Chapter–4: Secondary Market

4.1 Introduction

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. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets.

Role of the Secondary Market

For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, Secondary equity markets serve as a monitoring and control conduit—by facilitating value - enhancing control activities, enabling implementation of incentive-based management contracts, and aggregating information (via price discovery) that guides management decisions.

Difference between the Primary Market and the Secondary 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.

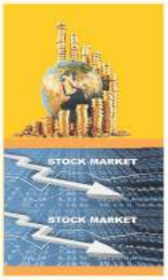
4.1.1 Stock Exchange

Role of a Stock Exchange in Buying and Selling Shares

The stock exchanges in India, under the overall supervision of the regulatory authority, the Securities and Exchange Board of India (SEBI), provide a trading platform, where buyers and sellers can meet to transact in securities. The trading platform provided by NSE 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 NSE trading members or the internet based trading facility provided by the trading members of NSE.

Demutualisation of Stock Exchanges

Demutualisation refers to the legal structure of an exchange whereby the ownership, the management and the trading rights at the exchange are segregated from one another.



Difference Between Demutualised Exchange and Mutual Exchange

In a mutual exchange, the three functions of ownership, management and trading are concentrated into a single Group. Here, the broker members of the exchange are both the owners and the traders on the exchange and they further manage the exchange as well.

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.

4.1.2 Stock Trading

Screen Based Trading

The trading on stock exchanges in India used to take place through open outcry without use of information technology for immediate matching or recording of trades. This was time consuming and inefficient. This imposed limits on trading volumes and efficiency. In order to provide efficiency, liquidity and transparency, NSE introduced a nationwide, on-line, fully-automated screen based trading system (SBTS) where a member can punch into the computer the quantities of a security and the price at which he would like to transact, and the transaction is executed as soon as a matching sale or buy order from a counter party is found.

NEAT

NSE is the first exchange in the world to use satellite communication technology for trading. Its trading system, called National Exchange for Automated Trading (NEAT), is a state of-the-art client server based application. At the server end all trading information is stored in an in-memory database to achieve minimum response time and maximum system availability for users. It has uptime record of 99.7%. For all trades entered into NEAT system, there is uniform response time of less than one second.

Placing Order with the Broker

You may go to the broker's office or place an order on the phone/internet or as defined in the Model Agreement, which every client needs to enter into with his or her broker.

Access to Internet Based Trading Facility

There are many brokers of the NSE who provide internet based trading facility to their clients. Internet based trading enables an investor to buy/sell securities through internet which can be accessed from a computer at the investor's residence or anywhere else where the client can access the internet. Investors need to get in touch with an NSE broker providing this service to avail of internet based trading facility.

Contract Note

Contract Note is a confirmation of trades done on a particular day on behalf of the client by a trading member. It imposes a legally enforceable relationship between the client and the trading member with respect to purchase/sale and settlement of trades. It also helps to settle disputes/claims between the investor and the trading member. It is a prerequisite for filing a complaint or arbitration proceeding against the trading member in case of a dispute. A valid contract note should be in the prescribed form, contain the details of trades, stamped with requisite value and duly signed by the authorized signatory. Contract notes are kept in duplicate, the trading member and the client should keep one copy each. After verifying the details contained therein, the client keeps one copy and returns the second copy to the trading member duly acknowledged by him.

Details required to be mentioned on the contract note issued by the stock broker

A broker has to issue a contract note to clients for all transactions in the form specified by the stock exchange. The contract note inter-alia should have following:

- Name, address and SEBI Registration number of the Member broker.
- Name of partner/proprietor/Authorised Signatory.
- Dealing Office Address/Tel. No./Fax no., Code number of the member given by the Exchange.
- Contract number, date of issue of contract note, settlement number and time period for settlement.
- Constituent (Client) name/Code Number.
- Order number and order time corresponding to the trades.
- Trade number and Trade time.
- Quantity and kind of Security bought/sold by the client.
- Brokerage and Purchase/Sale rate.
- Service tax rates, Securities Transaction Tax and any other charges levied by the broker.
- Appropriate stamps have to be affixed on the contract note or it is mentioned that the consolidated stamp duty is paid.
- Signature of the Stock broker/Authorized Signatory.

Maximum brokerage that a broker can charge

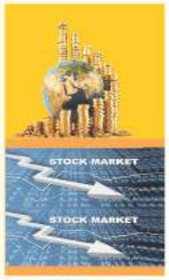
The maximum brokerage that can be charged by a broker from his clients as commission cannot be more than 2.5% of the value mentioned in the respective purchase or sale note.

Reasons to trade on a recognized stock exchange

An investor does not get any protection if he trades outside a stock exchange. Trading at the exchange offers investors the best prices prevailing at the time in the market, lack of any counter-party risk which is assumed by the clearing corporation, access to investor grievance and redressal mechanism of stock exchanges, protection upto a prescribed limit, from the Investor Protection Fund etc.

Registration of broker or sub broker

SEBI issues the registration certificate to the broker as well as sub-broker. A broker's registration number begins with the letters 'INB' and that of a sub broker with the letters 'INS'.



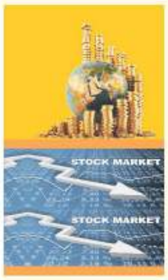
Precautions to be taken before investing in the stock markets

Here are some useful pointers to bear in mind before you invest in the markets:

- Make sure your broker is registered with SEBI and the exchanges and do not deal with unregistered intermediaries.
- Ensure that you receive contract notes for all your transactions from your broker within one working day of execution of the trades.
- All investments carry risk of some kind. Investors should always know the risk that they are taking and invest in a manner that matches their risk tolerance.
- Do not be misled by market rumours, during advertisement or 'hot tips' of the day.
- Take informed decisions by studying the fundamentals of the company. Find out the business the company is into, its future prospects, quality of management, past track record etc. Sources of knowing about a company are through annual reports, economic magazines, databases available with vendors or your financial advisor.
- If your financial advisor or broker advises you to invest in a company you have never heard of, be cautious. Spend some time checking out about the company before investing.
- Do not be attracted by announcements of fantastic results/news reports, about a company. Do your own research before investing in any stock.
- Do not be attracted to stocks based on what an internet website promotes, unless you have done adequate study of the company.
- Investing in very low priced stocks or what are known as penny stocks does not guarantee high returns.
- Be cautious about stocks which show a sudden spurt in price or trading activity.
- Any advise or tip that claims that there are huge returns expected, especially for acting quickly, may be risky and may to lead to losing some, most, or all of your money.

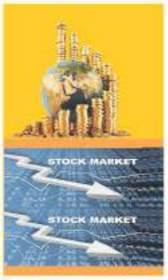
Do's and Don'ts while investing in the stock markets

- Ensure that the intermediary (broker/sub-broker) has a valid SEBI registration certificate.
- Enter into an agreement with your broker/sub-broker setting out terms and conditions clearly.
- Ensure that you give all your details in the 'Know Your Client' form.
- Ensure that you read carefully and understand the contents of the 'Risk Disclosure Document' and then acknowledge it.
- Insist on a contract note issued by your broker only, for trades done each day.
- Ensure that you receive the contract note from your broker within 24 hours of the transaction.



- Ensure that the contract note contains details such as the broker's name, trade time and number, transaction price, brokerage, service tax, securities transaction tax etc. and is signed by the Authorised Signatory of the broker.
- To cross check genuineness of the transactions, log in to the NSE website (www.nseindia.com) and go to the 'trade verification' facility extended by NSE. Issue account payee cheques/demand drafts in the name of your broker only, as it appears on the contract note/SEBI registration certificate of the broker.
- While delivering shares to your broker to meet your obligations, ensure that the delivery instructions are made only to the designated account of your broker only.
- Insist on periodical statement of accounts of funds and securities from your broker. Cross check and reconcile your accounts promptly and in case of any discrepancies bring it to the attention of your broker immediately.

  Please ensure that you receive payments/deliveries from your broker, for the transactions entered by you, within one working day of the payout date.
- Ensure that you do not undertake deals on behalf of others or trade on your own name and then issue cheques from a family members'/ friends' bank accounts.
- Similarly, the Demat delivery instruction slip should be from your own Demat account, not from any other family members'/friends' accounts.
- Do not sign blank delivery instruction slip(s) while meeting security pay in obligation.
- No intermediary in the market can accept deposit assuring fixed returns. Hence do not give your money as deposit against assurances of returns.
- "Portfolio Management Services' could be offered only by intermediaries having specific approval of SEBI for PMS. Hence, do not part your funds to unauthorized persons for Portfolio Management.
- Delivery Instruction Slip is a very valuable document. Do not leave signed blank delivery instruction slip with anyone. While meeting pay in obligation make sure that correct ID of authorized intermediary is filled in the Delivery Instruction Form.
- Be cautious while taking funding form authorized intermediaries as these transactions are not covered under Settlement Guarantee mechanisms of the exchange.
- Insist on execution of all orders under unique client code allotted to you. Do not accept trades executed under some other client code to your account.
- When you are authorizing someone through 'Power of Attorney' for operation of your DP account, make sure that:
  - your authorization is in favour of registered intermediary only.
  - authorization is only for limited purpose of debits and credits arising out of valid transactions executed through that intermediary only.
  - you verify DP statement periodically say every month/ fortnight to ensure that no unauthorized transactions have taken place in your account.



- authorization given by you has been properly used for the purpose for which authorization has been given.
- in case you find wrong entries please report in writing to the authorized intermediary.

➥ Don't accept unsigned/duplicate contract note.

➥ Don't accept contract note signed by any unauthorized person.

➥ Don't delay payment/deliveries of securities to broker.

➥ In the event of any discrepancies/disputes, please bring them to the notice of the broker immediately in writing (acknowledged by the broker) and ensure their prompt rectification.

➥ In case of sub-broker disputes, inform the main broker in writing about the dispute at the earliest. If your broker/sub-broker does not resolve your complaints within a reasonable period please bring it to the attention of the 'Investor Services Cell' of the NSE.

➥ While lodging a complaint with the 'Investor Grievances Cell' of the NSE, it is very important that you submit copies of all relevant documents like contract notes, proof of payments/delivery of shares etc. along with the complaint. Remember, in the absence of sufficient documents, resolution of complaints becomes difficult.

➥ Familiarize yourself with the rules, regulations and circulars issued by stock exchanges/SEBI before carrying out any transaction.

4.2 Products in the Secondary Markets

Types of products dealt in the Secondary Markets

Following are the main financial products/instruments dealt in the Secondary market which may be divided broadly into Shares and Bonds:

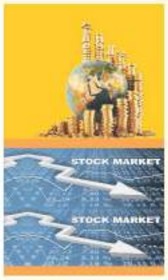
Shares:

Equity Shares: An equity share, commonly referred to as ordinary share, represents the form of fractional ownership in a business venture.

Rights Issue/ Rights Shares: The issue of new securities to existing shareholders at a ratio to those already held, at a price. For e.g. 2:3 rights issue at Rs.125, would entitle a shareholder to receive 2 shares for every 3 shares held at a price of Rs. 125 per share.

Bonus Shares: Shares issued by the companies to their shareholders free of cost based on the number of shares the shareholder owns.

Preference shares: Owners of these kind of shares are entitled to a fixed dividend or dividend calculated at a fixed rate to be paid regularly before dividend can be paid in respect of equity share. They also enjoy priority over the equity shareholders in payment of surplus. But in the event of liquidation, their claims rank below the claims of the company's creditors, bondholders/debenture holders.



Cumulative Preference Shares: A type of preference shares on which dividend accumulates if remained unpaid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.

Cumulative Convertible Preference Shares: A 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.

Bond: Is a negotiable certificate evidencing indebtedness. It is normally unsecured. A debt security is generally issued by a company, municipality or 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. The issuer usually pays the bond holder periodic interest payments over the life of the loan. The various types of Bonds are as follows:

Zero Coupon Bond: Bond issued at a discount and repaid at a face value. No periodic interest is paid. The difference between the issue price and redemption price represents the return to the holder. The buyer of these bonds receives only one payment, at the maturity of the bond.

Convertible Bond: A bond giving the investor the option to convert the bond into equity at a fixed conversion price.

Treasury Bills: Short-term (up to one year) bearer discount security issued by government as a means of financing their cash requirements.

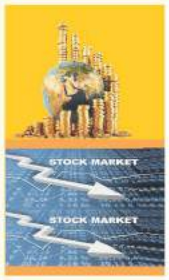
4.2.1 Equity Investment

Reasons to invest in equities

When you buy a share of a company you become a shareholder in that company. Shares are also known as Equities. Equities have the potential to increase in value over time. Research studies have proved that the equity returns have outperformed the returns of most other forms of investments in the long term. Investors buy equity shares or equity based mutual funds because:-

- Equities are considered the most rewarding, when compared to other investment options if held over a long duration.
- Research studies have proved that investments in some shares with a longer tenure of investment have yielded far superior returns than any other investment. The average annual return of the stock market over the period of last fifteen years, if one takes the Nifty index as the benchmark to compute the returns, has been around 16%.

However, this does not mean all equity investments would guarantee similar high returns. Equities are high risk investments. Though higher the risk, higher the potential returns, high risk also indicates that the investor stands to lose some or all his investment amount if prices move unfavourably. One needs to study equity markets and stocks in which investments are being made carefully, before investing.



Average return on equities in India

If we take the Nifty index returns for the past fifteen years, Indian stock market has returned about 16% to investors on an average in terms of increase in share prices or capital appreciation annually. Besides that on average stocks have paid 1.5% dividend annually. Dividend is a percentage of the face value of a share that a company returns to its shareholders from its annual profits. Compared to most other forms of investments, investing in equity shares offers the highest rate of return, if invested over a longer duration.

Factors that influence the price of a stock

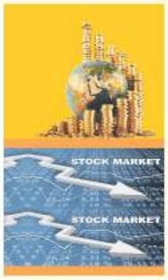
Broadly there are two factors: (1) stock specific and (2) market specific. The stock-specific factor is related to people's expectations about the company, its future earnings capacity, financial health and management, level of technology and marketing skills.

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 particular 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 stock-specific factors. Therefore, a prudent advice to all investors is to analyse and invest and not speculate in shares.

Meaning of the terms Growth Stock / Value Stock

Growth Stocks: In the investment world we come across terms such as Growth stocks, Value stocks etc. Companies whose potential for growth in sales and earnings are excellent, are growing faster than other companies in the market or other stocks in the same industry are called the Growth Stocks. These companies usually pay little or no dividends and instead prefer to reinvest their profits in their business for further expansions.

Value Stocks: The task here is to look for stocks that have been overlooked by other investors and which may have a 'hidden value'. These companies may have been beaten down in price because of some bad event, or may be in an industry that's not fancied by most investors. However, even a company that has seen its stock price decline still has assets to its name - buildings, real estate, inventories, subsidiaries, and so on. Many of these assets still have value, yet that value may not be reflected in the stock's price. Value investors look to buy stocks that are undervalued, and then hold those stocks until the rest of the market realizes the real value of the company's assets. The value investors tend to purchase a company's stock usually based on relationships between the current market price of the company and certain business fundamentals. They like P/E ratio being below a certain absolute limit; dividend yields above a certain absolute limit; Total sales at a certain level relative to the company's market capitalization, or market value etc.



Process to acquire equity shares

You may subscribe to issues made by corporates in the primary market. In the primary market, resources are mobilised by the corporates through fresh public issues (IPOs) or through private placements. Alternately, you may purchase shares from the secondary market. To buy and sell securities you should approach a SEBI registered trading member (broker) of a recognized stock exchange.

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.

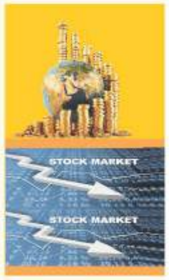
If an investor looks at a computer screen for a quote on the stock of say XYZ Ltd, it might look something like this:

Bid (Buy side)		Ask (Sell side)	
Qty.	**Price (Rs.)**	**Qty.**	**Price (Rs.)**
1000	50.25	50.35	2000
500	50.10	50.40	1000
550	50.05	50.50	1500
2500	50.00	50.55	3000
1300	49.85	50.65	1450
Total: 5850			**Total: 8950**

Here, on the left-hand side after the Bid quantity and price, whereas on the right hand side we find the Ask quantity and prices. The best Buy (Bid) order is the order with the highest price and therefore sits on the first line of the Bid side (1000 shares @ Rs. 50.25). The best Sell (Ask) order is the order with the lowest sell price (2000 shares @ Rs. 50.35). The difference in the price of the best bid and ask is called as the Bid-Ask spread and often is an indicator of liquidity in a stock. The narrower the difference the more liquid or highly traded is the stock.

Portfolio

A Portfolio is a combination of different investment assets mixed and matched for the purpose of achieving an investor's goal(s). Items that are considered a part of your portfolio can include any asset you own-from shares, debentures, bonds, mutual fund units to items such as gold, art and even real estate etc. However, for most investors a portfolio has come to signify an investment in financial instruments like shares, debentures, fixed deposits, mutual fund units.



Diversification

It is a risk management technique that mixes a wide variety of investments within a portfolio. It is designed to minimize the impact of any one security on overall portfolio performance. Diversification is possibly the best way to reduce the risk in a portfolio.

Advantages of having a diversified portfolio

A good investment portfolio is a mix of a wide range of asset class. Different securities perform differently at any point in time, so with a mix of asset types, your entire portfolio does not suffer the impact of a decline of any one security. When your stocks go down, you may still have the stability of the bonds in your portfolio. There have been all sorts of academic studies and formulas that demonstrate why diversification is important, but it's really just the simple practice of "not putting all your eggs in one basket." If you spread your investments across various types of assets and markets, you'll reduce the risk of your entire portfolio getting affected by the adverse returns of any single asset class.

4.2.2 Debt Investment

Debt Instrument

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.

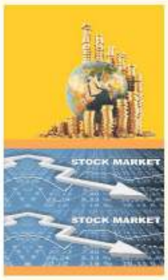
In Indian securities markets, the term *bond' is used for debt instruments issued by the Central and State governments and public sector organizations and the term ^debenture' is used for instruments issued by private corporate sector.

Features of debt instruments

Each debt instrument has three features: Maturity, coupon and principal.

Maturity: Maturity of a bond refers to the date, on which the bond matures, which is the date on which the borrower has agreed to repay the principal. Term-to-Maturity refers to the number of years remaining for the bond to mature. The Term-to-Maturity changes everyday, from date of issue of the bond until its maturity. The term to maturity of a bond can be calculated on any date, as the distance between such a date and the date of maturity. It is also called the term or the tenure of the bond.

Coupon: Coupon refers to the periodic interest payments that are made by the borrower (who is also the issuer of the bond) to the lender (the subscriber of the bond). Coupon rate is the rate at which interest is paid, and is usually represented as a percentage of the par value of a bond.



Principal: Principal is the amount that has been borrowed, and is also called the par value or face value of the bond. The coupon is the product of the principal and the coupon rate.

The name of the bond itself conveys the key features of a bond. For example, a GS CG2008 11.40% bond refers to a Central Government bond maturing in the year 2008 and paying a coupon of 11.40%. Since Central Government bonds have a face value of Rs.100 and normally pay coupon semi-annually, this bond will pay Rs. 5.70 as six-monthly coupon, until maturity.

Interest payable by a debenture or a bond

Interest is the amount paid by the borrower (the company) to the lender (the debenture-holder) for borrowing the amount for a specific period of time. The interest may be paid annual, semi-annually, quarterly or monthly and is paid usually on the face value (the value printed on the bond certificate) of the bond.

Segments in the Debt Market in India

There are three main segments in the debt markets in India, viz., (1) Government Securities, (2) Public Sector Units (PSU) bonds, and (3) Corporate securities.

The market for Government Securities comprises the Centre, State and State-sponsored securities. In the recent past, local bodies such as municipalities have also begun to tap the debt markets for funds. Some of the PSU bonds are tax free, while most bonds including government securities are not tax-free. Corporate bond markets comprise of commercial paper and bonds. These bonds typically are structured to suit the requirements of investors and the issuing corporate, and include a variety of tailor-made features with respect to interest payments and redemption.

Participants in the Debt Market

Given the large size of the trades, Debt market is predominantly a wholesale market, with dominant institutional investor participation. The investors in the debt markets are mainly banks, financial institutions, mutual funds, provident funds, insurance companies and corporates.

Credit rating for bonds

Most Bond/Debenture issues are rated by specialised credit rating agencies. Credit rating agencies in India are CRISIL, CARE, ICRA and Fitch. The yield on a bond varies inversely with its credit (safety) rating. The safer the instrument, the lower is the rate of interest offered.

Acquire securities in the debt market

You may subscribe to issues made by the government/corporates in the primary market. Alternatively, you may purchase the same from the secondary market through the stock exchanges.