Chapter-I

Introduction

The capital market consists of a series of channels—through which the savings of the community are made available for industrial and commercial enterprises and for public. It embraces not only the system by which the public takes up long term security directly or through intermediaries but also the elaborate network of institutions responsible for short term and medium term lending. But there is difference between capital market and money market. In money market, dealings take place for short term funds, whereas in case of capital market, long term securities are traded to meet the long term requirements. The distinction between the money and the capital market is based on the difference in the period of maturity of financial assets, which is arbitrary, but one year dividing point in this regard is mostly accepted in the financial markets.

Capital markets not only plays a crucial role in the economy of developed countries but also in the development of the underdeveloped countries like India. Savings and investments are vital factors for economic development and growth of an economy. Generally, units which save and invest are different and capital markets provides a bridge by which savings of surplus units are transmitted into long term investments by deficit units. The pace of economic development along with other things depends upon the rate of long term investments and capital formation in a country. The rate of capital formation depends upon the rate of savings, rate of investments and financial market. The capital
market plays a vital role in mobilising the savings and making them available to the potential users and investors. An active capital market, through its price mechanism allocates the scarce financial resources to the most productive uses at lower cost.

Generally, the following factors effect the capital market:

(i) government fiscal and industrial policies;
(ii) general economic conditions prevailing in a country with particular reference to industrial production and profitability;
(iii) trends in the capital and money market with particular reference to price and savings situation from time to time;
(iv) demand for capital from public and private sectors for developmental expenditure by way of new issue of industrial securities; and
(v) investors preference for liquidity and forward looking expectations as reflected in the pattern of yields and movements in prices of securities in the secondary market.

The funds can be raised by new companies as well as existing companies by issuing securities to meet its requirements. When the shares/debentures are issued by new companies it is known as 'initial issue' and in the case of existing companies it is called 'further issue'.
1.1 Development of Capital Market in India

The public financial institutions and non-banking institutions are important ingredients of capital market. The development bankers, besides providing finance, provide consultancy, technical know-how and training i.e. finance and promotion simultaneously. Thus, in the modern era, development banks are considered as "gap fillers". The development banks derive most of their funds from the government through capital contribution, loan capital from government and R.B.I., borrowings by way of government guaranteed bonds from domestic markets, borrowings in foreign currency from international capital market and own generation by way of repayment of past borrowings and ploughing back of profits. However, the funds are not strongly linked with the saving units in our economy. In a developing country like India, owing to certain bottlenecks, the development banks at national as well as state level perform the following activities:\n
(i) grant of loans for creation of fixed assets like building and plant and machinery;
(ii) underwriting of shares, stocks, bonds and debentures;
(iii) guaranteeing deferred payments for the purchase of capital equipment within India;
(iv) grant of foreign exchange loans under the World Bank loan scheme extended by the World Bank to finance the import of machinery from abroad as also for payment of technical know-how and engineering fees;
(v) grant of composite loans for the purchase of equipments and working capital requirements to unemployed person to set up "House Hold Industries";

(vi) grant of special capital assistance;

(vii) grant of loans for modernization of existing units;

(viii) grant of seed capital assistance;

(ix) grant of subsidies and encouraging export promotion and import substitution industries; and

(x) promoting backward areas and regional development.

After independence, immediate need was felt for an institutional set up to meet the requirements for long term finance, both in the form of term loans and for subscription to share capital for setting up industrial enterprises. In order to cater to these needs, the Industrial Finance Corporation of India (IFCI) came into existence in 1948. The setting up of Industrial Finance Corporation of India (IFCI) on 1st July, 1948 under the IFC Act, 1948 marks the beginning of the era of development banking in India. The IFCI was established jointly by Government of India, Reserve Bank of India and the financial institutions, to provide medium and long term credit to industrial enterprises, joint stock companies as well as cooperative sectors in the country. A significant feature of IFCI's operations has been the integration of its lending and investment policies
with the country's Five Year Plans. Direct financing is the IFCI's main business, which includes assistance in the form of rupee loans, foreign currency loans, underwriting/direct subscription to shares and debenture and guaranteeing of loans raised by industrial concerns etc. The Industrial Finance Corporation (Amendment) Act, 1982 has broadened the scope of IFCI's activities like merchant banking and other promotional activities. The introduction of conversion clause has also brought about a significant change. The IFCI has played a pivotal role in the development of security market, however, the role of IFCI in the New Issue Market is confined only through its underwriting operations of shares, stocks and debentures. Although IFCI was formed in 1948, its underwriting operations began only from 1958. The total assistance sanctioned by IFCI during 1988-89 is Rs. 1905.61 crores out of which Rs. 1005.30 crores has been disbursed. The amount sanctioned for underwriting and direct subscriptions of equity, preference shares and debentures was Rs. 90.2 crores, against which Rs. 13.96 crores has been disbursed in the same year.

At the time of setting up IFCI, the necessity to establish similar institutions for assisting smaller industries in different states had been recognised as it was very difficult for a single institution to satisfy capital needs of smaller concerns sprawling all over the country. Accordingly the State Financial Corporation (SFC) Act was enacted by the Government of India in 1951, which came into effect in 1952. Various State
Financial Corporations like Punjab Financial Corporation, Himachal Pradesh Financial Corporation were set up to cater to the needs of small scale units. The SFCs provide loans and underwriting assistance to projects which are being promoted by smaller entrepreneurs. An SFC can provide the maximum assistance to a single unit of small or medium size to the extent of Rs.90.00 lacs. These institutions are closely modelled on the lines of IFCI with the difference in scope of their activities. During 1988-89 Rs.1690.16 crores had been sanctioned by SFCs out of which Rs.1130.40 crores had been disbursed. The operations carried through underwriting and direct subscriptions by these SFCs is not enthusiastic. Their contribution in this regard has been reduced to zero in the form of underwriting.

For encouraging industrial development in private sector and developing capital market, a considerable provision of underwriting facilities were considered necessary and in order to fill the gap another development bank called Industrial Credit and Investment Corporation of India (ICICI) was ushered in Jan., 1955. It was set up with support from the Government of India, the World Bank, the Commonwealth Development Finance Company (CDFC) and other foreign institutions for the purpose of fostering the development of industries in the private sector. The range of operational activities of ICICI is very wide in the sense that even if an applicant is a foreigner, he will be entitled to assistance, provided he is prepared to make a substantial contribution to the project cost. A special feature of its activities
has been merchant banking and it has a separate division to attend to this work. It assists in managing public issues, raising term loans etc. In the earlier period, the thrust of its activities was on providing term loans in foreign currency and taking active part in the underwriting and direct investment in shares of industrial units. With the rapid growth in the demand for domestic capital goods and resultant indigenisation in the supply of capital goods, ICICI's rupee assistance gradually increased.

The ICICI's role in the security market has two-fold significance. Firstly, it underwrites the public issues of shares and debentures and secondly, it also directly subscribes to these securities. During 1988-89 the total assistance sanctioned by ICICI is Rs.2056.11 crores and amount disbursed is Rs.1085.61 crores. The underwriting and direct subscription by ICICI during 1986-89 accounts Rs.109.01 crores as sanctions and Rs.36.59 crores as disbursement.8

There was another milestone in the field of institutionalisation of the capital market i.e. the nationalisation of life insurance business in 1956 to form Life Insurance Corporation (LIC). LIC was set up as a statutory corporation under the Life Insurance Corporation Act, 1956. The main purpose of the Corporation was to carry on life insurance business. Apart from this, it has gradually developed into a specialised All India Financial Institution through its investment in the shares of promising industrial enterprises, granting loans on mortgage of fixed assets, under-
writing new issues and making investments in Government Securities. It maintains close contacts with the other All India Financial Institutions for coordination of its investments. Though, a small proportion of its total resources is channelled into private sector, the size of the LIC's resources is such that even this small proportion constitutes a big source of industrial finance in the country. During 1988-89, LIC sanctioned assistance of Rs.845.07 crores and disbursed Rs.626.88 crores. The underwriting and direct subscriptions sanctioned by LIC during 1988-89 were Rs.334.46 crores and amount disbursed against this was Rs.198.22 crores. The level of operations of LIC is much higher in comparison to other financial institutions. The LIC being the largest investor in the capital market enjoys underwriting activity in a manner different from that followed by the other institutional underwriters and its underwriting of shares and debentures has been quite significant in recent years.

During 1960s different state Governments, with a view to boost the pace of industrial development in their regions, established State Industrial Development Corporations (SIDCs). During 1988-89, these SIDCs had sanctioned assistance of Rs.821.10 crores and disbursed Rs.537.80 crores. There were certain drawbacks in the operations of these institutions except LIC. Therefore, the need was felt to have an All India Institution which could, besides providing financial assistance, mobilize resources of the people particularly those having small savings. Thus, Unit Trust of India (UTI) was established in 1964, under
the Unit Trust of India Act, 1963. The main objective of the UTI is to provide the facility of equity investment to savers, particularly belonging to the small and medium income groups, thereby, supplementing efforts of saving institutions, in mobilising the savings of the community for national building activities. It channels these savings into productive activities, by investing its funds in the shares and debentures of industrial undertakings.

Until 1970, a larger and an increasing proportion of the unit fund was invested in securities yielding a fixed return viz. preference shares and debentures as compared with the equity investment. However, since 1970, there has been shift in favour of equity investments with a view to earn a better return and capital appreciation. The investment portfolio of the UTI is built through purchase of securities from the stock market and by way of subscription to new capital issues. During 1988-89 the UTI sanctioned assistance of Rs.1973.14 crores out of which Rs.1091.24 crores were disbursed. The underwriting and direct subscription by UTI during 1988-89 amounted to Rs.761.70 crores as sanctions and a disbursement of Rs.482.57 crores took place in that year.

With a view to coordinate and integrate the activities of All India Financial Institutions, the Industrial Development Bank of India (IDBI) was set up in 1964 under the IDBI Act, 1964 as a wholly owned subsidiary of the Reserve Bank of India.
(RBI). It is an apex institution in the structure of industrial financing institutions in the country. As the apex development bank of the country, IDBI has been vested with the responsibility for strengthening the resources of the financial institutions including banks. This function is performed by refinancing industrial term loans granted by eligible Financial Institutions, by rediscounting machinery bills, and by subscription to share capital and bonds issues of SFCs, SIDCs, IFCI, ICICI & IRBI. The other activities of IDBI are same like IFCI and ICICI i.e. direct assistance in the form of rupee loan, underwriting direct subscription and deferred payment guarantee.

IDBI is empowered to finance all types of industrial concerns, including those engaged in the research and development of any process of product or in providing special technical knowledge or other services for the promotion of industrial growth. It has introduced a number of promotional scheme along with other financial institutions, to ensure that the available resources are deployed intomore desirable channels and has implemented policies that would help augment resources, both financial and entrepreneurial. IDBI is playing important role as the principal financial institution for coordinating, in conformity with national priorities, the working of the institutions and for providing credit and other facilities for the development of industry in the country.
During 1988-89 the IDBI sanctioned total assistance of Rs.5129.27 crores and Rs.3611.24 crores were disbursed in the same year. The underwriting and direct subscription during 1988-89 is Rs.171.90 crores out of which Rs.41.51 crores disbursed.

Apart from this, Industrial Reconstruction Corporation of India (IRCI), renamed later as Industrial Reconstruction Bank of India was also set up. In order to provide a forceful direction to the process of Rural Development the National Bank for Agriculture and Rural Development (NABARD) was established in 1982. The Export-Import Bank of India (EXIM Bank) was also established in 1982 to cater to the financial requirements of the exporters and importers for financing international trade.

Merchant Banking in India is of recent origin. It had its beginning in India in 1967. The State Bank of India started merchant banking division in 1970. The ICICI set up their merchant banking division followed by a few other banks like Syndicate Bank, Bank of India, Chartered Bank, Mercantile Bank etc. Over a period, merchant banks extended their activities to domestic business of syndication of short term and long term finance, underwriting of new issues, acting as registrars and share transfer agents, debenture trustees, portfolio managers, negotiating agents for mergers and take over etc. The merchant banking today is a protective and promoting force to entrepreneurs, corporate sector and investors. The role can be enlarged both
in domestic and international market. In the context of the massive investment that is envisaged in the various sectors of the economy and industry in particular, merchant banking expertise is likely to be in a much greater demand in the coming years.

Thus, the All India Financial Institutions have made a tremendous progress in mobilising resources through New Issue Market as well as secondary market.

1.2 Security Market

Each and every enterprise in the market is in needs of funds and it approaches the investing sources viz. individuals, investment institutions, development banks, commercial banks etc. to subscribe to its new issue. The securities thus floated subsequently change hands among individuals and institutional investors in the stock exchange. The former market is known as primary or New Issue Market and later is called secondary market.

The main function of New Issue Market is to facilitate the transfer of resources from savers to entrepreneurs seeking to establish new enterprise or to expand and diversify existing ones. Such facilities are of crucial importance in the context of in whose hands savings accumulate and identifying and tapping prospective savers and then applying for productive uses. The New Issue Market is a complex of institutions through which funds can be obtained directly or indirectly by those who require them from small investors. The seekers of the funds include the Central Government, the State Governments and the
Corporate Sectors. Among the investors are the banks, insurance companies, investment trusts, companies and individuals.

There is a wide range of borrowers and users in the financial as well as capital market. The long term demand of the borrowers is met through security markets. A financial security is a legal instrument that represents either an ownership claim or a creditorship claim. The ownership securities are equity and preference shares whereas creditorship securities are debentures and bonds. A debt security is used to raise a loan with a promise to repay the loan at some future date and interest is also paid on the borrowed money. The owner of a debt security is named as a creditor. The securities can also be classified as Government securities and industrial securities.

1.2.1 Government Securities

The Government securities are the securities which are issued by Central Government, State Governments and local self-governments which includes the authority like Corporations and municipalities, autonomous bodies, like port trusts, improvement trusts, state electricity boards, metropolitan authorities, and public sector corporations. The Government securities are also issued by the agencies like I.D.B.I., I.F.C.I., S.F.C.s., S.I.D.C.s and housing boards etc. The Government securities plays a significant role in the Stock Market of India. The popular form of government securities are bonds and debentures.
1.2.2 Industrial Securities

The new as well as existing companies need to raise the funds to meet the requirements for expansion, diversification and modernisations etc. The funds are raised through industrial securities in the security markets. The instruments of raising funds in the industrial securities market are equity shares, preference shares, debentures and bonds. The size of industrial security market in India is relatively much smaller because of savings and investment habits, level of education and industrial infrastructure. During 1987-88, the household sector savings contributed 121.61 percent of the total net domestic savings in India. The capital raised by non-government companies in the same year constitute 4.37 percent of the total domestic savings. Thus, industrial securities have not emerged popular mode of investment in India so far. The industrial securities market in India as compared to that of industrialised countries presents a gloomy picture.

The industrial securities market can be divided into two parts, i.e. New Issue Market and Secondary Market. The New Issue Market (NIM) can be defined as a place where 'new' or 'initial' issues take place. In other words, we can say that 'new' securities, which were not previously available in the market and are issued to the public by the new companies. However,
it is to be noted that new issue market has no geographical existence. It consists of the institutions through which the savings of the community are made available to the industrial and commercial world. Secondary market provides liquidity to the existing securities\textsuperscript{17}. There were 19 recognised stock exchanges in India upto 1990. The speculation factor has dominated the Indian Stock market since inception.

1.2.3 Marketing of Securities - New Issue Market

In New Issue or Primary Market the first hand securities are traded. When the company issues the share for the first time, this issue is called 'Initial' issue. A company, in order to raise the initial capital, always uses the initial equity and preference shares. The new issue may be offered either for cash subscription or for consideration other than cash. The selling and distribution of new issue is highly specialised activity and requires both experience and skill. The choice of exact method of selling depends upon the number, distribution character and sentiments of prospective buyers. The marketing of securities to a limited number of specialised institutions will be different from that of a large number of small investors spread into a vast area. The existence of different specialised institutions for facilitating the security market is essential.

There are various methods of marketing the new issues namely public issue, offer for sale, private placement and right issues\textsuperscript{18}. 
Public Issue

This is the most prevalent method for raising funds in case of new issue market. Under this method, the issuing company makes a direct appeal to the investors by organising an advertisement through the prospectus carrying all needed information. The issue price in the case of new companies is invariably the face value of the securities and in case of existing companies, sometimes includes the premium amount, also. Under this method, the issues are also underwritten to ensure the success of the issue arising out of the unsatisfactory public response which generate confidence among potential investors.

Legally no company can raise the capital from the public without issuing a prospectus as described by the Companies Act, 1956. A prospectus is a notice circular advertisement or any other document inviting offers from the public for subscription or purchase of any shares in or debentures of a body corporate.

The Companies Act, 1956, provides both civil and criminal liability for any mis-statement in the prospectus. It may be mentioned that the issue of prospectus is not obligatory if a company is able to find all the capital necessary for its purposes without having to go to the public for raising the same. However, it is obliged to prepare and fill with the Registrar of Companies a statement in lieu of prospectus. In addition to the above requirements for the issue of prospectus, it should also contain an information to comply with the established practices.
and rules of the stock exchange. It should also mention in the prospectus that an application has been forwarded to the stock exchange for a quotation of its shares.

The method of issuing securities through prospectus has many advantages like it is simple and easy to operate, helpful in mobilising funds from a large section of the investing public and there is no discrimination in this method because a transaction is carried as in the full light of publicity and that a fixed quantity of stock will have to be allotted among applicants. This method is also useful to prevent the concentration of wealth and economic power because share ownership is widely diffused.

There is, however, an element of uncertainty and risk of public failing to subscribe for the requisite amount viz. minimum subscription due to the changing money market conditions and changing public response. Issue of securities particularly by a new company without the services of underwriters and brokers is a dangerous affair because there is no assurance of sale. This is a highly expensive method, as the cost of floatation involves underwriting expenses, brokerage, and other administrative expenses. Under the companies Act, 1956, the underwriting commission is subject to an overall limit of 5 percent on shares and 2½ percent on debentures. The issuing companies usually remunerate the brokers with a 1 percent commission on shares and 0.5 percent on debentures. The administrative cost includes printing charges of prospectus, advertisement or publicity charges, accountancy charges, legal
charges, bank charges, stamp duty, listing fee, travelling expenses, registration fee, filling of documents charges, mortgage deed registration fee postage etc.

Hence, this method is suitable for large issues only and it cannot be effectively used in case of small issues.

Despite the strong objections raised against this method, this method is most popularly used in India, particularly in case of new issue market.

Offer for Sale

Due to shortcomings of public issue method, another method by which securities can be issued is by means of an offer for sale. Under this method, shares are not directly issued to the public, but there are certain intermediaries through which shares are issued to the public like issuing houses or firms of stock brokers. The issuing company sells the securities enbloc to the issuing houses or stock brokers at an agreed fixed price and the securities, thus acquired by the intermediaries, are resold to the ultimate investors. Generally, the securities are issued to the public at a price higher than the price at which they were acquired from the company. Thus the 'remuneration' or 'turn' of stock brokers or issuing houses is the difference between the sale and the purchase price.20

This method differs from the public issue method on the ground that shares in the later case are issued directly
to the public where as in the former, these are issued through issuing houses or stock brokers. In the case of public issue method, the issuing houses receives a fee based upon the size of the issue and the complications involved in supervision as they act as agents of the issuing company. The issuing houses or stock brokers meet subsidiary expenses such as underwriting commission, the cost of advertisement and prospectus etc. from the 'turn' whereas these are borne by the companies themselves in the case of public issue method.

The method of offer for sale has certain advantages over other methods of floatation of securities. This method is cheap or less expensive. The issuing company is saved from the cost and trouble of selling the shares to the public. It also reduces risk and uncertainty to some extent.

The method is, however, complex and complicated to operate. Further, the securities are sold to the investing public usually at a premium and the additional money is pocketed by the issuing houses.

Placement Method

The third method of marketing securities in case of New Issue Market is private placement method. Under this method, firstly, securities are issued to the issuing houses or stock brokers and then these houses issue securities to the selected investors. They are not offered to the public directly. These securities are issued to those clients who has already purchased shares from the issuing houses which may be individual or
institutional investors\textsuperscript{21}. The shares are issued at a higher price than the purchase price by issuing houses and the difference is known as their 'turn' or 'remuneration'.

The securities may be quoted or unquoted. When unquoted securities are sold, it is known as private placing. These unquoted securities are generally of small companies but there may occasionally be unquoted securities in large companies as well. In case of quoted shares, the placement takes place through stock exchange.

Private placing of securities with investors has grown in popularity in recent times. This method is relatively cheap. The underwriting commission, brokerage and other administrative expenses are comparatively lower than public issue and offer for sale. It is useful to the issuing companies because companies are saved from the formalities which are carried on in case of public issue etc. This method is less complicated and it also reduces risk and uncertainty because shares are underwritten by the issuing houses.

This method has also certain shortcomings. This method is not favourably received by the investing public. It is suitable only in case of small issues which cannot bear the high expenses. It cannot be applied successfully in case of large issues. This may lead to the concentration of power and wealth into a few hands.
Thus, it is clear that placement method is suitable where new issues are floated by small companies which suffer from a financial constraint.

Right Issue

Right issue or privileged subscription means giving privilege to certain investors in subscription of securities. In this method, the company gives privilege to its existing shareholders for the subscription of the new shares according to the terms and conditions of the company and the shares which remain unsubscribed are open to the public for subscription. In case of companies whose shares are already listed and widely held shares can be offered to the existing shareholders. This is called right issue. The shareholders are offered the right in proportion to the number of shares they already possess.

According to companies Act, 1956, it is necessary for a company while issuing new shares to increase its capital, the shares have to be first offered to the existing shareholders with a right to renounce them in favour of a nominee. Generally, right issues are not underwritten but to ensure full subscription, few companies have resorted to underwriting of right shares. The right issues are generally associated with the expansion of business and usually these are offered during the prosperity.

Right issue method has various advantages over other methods of floatation of securities. The cost of marketing the securities is reduced considerably. The usual expenses like underwriting commission, brokerage and other administrative
expenses are either non-existent or constitute very small portion. The present shareholders can maintain their equity both in voting as well as in surplus. The management of applications and allotment is less cumbersome, because the number is limited. The members get these rights shares at a low price than the current market price.

There are few investors who raise certain objections while using this method. In their opinion, this method can be used only by existing companies and the general investing public gets little opportunity to participate in the right issues. The pre-emptive right of existing shareholders may conflict with the broader objective of wider diffusion of share-ownership.

The method of marketing of securities to be used depends upon many factors. The issue mechanism would vary from market to market and the nature of investing public. The methods namely, offer for sale and private placement are not common in India. There are only few companies those who have resorted to these methods. The most popular methods which are used in India, are public issues through prospectus and right issues. The public issue method is most accepted method and frequently used.

1.2.4 Secondary Market

Once the new issues are floated and subscribed by the public, then these are traded in the secondary market. This market generally deals in existing securities. The main function is to provide liquidity to such securities by creating
a ready market for securities. It encourages the prospective
investors to invest into either old or new securities. The
existing issues of companies are traded either in stock exchange
or 'Over the Counter' market and third market.

Stock Exchange

Stock exchange in a common parlance is a place
where stock and shares are bought and sold. There are several
buyers and sellers of different shares with the result that
prices are competitive. A stock exchange provide an open auction
market\(^{23}\). The Securities Contracts (Regulation) Act, 1956 defines
a stock exchange as an "association, organisation or body of
individuals, whether incorporated or not, established for the
purpose of assisting, regulating and controlling business in
buying, selling and dealing in second hand securities". The
securities market popularly known as stock exchange is a highly
organised market in which Government Securities, Stocks and Shares
are dealt in. A stock exchange has all the characteristics of a
market in the economic sense\(^{24}\). Stock exchange forms the nucleus
around which the different components of the financial market
rotate and get nourishment. It forecasts the financial climate
and reflects the psychology of investment. Thus, it is clear that
in stock exchange only second hand securities are traded and
which are also listed on the stock exchange.

There were 19 stock exchanges in our country,
which are insufficient to cater to vast population and wide
gеographical distribution. The trading of securities through
stock exchange are playing vital role in mobilising the savings
into effective investments. However, the present working system of stock exchange in India, which needs to be improved in accordance with the prevailing circumstances in the country, has not proved so effective in channelising the savings of public.

Over the Counter (OTC) Market

Over the counter market is an informally organised group of brokers and dealers. It deals with primary issues as well as secondary transactions especially of those securities which are not listed on the stock exchanges. Their prices are determined through direct negotiations between stock brokers and not through open bidding as in the case of listed securities of stock exchanges. In Over the Counter Market, the business is not conducted at a particular place. However, some stocks trade in the OTC market because the company is small or the company is not interested to list the security on a stock exchange. Thus, it can be defined only place where certain stocks can be sold or purchased. Such markets have limited marketability and liquidity.

Third Market

Third market has much similarities with over the Counter Market. The only difference is that in third market the trading takes place in listed securities among institutional or big investors off the exchange. Thus, it is over the counter trading in listed stocks. In the third market, prices are negotiated and dealers have no responsibility for maintaining a market.
Thus, it is evident that the objective of floatation of securities in case of new issue market as well as secondary market, is to facilitate the transfer of resources from savers to entrepreneurs, seeking to establish new units or to expand and diversify existing ones.

1.3 Instruments of Security Market

The instruments for raising funds in the security market are equity shares, preference shares, debentures and bonds. A company can use any one of these instruments to tap the savings of people with different habits and temperaments regarding investment of the savings. However, these instruments differ in characteristics and satisfy the needs of different types of investors.

1.3.1 Equity Shares

Equity Shares (also known as ordinary shares) are those shares which carry no special rights or claim in respect of annual dividend and the return of capital at the time of winding up of a company. In other words, equity shares are those shares which are not preference shares. The equity shareholders are not given any guarantee of dividend on their investments in the company. They are entitled to receive such dividends as are determined by the Board of Directors and approved by the Annual General Meeting of the Company.

They are residual claimants of profits and assume ultimate risk associated with ownership. The liability of the equity shareholders is limited to the par value.
The equity shares carry certain advantages in favour of the issuing company and investors as compared to the other forms of instruments of raising capital. Investment in these securities is permanent but not illiquid due to secondary market. Besides, the enlargement of the equity base increases the borrowing capacity of the company. The equity shareholders are the real risk bearers of business enterprise. It is they who provide "venture" capital for the company without investing or any special condition for the safety of their capital or the rate of return on their investments. In the event of losses to the company, the losses are absorbed by this group of shareholders. In case of higher profits in a successful business these shareholders gets handsome return which is paid after paying all the fixed burdens like interest on debentures, dividend on preference shares, taxes etc.

There are certain disadvantages to the company that employs equity shares as a financing device. The equity shares is a costly mode of raising capital than the preference shares and debentures. The cost of issue expenses is generally higher in case of equity shares. Moreover, the excessive issues of equity shares may result in over capitalisation.

1.3.2 Preference Shares

Preference shares are those shares which carry certain priorities in regard to the payment of dividend and return of capital and are subject to certain limitations in regard to voting rights. The preference enjoyed by the preference...
shareholders are of two types:

Preference in regard to dividend out of every year's net profit of the company and preference as to repayment of capital out of the residual assets of the company in the event of winding up of the company. The preference shareholders get fixed rate of dividend subject to the ceiling rate fixed by the Controller of Capital Issues under Capital Issues (Control) Act, 1947. The preference shares is a hybrid form of security; combining the features of debentures, i.e. fixed rate of return and of equity shares as claims of ownership.

There are different types of shares which can be issued by a company such as, Cumulative and non-cumulative; convertible and non-convertible; participating and non-participating; and redeemable and irredeemable. In India, most of the preference shares are in form of cumulative and redeemable preference shares. Convertible preference shares are also in vogue whereas, preference shares with participation are not being issued in practice.

There are certain benefits of raising capital through issue of preference shares. The preference shares carry a fixed rate of dividend and can, therefore, be used to increase the return on equity or earning per share of a company. From the company's point of view, preference shares are preferred to debentures as the risk of insolvency is reduced. If the earnings of a company are not sufficient and stable to meet the liability of debentures, it may justify the inclusion of preference share while raising capital in the market.
The limitation of the preference share is that it does not carry voting rights, except on those issues which effect their interests such as non-payment of dividends for more than two years in the case of non-cumulative preference shares and three years in the case of cumulative preference shares. Undoubtedly, preference shares have certain advantages but this instrument of raising capital has lost its importance in the recent years. Very few preference share issues are taking place in the security market.

1.3.3 Debentures

A company may finance part of its capital needs by raising loan through debentures. The long term finance required for the expansion and modernisation of the business may be raised by issuing debentures, thus it constitutes the loaned capital of the company.

A debenture may be defined as a document issued by the company as an evidence of its debt. It is an acknowledgement of debt or loan under the seal of the company. Debenture is a document which provides for the payment of a principal sum and interest thereon at regular intervals, which is usually secured by a fixed or floating charge on the company's property or undertaking.

There is a difference between a debenture holder and a shareholder. The shareholders are the owners of the company whereas debentureholders are the creditors. The debentureholders
get fixed interest which is obligatory and the shareholders get dividend which is at the discretion of the Board of Directors. The ceiling rate of interest on debentures is fixed by the Controller of Capital Issues.

The debentures are classified on the basis of transferability, security offered and redeemability. Thus, debentures may be redeemable and irredeemable, secured and unsecured, registered and bearer, priority debentures etc. 29.

There are various advantages of raising of funds through debentures. It has tax benefit. The cost of raising debt capital is lower as compare to other forms of raising capital and it avoids dilution of control.

A company with stable earnings and dealing in goods or services for which demand is not highly elastic and which has adequate fixed assets should raise funds through debt capital.

This instrument of raising capital in the capital market is also having certain disadvantages. A company whose earnings are highly fluctuating should not raise finance through debentures. The risk of insolvency and fluctuation in earnings are influenced by the quantum of debt. There will be higher financial risk, if the debt is on higher side. A company having a low proportion of fixed assets to total assets may not find it easy to issue debentures because it lacks substantial security to offer to debentureholders.
1.4 Legal Environment and Security Market

The growth of security market of a country has been influenced by the legislative measures taken by that country from time to time. The policy changes has great impact on the minds of public which ultimately affects the saving habits. For effective mobilisation of funds it is necessary that the interest of the potential investors should be protected adequately.

In the pre-independence, the earliest legislation relating to stock market was introduced in the 19th century. This legislation was passed in 1865 but it lost its impact due to outbreak of the American Civil War. Thereafter, the Atlay Stock Exchange Enquiry Committee set up in 1923. This Committee in its report emphasised the necessity of the Stock Exchange framing and maintaining a systematic and set of rules and regulations in the interest of the general investing public and of the trade itself. The next step towards special legislation for controlling stock market was Bombay Securities Contracts Control Act, 1925. This Act gave certain powers to Government in regard to recognition of Stock Exchange etc. but this Act proved ineffective in regulating security trading and government control thereunder was nominal, practically. The Bombay Security Contracts Control Act remained in force till the Securities Contracts (Regulation) Act, 1956 enacted by the Central Government. The main acts which effect the securities markets are Companies Act, 1956, Capital Issues Control Act 1947, Securities Contract (Regulation) Act, 1956, Securities Contract (Regulation) Rules 1957 etc.
1.4.1 Companies Act, 1956

After independence the Government of India passed various legislations so that investors can have confidence while investing their savings. With a view to protect the interest of a large number of shareholders and creditors of companies, to help the development of corporate sector on healthy lines and to help the attainment of the ultimate ends of social and economic policy of the Government, the Companies Act, 1956 was passed. It was not enacted purely from legalistic point of view but it was also passed on the changing social needs of the country.

The Companies Act, 1956 together with its amendments, is the substantive law in our country today and contains a large number of new and startling provisions for public control over the functioning of joint stock companies. The following are the basic objectives of the Companies Act, 1956:

(a) minimum assured standard of business integrity and conduct in the promotion and management of companies;

(b) full and fair disclosure of all reasonable information relating to the affairs of the company;

(c) effective participation and control by shareholders and the protection of their legitimate interests;

(d) enforcement of a proper performance of their duties by the company management; and
(e) powers of intervention and investigation into the affairs of companies when they are managed in a manner prejudicial to the interest of the shareholders or to the public interest.

A company has to operate within the legal framework prevailing in the country. The Companies Act deals with the formation and management of new companies. With the growth of joint stock companies, the capital market has taken a new turn in the development of the country.

1.4.2 The Capital Issues (Control) Act, 1947

Another ingredient of regulatory legislation is the Capital Issues (Control) Act, 1947, which prescribes the approval of the Controller of Capital Issues for all issues of capital. It is one of the major instruments through which the Government regulate the working of capital market particularly the new issues. Capital Issues Control was first introduced under the Defence of India Rule 94-A which was promulgated on 17th May, 1943 under the Defence of India Act, 1939. Capital Issues Control was retained after the war and Defence Rule 94-A was replaced by the Capital Issues (Continuance of Control) Act, in April, 1947. This Act was passed partly to check the inflationary trends in the economy and partly to secure a balanced investment of the country's resources in industry, agriculture and social services. Thus, the main objective of this pragmatic step was to ensure that investments in the country in the various
sectors of economy takes place in a planned manner and in accordance with the priorities laid down in the plans.

The main objectives of this Act are as under:

(i) to ensure that investment does not take place contrary to the objectives of the Five Year Plans or flow into the unproductive uses;

(ii) to prevent setting up of new undertakings either in overcrowded lines and/or regions;

(iii) to promote the growth of joint sector companies in the general public interest with sound capital structure;

(iv) to regulate capital reorganisations plans of companies for merger and amalgamation;

(v) to direct and distribute appeals to the public subscription to new issues of capital so as to avoid any undue concentration and overcrowding in a particular period; and

(vi) to regulate the terms and conditions of foreign capital participation in Indian companies and the regulation of the terms and conditions of dilution or repatriation of foreign equity.

The scope of control of capital issues extends to all companies which makes a issue of capital or make any public offer of securities for sale in India. It also applies
to the companies registered in India but make public issue or public offer outside India. However, this Act is not applicable in the following categories of companies:

(i) private companies as defined in Section 3 of the Companies Act, 1956 provided these are not registered under Section 26 of MRTP Act, 1969;

(ii) government companies; and

(iii) banking, insurance and provident fund societies incorporated as companies.

Under the Capital Issues (Control) Act, 1947, the consents of the Controller of Capital Issues is necessary for the issues of following type of securities:

(i) issue of capital in excess of Rs.1.00 crore presently during a period of 12 months;

(ii) public offer of securities at a premium or discount;

(iii) to renew or postpone the maturity date;

(iv) issue of bonus shares of any amount by public or private companies;

(v) issue of preference shares carrying rights and conversion; and

(vi) issue of securities which involves relaxation of any of the conditions mentioned in the Capital Issues (Exemption) order, 1969 which apart from the clauses
referred above relates to the cases of shares arising from revaluation of assets or creation of intangible assets; where rate of dividend on preference shares exceeds the specified limit; promoter's share is below the prescribed limit; where the amount of preference share capital is more than 1/3rd of the equity capital; and where debt/equity ratio exceeds 2:1.

The evaluation criteria by the Controller of Capital Issues is in accordance with the guidelines & policies formulated by the Government from time to time under the changing environment. The main aspects which are taken into consideration are adequacy of capital structure, promoter's stake, issue price, listing of security and timing of issues etc. The above aspects are or can be considered under the fresh issue of capital by new companies, further issue of capital by existing companies of rights share and bonus shares.

1.4.3 The Securities Contract (Regulation) Act, 1956

The Securities Contract (Regulation) Act, 1956\(^\text{32}\) came into force throughout India on 20th Feb., 1957. This Act permits only those exchanges which have been recognised by the Central Government to function in any notified state or area. It prescribes the requirement, a company must comply with before its shares can be listed on any recognised stock exchange in the country.
There is no statutory obligation that every public limited company should get its share listed on a recognised stock exchange. However, a company declaring in the prospectus its intention of applying for enlistment is bound under Section 73 of the Companies Act, to make a listing application to the stock exchange concerned. It is also bound to abide by the prescribed requirements in order to have its shares admitted to dealings failing which it has to refund the application money to those who have subscribed for the share capital. Further, the Government reserves the power under Section 21 of the Securities Contracts (Regulation) Act, 1956 to compel a public limited company when it is so necessary or expedient, in the interests of the trade or of the public to comply with the prescribed requirements and list its shares on a recognised stock exchange.

This Act aims at having a strong and healthy investment market so that members of the public may invest their savings with full confidence. This Act, in conjunction with the Companies Act is envisaged to create those basic conditions on which the edifice of a sound and revitalised private sector can be built up. The Act prevents the undesirable transactions in securities and to regulate and control the activities of stock exchanges. Under this Act, the Central Government, has been vested with wide powers which imposes strict government control over the stock exchanges.

Under the provisions of this Act, the government may take appropriate action to provide for and ensure reasonable uniformity in respect of the rules and bye-laws of various stock
exchanged. It is helpful to prevent unhealthy speculations and other undesirable activities of stock exchanges and to take suitable disciplinary action against the members whose books/records reveals malpractices like excessive trading, under reporting of transactions, trading in unlisted securities etc. The government may also take action to have periodical inspection of the books of accounts and other records of members especially of those indulging in or suspected to be indulging in excessive speculative trading. The provisions of the Act mainly relates to recognition of stock exchange, control over the trading methods and practices of the recognised stock exchange, regulations and contracts and options in securities and listing of securities. These provisions have been discussed in detail under the head secondary market. This Act has been amended from time to time in accordance with the requirements so that control and management of secondary market is conducted efficiently and effectively. This Act is also helpful in activating the New Issue Market through secondary market. But there is need to bring a radical changes in the rules and bye laws of the stock exchanges in order to meet the growing volumes of securities and infrastructure available in the country. Though, various efforts have been made in this direction by the Government but it has not brought fruitful results.

In addition to the above Acts, the Payment of Bonus Act, 1965 was passed with a view to impose statutory liability upon employer of each establishment concerned by the
Act to pay bonus to employees in the establishment. The Ministry of Finance, Government of India, revised its guidelines of 14th August, 1975 for issue of bonus shares by a further announcement on 18th August, 1981. These provisions relate to capitalisation of reserves, increase in the authorised capital, rate of dividend, residual reserves, contingent liabilities and declaration of bonus issues etc.

These guidelines for the issue of bonus shares have also a great impact on the functioning of capital markets. According to the new scheme of incentives announced by the Central Government on 27th April, 1983, the backward areas of the country have been divided into 3 categories which consists of 299 districts. There are zero industry zones or areas where no industry has been set up. These districts have been identified and the efforts are being made to develop these areas.

To promote the developmental of small scale industries several measures have been taken such as units in the small scale sector need not obtain industrial licences provided the item of manufacture is not governed by special regulations. The Government of India has reserved numerous items exclusively for the small scale sector to ward off competition from larger undertakings. The Government of India provides comprehensive assistance to small entrepreneurs. These include market surveys, feasibility reports, training programmes and guidance in procurement of various inputs. Under the State Aid to Industries Act, the State Governments provide finance in the form of loans, guarantees for loans
raised from banks, subscription to shares and debentures etc. In addition to these, small scale industries are provided with financial assistance in various ways.

Thus, various Acts, which have been passed and amended from time to time has effected capital market in the recent years. It has made tremendous progress during last decade.

1.5 Conclusion

Finance plays the most crucial role in the economic development and building a strong infrastructure in a country, particularly in a developing country like India. The planned economic development can only be achieved, when a country has a well organised, regulated, efficient and effective capital market for mobilising the savings from the households, commercial undertakings etc. and channelising the funds in the proper direction as laid down in the national objectives. The role of the capital market can be gauged through its efficiency and effectiveness to meet the financial requirements of the Central Government, State Governments, local self Governments and the private corporate sector.

A well organised capital market, provides the essential attributes of liquidity, marketability, safety and price continuity to the long term securities. The borrowings by Government and local bodies and the operation of the various financial institutions make the capital market a complex organisational entity susceptible to pushes and pulls from several
directions. In India the capital market is not organised to that extent as in the developed countries like U.S.A., U.K. and Japan etc. But after independence, the stock market made tremendous progress in this field and a large number of financial institutions like I.D.B.I., I.F.C.I., I.C.I.C.I., S.F.C.s., S.I.D.C.s., L.I.C., U.T.I. and G.I.C. etc. came into existence to fill up the structural gaps. These various types of public financial institutions provide long term funds to public as well as private corporate sector. Commercial banks, issue houses, leasing companies, venture fund, mutual funds, etc. also play a significant role in developing the capital market.

Stock exchanges facilitate the sale of initial issues and subsequently provides liquidity and marketability to the securities subscribed by the individuals and institutions. The investors are always interested that their invested capital must be liquid and convertible. Thus, a well-organised stock market has proved undoubtedly a significant economic institution in a country. The security market has played a vital role to bring the economic prosperity by encouraging investment in securities. The new issue activity has been growing consistently, though there have been fluctuations from year to year. The security market has taken a new turn with the encouraging response of investing public in equity shares and debentures. The Government of India took various steps to activate the securities market like increasing the rate of dividend on preference shares and interest rate on debentures. It has also introduced the buy back arrangements by the investing institutions.
A series of changes has been observed in the pattern of capital issues because of many legislative steps taken by Government to bring efficiency in the functioning of capital market of the country and make passive securities to active securities. For protecting the interest of investors, the Government of India passed various legislation like Companies Act, 1956, Capital Issues (Control) Act, 1947, Securities Contracts (Regulation) Act, 1956. These legislations have brought many changes in the working of capital market in India, but there is need for bringing radical changes in view of the growing demands for funds.

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