from the public. In simple words, it is a legal certificate that shows the investment amount (principal amount), the interest rate and the schedule of payments. The investor receives the principal and interest at the end of maturity.

The following are the important features of debentures:

1) It is a written promise by the issuing company that owes the specified money to the holder.

2) It is issued in the form of a certificate in written form to the lender.

3) Its face value is predetermined.

4) It is a debt instrument that the company issues with a maturity date mentioned in the certificate. Basically, it provides the time of repayment of the principal amount and interest on the maturity date.

5) The holders receive a fixed rate of interest payment periodically, either half-yearly or annually. The rate of interest of this instrument varies depending on the company, the current market conditions and the nature of business operations.

6) As per the deed, this long term debt instrument carries an assurance of repayment on the specified due date. Also, they can be redeemed at par, premium or discount.

Q14.What is Stock Exchange? State its features.

Answer - Stock exchanges are organized and regulated markets for various securities issued by corporate sector and other institutions. It is a secured place where trading is done in a systematic way. A stock exchange is a market where the listed stocks, shares and other such securities are bought and sold. Listed securities are those securities which appear on the approved list of a Stock Exchange. Only listed securities are traded on the floor of the Stock Exchange.

The features of stock exchange-

- A stock exchange is an institution which provides a platform for purchase and sale of existing shares.
- Stock Exchanges are located in a specific place or building where official activities are performed.
- It provides security to transactions since the trading is strictly regulated.
- Both genuine investors and speculators buy and sell securities in the exchange.
- Provides liquidity to investments by facilitating exchange of security into money and vice versa.
- Stock Exchange is an open market. Free play of market forces of demand and supply acts as a mechanism for determination of the prices of securities.

Q15. Explain the functions of Stock Exchange.

Answer - Following are some of the most important functions that are performed by stock exchange:

(a) Role of an Economic Barometer - Stock exchange serves as an economic barometer that is indicative of the state of the economy. Every major change in the country be it political, social or economic is reflected in the prices of shares. The rise or fall in the share prices indicates the upward and downward movement of economy in the country.

(b) Valuation of Securities - Stock market helps in the valuation of securities based on the factors of supply and demand. The securities offered by companies that are profitable and growth-oriented tend to be valued higher. Valuation of securities helps creditors, investors and government in performing their respective functions.

(c) Transactional Safety: Transactional safety is ensured as the securities that are traded in the stock exchange are listed, and the listing of securities is done after verifying the company's position. All companies listed have to adhere to the rules and regulations as laid out by the governing body.

(d) Encourages investment and savings: Stock market serves as an important source of investment in various securities which offer greater returns. Investing in the stock market makes for a better investment option than gold and silver.

(e) Contributor to Economic Growth: Stock exchange offers a platform for trading of securities of the various companies. This process of trading involves continuous disinvestment and reinvestment, which offers opportunities for capital formation and subsequently, growth of the economy.

(f) Making the public aware of equity investment: Stock exchange helps in providing information about investing in equity markets and by rolling out new issues to encourage people to invest in securities.

(g) Offers scope for speculation: By permitting healthy speculation of the traded securities, the stock exchange ensures demand and supply of securities and liquidity.

(h) Facilitates liquidity: The most important role of the stock exchange is in ensuring a ready platform for the sale and purchase of securities. This gives investors the confidence that the existing investments can be converted into cash, or in other words, stock exchange offers liquidity in terms of investment.

(i) Better Capital Allocation: Profit-making companies will have their shares traded actively, and so such companies are able to raise fresh capital from the equity market. Stock market helps in better allocation of capital for the investors so that maximum profit can be earned.