

FINANCIAL MARKETS

Money Market & Capital Market

A Complete Study Note for University Examinations

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A) Financial Markets: Meaning & Importance

Meaning of Financial Market

- A **financial market** is a marketplace where buyers and sellers participate in the trade of financial assets such as shares, bonds, debentures, currencies and derivatives.
- It is a mechanism that **brings together the savers (surplus units) and the borrowers (deficit units)** of funds, enabling the flow of funds from those who have surplus money to those who need it.
- Financial markets **do not necessarily refer to a physical place**; the transactions can take place over the phone, through brokers, or electronically through online trading platforms.
- They facilitate the **creation and exchange of financial assets** and help in the determination of the price of these assets through the interaction of demand and supply.
- Financial markets are broadly classified into **Money Market** (for short-term funds) and **Capital Market** (for long-term funds).

A financial market may be defined as the mechanism through which funds flow from those economic units (individuals, households, businesses and government) that have surplus funds to those that are in need of funds. In simple terms, it is a platform that connects investors, who wish to invest their surplus money, with borrowers, who need funds for various purposes such as expansion of business, working capital requirements, or meeting government expenditure. The financial market performs the crucial economic function of channelling savings into productive investment, thereby contributing to the overall growth of the economy. It includes a wide range of markets such as the stock market, bond market, money market, foreign exchange market and derivatives market, each dealing with a specific type of financial instrument.

Importance of Financial Markets

- **Mobilisation of Savings:** Financial markets mobilise the scattered savings of individuals and institutions and channel them into productive investment avenues.
- **Capital Formation:** By connecting savers with borrowers, financial markets facilitate capital formation, which is essential for economic growth and development.
- **Price Discovery:** The interaction of buyers and sellers in the financial market helps in determining the fair price of financial assets based on demand and supply forces.
- **Provision of Liquidity:** Financial markets provide liquidity to investors by allowing them to buy and sell financial assets easily, thus converting investments into cash whenever required.
- **Reduction in Transaction Costs and Information Costs:** Financial markets reduce the cost and time required to search for prospective buyers and sellers, and also provide easy access to information about securities.
- **Facilitates Economic Growth:** By ensuring smooth flow of funds to productive sectors, financial markets contribute to industrialisation, employment generation and overall economic development.
- **Risk Sharing/Risk Transfer:** Financial markets, especially derivative markets, allow participants to transfer risk (such as price risk, interest rate risk) to those who are willing to bear it.
- **Facilitates Government Borrowing:** Financial markets, particularly the money market, enable governments to raise funds through instruments like treasury bills to meet short-term and long-term expenditure.
- **Helps in Monetary Policy Implementation:** Central banks use financial markets, especially the money market, as a medium to implement monetary policy and regulate money supply in the economy.

- **Encourages Entrepreneurship:** Availability of funds through capital markets encourages entrepreneurs to set up new ventures and expand existing businesses.

Financial markets occupy a pivotal position in any modern economy because they act as intermediaries between savers and investors, ensuring optimum allocation of scarce financial resources. Without well-developed financial markets, savings would remain idle and could not be converted into productive investment. Financial markets also provide a continuous valuation mechanism for financial assets, allow investors to diversify risk, and provide the government and central bank with tools to regulate liquidity and implement fiscal and monetary policy. In short, an efficient financial market system is a precondition for sustained economic growth, industrial development and financial stability of a nation.

B) Money Market

Concept of Money Market

- The **money market** is that segment of the financial market where short-term funds (with maturity of **one year or less**) are borrowed and lent.
- It deals in monetary assets whose **period of maturity is up to one year**, such as treasury bills, commercial paper, certificates of deposit, call money and commercial bills.
- It is **not a single physical location**, but a network of institutions such as commercial banks, RBI, non-banking financial companies, discount houses and acceptance houses dealing in short-term instruments.
- The main function of the money market is to provide a mechanism for **adjusting liquidity** of banks, financial institutions, and other short-term surplus/deficit units.
- It acts as a **balancing mechanism** for evening out short-term surpluses and deficits of funds in the economy.

The money market can be defined as a market for short-term funds and financial assets that are near substitutes for money. It enables participants to borrow and lend for periods ranging from overnight to one year. The instruments dealt with in the money market are highly liquid and carry low risk since they are generally issued by the government, banks and highly rated corporates. In India, the Reserve Bank of India (RBI) plays the central role in regulating the money market as it is closely linked with the implementation of monetary policy.

Objectives of Money Market

- **To provide an equilibrium mechanism** for evening out short-term demand for and supply of funds.
- **To provide a focal point for RBI's intervention** for influencing liquidity and general level of interest rates in the economy.
- **To provide reasonable access to users of short-term funds** so that their genuine requirements are met at a reasonable cost.
- **To enable the central bank (RBI)** to control the money supply and implement monetary policy effectively.
- **To provide short-term liquidity to banks and financial institutions** so that they can meet their day-to-day cash requirements.
- **To facilitate the government** in raising short-term funds at low cost through instruments like treasury bills.

The money market is designed to serve several interlinked objectives. First, it ensures that funds flow smoothly between institutions with a temporary surplus and those facing a temporary shortage, thereby maintaining liquidity in the banking system. Second, it acts as a transmission channel through which the central bank's monetary policy actions get transmitted to the rest of the economy. Third, it provides an avenue for the government and corporates to raise low-cost, short-term working capital. Overall, a well-functioning money market ensures stability of short-term interest rates and efficient utilisation of surplus funds available with banks and institutions.

Instruments of Money Market

- **Treasury Bills (T-Bills):** Short-term borrowing instruments issued by the Government of India, sold at a discount and repaid at par value, with maturities of 91 days, 182 days, and 364 days.

- **Commercial Paper (CP):** An unsecured, short-term promissory note issued by highly rated corporates to raise funds directly from the market, usually for meeting working capital requirements.
- **Certificate of Deposit (CD):** A negotiable, unsecured instrument issued by banks and financial institutions to raise short-term funds from the market at a market-determined interest rate.
- **Call Money/Notice Money:** Money borrowed or lent for a very short period, generally overnight (call money) or for a period up to 14 days (notice money), mainly used by banks to meet reserve requirements.
- **Commercial Bills (Bills of Exchange):** A short-term, negotiable, self-liquidating instrument used to finance credit sales of goods, which can be discounted with a bank before maturity.
- **Repurchase Agreements (Repo & Reverse Repo):** Short-term borrowing/lending arrangements in which securities are sold with an agreement to repurchase them at a future date at a predetermined price; used by RBI to manage liquidity.
- **Banker's Acceptance:** A time draft drawn on and accepted by a bank, guaranteeing payment on a specified date, commonly used in international trade financing.
- **Money Market Mutual Funds (MMMFs):** Mutual fund schemes that invest exclusively in money market instruments, providing small investors an opportunity to participate in the money market.

Each of these instruments differs in terms of issuer, maturity period, degree of risk, negotiability and yield. Treasury bills are considered the safest instrument since they are backed by the sovereign guarantee of the government, while commercial paper and certificates of deposit carry slightly higher risk as they are issued by corporates and banks respectively. Call money is the most liquid and is used predominantly by banks for maintaining the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). Together, these instruments give depth and variety to the money market and allow different classes of participants to manage their short-term liquidity requirements efficiently.

Characteristics of Indian Money Market

- **Dichotomic Structure:** The Indian money market is divided into two sectors — the organised sector (comprising RBI, commercial banks, and financial institutions) and the unorganised sector (comprising indigenous bankers and money lenders).
- **Multiplicity of Interest Rates:** There exist several rates of interest prevailing at the same time for the same type of instrument, prevailing due to lack of mobility of funds from one section of the market to another.
- **Seasonal Stringency of Funds:** The demand for money is highly seasonal in India due to the agrarian nature of the economy, leading to variations in demand for funds during the busy season (November to June) and slack season.
- **Absence of Integration:** There is a lack of proper integration between different segments of the money market, and also between the organised and unorganised sectors.
- **Predominance of Cash Transactions:** A large part of the transactions, especially in rural areas, are conducted in cash rather than through negotiable instruments.
- **Existence of Indigenous Bankers:** Indigenous bankers and money lenders still play a significant role in providing credit in the unorganised sector.
- **Lack of Organised Bill Market:** The bill market in India is not as developed as in advanced countries due to lack of standardisation and reluctance of parties to use bills.
- **Dominance of RBI:** RBI plays a dominant role in regulating and controlling the money supply and interest rates in the Indian money market through various monetary policy tools.

- **Growing Institutionalisation:** In recent years, the Indian money market has seen greater institutionalisation with the emergence of Discount and Finance House of India (DFHI), money market mutual funds and other specialised institutions.

The Indian money market has certain distinctive features that set it apart from money markets in developed economies. It continues to exhibit a dual character with a well-regulated organised sector operating alongside a less regulated, traditional unorganised sector comprising indigenous bankers and moneylenders, particularly in rural areas. Interest rates in the Indian money market are not uniform and tend to vary widely across regions and institutions due to poor mobility of funds. Furthermore, the seasonal nature of the Indian economy, driven by agriculture, creates a fluctuating demand for short-term credit throughout the year. Despite reforms since the 1990s aimed at deepening and widening the market through new instruments and institutions, certain structural characteristics inherited from the past continue to influence the functioning of the Indian money market.

Defects of Indian Money Market

- **Absence of Integration:** There is a lack of integration between various segments of the money market and also between the organised and unorganised sectors, leading to inefficient allocation of funds.
- **Multiplicity and Disparity of Interest Rates:** Different interest rates prevail simultaneously in various segments due to poor mobility of funds, creating inefficiency in the pricing of credit.
- **Shortage of Funds/Seasonal Stringency:** The Indian money market suffers from a chronic shortage of funds, and this shortage becomes acute during the busy season due to the seasonal nature of agriculture and industry.
- **Absence of Organised Bill Market:** The market for bills of exchange is underdeveloped, restricting an important source of short-term finance for trade and industry.
- **Inadequate Banking Facilities:** Despite expansion, banking facilities remain inadequate in rural and semi-urban areas, forcing borrowers to depend on indigenous bankers and money lenders who charge exorbitant interest rates.
- **Lack of Uniformity in Banking Practices:** Different banks and financial institutions follow different lending norms, documentation, and practices, leading to a lack of standardisation.
- **Existence of Unorganised Sector:** The continued dominance of the unorganised sector (indigenous bankers, moneylenders) makes it difficult for RBI to regulate and control the entire money market effectively.
- **Limited Instruments in the Past:** Historically, the Indian money market suffered from a narrow range of instruments, restricting the choices available to investors and borrowers (though this has improved with reforms).
- **Poor Mobility of Funds:** Funds do not flow easily from one segment of the market to another or from one region to another, leading to imbalances in the availability of credit.

The Indian money market, despite considerable progress after the financial sector reforms of the 1990s, continues to suffer from certain structural weaknesses. The persistence of the unorganised sector, comprising indigenous bankers and money lenders who operate outside the purview of RBI regulation, creates a parallel credit system with significantly higher interest rates. The lack of integration among sub-markets means that surplus funds in one segment cannot be easily transferred to a deficit segment, leading to disparity in interest rates across the country. Additionally, the seasonal nature of demand for credit, especially linked to agricultural operations, creates periodic stringency of funds. These defects reduce the overall efficiency of the money market in channelling funds and implementing monetary policy uniformly across the economy.

Measures to Improve the Indian Money Market

- **Establishment of Specialised Institutions:** Setting up of institutions like the Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI) to develop and stabilise the money market.
- **Introduction of New Instruments:** Introduction of instruments such as Commercial Paper, Certificates of Deposit, and Repo/Reverse Repo to widen and deepen the money market.
- **Deregulation of Interest Rates:** Gradual deregulation of interest rates on money market instruments to allow market forces to determine rates and reduce distortions.
- **Development of the Bill Market:** Encouraging the use and discounting of commercial bills through schemes like the Bill Market Scheme introduced by RBI to develop an organised bill market.
- **Expansion of Banking Network:** Extending banking facilities to rural and semi-urban areas to reduce dependence on indigenous bankers and money lenders.
- **Integration of Organised and Unorganised Sectors:** Steps to bring the unorganised sector under the regulatory ambit of RBI to achieve better coordination and control.
- **Electronic Trading and Settlement Systems:** Introduction of electronic dealing systems such as Negotiated Dealing System (NDS) and Real Time Gross Settlement (RTGS) to improve efficiency and transparency.
- **Entry of New Participants:** Allowing entry of Money Market Mutual Funds and other financial institutions to widen the investor base and improve liquidity.
- **Strengthening of Regulatory Framework:** Continuous strengthening of RBI's regulatory and supervisory framework to ensure stability and prevent excessive volatility.
- **Improved Communication and Technology:** Use of modern technology and communication systems to improve fund mobility and information flow between different centres and institutions.

Recognising the defects in the money market, the Reserve Bank of India, especially after the recommendations of the Sukhamoy Chakravarty Committee (1985) and the Narasimham Committee (1991), initiated a series of reforms. These reforms focused on introducing new short-term instruments to widen the market, deregulating interest rates to make them market-determined, developing an active bill market, and encouraging the participation of a wider range of institutions such as money market mutual funds. Additionally, technological upgrades such as the Negotiated Dealing System and Real Time Gross Settlement have improved transparency, efficiency and speed of transactions. These measures, taken together, have significantly improved the depth, liquidity and efficiency of the Indian money market, even though certain structural challenges continue to persist, especially in rural areas.

C) Capital Market

Concept of Capital Market

- The **capital market** is that segment of the financial market which deals in **long-term funds**, i.e., funds with a maturity period of **more than one year**.
- It provides a platform for raising **medium and long-term capital** through instruments such as shares, debentures and bonds.
- It is a market for **both equity and debt instruments**, and includes both the primary market (new issues) and the secondary market (existing securities).
- The capital market channels the savings of households and institutions into **long-term productive investments** in industry, infrastructure and government projects.
- Participants include companies, government, financial institutions, mutual funds, insurance companies, foreign institutional investors (FIIs) and individual investors.

The capital market may be defined as the institutional arrangement for borrowing and lending long-term funds required for setting up new business units, expansion, or modernisation of existing enterprises, and for financing long-term government expenditure. Unlike the money market, which deals with instruments having maturity of less than one year, the capital market deals with medium and long-term securities. The capital market is broadly divided into the primary market, where new securities are issued for the first time, and the secondary market, where already issued securities are bought and sold among investors. The Securities and Exchange Board of India (SEBI) is the principal regulator of the capital market in India.

Objectives of Capital Market

- **Mobilisation of Long-Term Savings:** To mobilise the long-term savings of individuals and institutions and channel them towards productive investment.
- **Facilitation of Capital Formation:** To provide a mechanism through which businesses and government can raise long-term capital for expansion, modernisation, and infrastructure development.
- **Provision of Liquidity:** To provide liquidity to investors by enabling them to buy and sell securities easily in the secondary market.
- **Price Discovery:** To facilitate fair price discovery of securities through the forces of demand and supply operating in an organised market.
- **Encouragement of Industrial Growth:** To provide adequate funds for industrial and infrastructural growth of the economy, thereby contributing to overall economic development.
- **Risk Diversification:** To provide investors with a variety of instruments so that they can diversify their investment portfolio and manage risk.
- **Reduction of Transaction Costs:** To reduce the cost and time involved in bringing together borrowers and lenders of long-term funds.
- **Investor Protection:** To ensure protection of investor interests through proper regulation, disclosure requirements and grievance redressal mechanisms.

The capital market serves the fundamental purpose of bridging the gap between savers and long-term users of funds in the economy. Its objectives extend beyond mere fund mobilisation; it is also expected to provide a fair and transparent price discovery mechanism, ensure adequate liquidity for investors, and protect the interests of small investors through appropriate regulatory oversight. In India, this regulatory role is primarily discharged by SEBI, which has, over the years, introduced measures such as dematerialisation of securities, online trading, and stringent disclosure norms to make the capital market more efficient, transparent and investor-friendly.

Types of Capital Market

(i) Primary Market

- The **primary market**, also known as the **new issue market**, is where companies raise **fresh capital by issuing new securities** for the first time to the public or select investors.
- Funds raised in the primary market flow **directly to the issuing company or government**, unlike the secondary market where transactions occur between investors.
- **Methods of raising capital in the primary market include:**
 - **Public Issue/IPO (Initial Public Offer):** Offering shares to the general public for the first time through a prospectus.
 - **Further Public Offer (FPO):** A listed company issuing additional shares to the public to raise further capital.
 - **Rights Issue:** Offering new shares to existing shareholders in proportion to their current holding, usually at a discounted price.
 - **Private Placement:** Selling securities directly to a select group of institutional or high-net-worth investors rather than to the general public.
 - **Preferential Allotment:** Issue of shares or convertible securities to a select group of investors at a price determined as per SEBI guidelines.
 - **Offer for Sale:** Existing shareholders (often promoters) offering their shares to the public through the stock exchange mechanism.
 - **Bonus Issue:** Issue of additional shares to existing shareholders free of cost, out of the company's reserves, in proportion to their holding.

The primary market plays a crucial role in capital formation as it is the source through which new capital enters the economy. Companies use the primary market to raise funds for setting up new projects, expansion, diversification, or repayment of existing debt. Various intermediaries such as merchant bankers, underwriters, registrars and lead managers assist companies in the process of issuing securities. SEBI regulates the primary market to ensure adequate disclosure of information to investors through the prospectus and to protect investors from fraudulent and unfair practices.

(ii) Secondary Market

- The **secondary market**, also known as the **stock market or stock exchange**, is where **already issued securities are bought and sold** among investors.
- Unlike the primary market, funds raised in the secondary market **do not flow to the company**; they merely change ownership between investors.
- In India, the major stock exchanges include the **Bombay Stock Exchange (BSE)** and the **National Stock Exchange (NSE)**.
- **Functions of the secondary market include:**
 - Providing **liquidity and marketability** to existing securities.
 - Ensuring **continuous price discovery** of securities based on demand and supply.
 - Providing a **safe and transparent** mechanism for the transfer of securities.
 - Reflecting the **health of the economy** through market indices such as Sensex and Nifty.
- **Characteristics of the secondary market:**
 - It operates through **recognised stock exchanges** under the regulation of SEBI.

- Trading is conducted through **registered brokers/sub-brokers** and now predominantly through **electronic/online trading platforms**.
- Prices of securities are determined **continuously** based on demand and supply during trading hours.

The secondary market complements the primary market by providing an efficient mechanism through which investors can convert their securities into cash whenever needed. This liquidity feature encourages more investors to participate in the primary market as well, since they know they can exit their investment whenever required. Stock exchanges also perform an important role in providing continuous and transparent pricing information, which helps investors make informed decisions. With the advent of dematerialisation and online trading, the Indian secondary market has become highly efficient, transparent, and accessible to investors across the country.

Instruments of Capital Market

- **Equity Shares:** Represent ownership in a company and entitle the holder to a share in profits (dividend) and voting rights; equity shareholders bear the highest risk but also enjoy the potential for higher returns.
- **Preference Shares:** Shares that carry a fixed rate of dividend and have preference over equity shares in payment of dividend and repayment of capital at the time of winding up, but generally do not carry voting rights.
- **Debentures/Bonds:** Long-term debt instruments issued by companies or government to raise borrowed funds, carrying a fixed rate of interest and a specified maturity date.
- **Government Securities (G-Secs):** Long-term securities issued by the central or state government to raise funds, generally considered risk-free due to sovereign backing.
- **Zero Coupon Bonds:** Bonds issued at a discount to their face value and redeemed at par, without any periodic interest payment.
- **Convertible Debentures:** Debentures that can be converted into equity shares of the company after a specified period, as per the terms of issue.
- **Mutual Fund Units:** Units issued by mutual funds representing a proportionate share in a diversified portfolio of securities managed by professional fund managers.
- **Derivatives (Futures & Options):** Financial contracts whose value is derived from an underlying asset such as shares, indices or commodities, used mainly for hedging and speculation.

The capital market offers a diverse range of instruments catering to different risk appetites and investment objectives of investors. Equity instruments such as ordinary and preference shares provide ownership and a share in the company's profits, while debt instruments such as debentures, bonds and government securities provide fixed returns with comparatively lower risk. Hybrid instruments like convertible debentures combine the features of both debt and equity. The presence of such a wide variety of instruments enables investors to construct a diversified portfolio according to their risk-return preference, while giving companies and the government multiple avenues to raise long-term capital.

Money Market vs Capital Market

Although both the money market and the capital market are integral components of the financial market and perform the common function of channelling funds from savers to borrowers, they differ significantly in terms of the nature of instruments dealt with, tenure, participants, risk, liquidity and regulatory framework. The following table highlights the key points of distinction between the two markets:

Basis of Distinction	Money Market	Capital Market
Meaning	Market for short-term funds and instruments	Market for medium and long-term funds and instruments
Maturity Period	Up to one year	More than one year
Instruments	Treasury bills, commercial paper, certificates of deposit, call money, commercial bills	Equity shares, preference shares, debentures, bonds, government securities
Purpose	To meet short-term working capital and liquidity requirements	To meet long-term capital requirements such as expansion and modernisation
Risk Involved	Low risk due to short tenure and high credit quality of issuers	Comparatively higher risk, especially in equity instruments
Liquidity	Highly liquid	Relatively less liquid than money market instruments, though secondary market provides liquidity
Return/Yield	Lower returns due to short tenure and low risk	Generally higher returns to compensate for higher risk
Participants	RBI, commercial banks, financial institutions, corporates	Companies, government, individual investors, mutual funds, FII, insurance companies
Regulator (India)	Reserve Bank of India (RBI)	Securities and Exchange Board of India (SEBI)
Market Type	Informal, over-the-counter in nature	Organised, operates mainly through recognised stock exchanges
Basic Function	Provides working capital/liquidity adjustment	Provides fixed capital/long-term investment

In essence, the money market and the capital market are complementary rather than competing segments of the financial system. While the money market ensures short-term liquidity and helps in the implementation of monetary policy, the capital market provides the long-term funds necessary for capital formation, industrial growth and infrastructure development. A well-developed financial system requires both markets to function efficiently and in a coordinated manner, since together they provide the complete range of financial instruments needed by savers and borrowers across different time horizons.

INSTRUMENTS OF MONEY MARKET

and

PRIMARY & SECONDARY MARKET OF CAPITAL MARKET

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Instruments of Money Market

The money market deals in a variety of short-term instruments, each having a maturity of up to one year. These instruments differ in terms of issuer, degree of risk, liquidity and yield, but all of them serve the common purpose of providing short-term funds to borrowers and a safe avenue of investment to lenders. The important instruments of the money market are discussed below in detail.

1. Treasury Bills (T-Bills)

- **Meaning:** Treasury Bills are short-term debt instruments **issued by the Government of India** through the Reserve Bank of India to raise short-term funds for meeting temporary cash flow mismatches.
- **Issuer:** Issued only by the **Central Government**; state governments do not issue treasury bills.
- **Maturity:** Available in three maturities — **91 days, 182 days and 364 days**.
- **Method of Issue:** Issued at a **discount to face value** and redeemed at par (face value) on maturity; the difference represents the return to the investor.
- **Risk-Free Nature:** Considered the **safest money market instrument** since they carry a sovereign guarantee, hence practically zero default risk.
- **Highly Liquid:** T-Bills are **highly liquid** and can be easily sold in the secondary market before maturity.
- **Minimum Investment:** Issued in denominations as low as ₹25,000 and in multiples thereof, making them accessible to a wide range of investors.
- **Method of Sale:** Sold through **auctions** conducted by RBI on behalf of the Government, generally on a weekly basis.
- **No Interest Payment:** Being discount instruments, T-Bills **do not carry any explicit interest/coupon rate**; the return is the difference between issue price and face value.
- **Used for SLR Compliance:** Banks use treasury bills to meet their **Statutory Liquidity Ratio (SLR)** requirements.

Treasury Bills are one of the oldest and most important instruments of the Indian money market. They are issued by the RBI on behalf of the Central Government to bridge temporary mismatches between government receipts and expenditure. Since they are backed by the sovereign guarantee of the Government of India, treasury bills are regarded as one of the safest instruments available in the financial system, carrying virtually no default risk. They are sold through a competitive bidding (auction) process, in which banks, primary dealers, financial institutions, and increasingly individuals and corporates, participate. Because they are issued at a discount and redeemed at face value, the yield on treasury bills is implicit in the difference between the purchase price and the redemption value, rather than being paid out as periodic interest. Treasury bills also play a critical role in the conduct of monetary policy — RBI uses these instruments in its open market operations to regulate liquidity in the banking system. Additionally, since treasury bills qualify as approved securities, commercial banks hold them to meet their Statutory Liquidity Ratio requirement mandated by RBI. The active secondary market in treasury bills also gives them a high degree of liquidity, allowing holders to sell their holdings before maturity if they need funds urgently. Overall, treasury bills serve the dual purpose of helping the government manage its short-term cash needs at a low cost, while providing banks, institutions and investors with a safe, liquid, and reasonably remunerative short-term investment avenue.

2. Commercial Paper (CP)

- **Meaning:** Commercial Paper is an **unsecured, short-term promissory note** issued by highly-rated corporates, primary dealers and financial institutions to raise funds directly from the money market.

- **Issuer:** Issued by **large, creditworthy companies**, primary dealers, and All-India Financial Institutions (AIFIs).
- **Purpose:** Primarily used to **finance working capital requirements** and as a substitute for bank borrowing.
- **Maturity:** Ranges from a **minimum of 7 days to a maximum of 1 year** from the date of issue.
- **Unsecured Instrument:** CP is **not backed by any collateral or security**, hence it can only be issued by entities with a strong credit standing.
- **Credit Rating Requirement:** A company must obtain a **minimum specified credit rating** from an approved credit rating agency before it can issue CP.
- **Discount Instrument:** Like treasury bills, CP is issued at a **discount to its face value** and redeemed at par.
- **Denomination:** Issued in **multiples of ₹5 lakh**, with a minimum investment amount prescribed by RBI guidelines.
- **Negotiable & Transferable:** CP is a **negotiable instrument** and can be freely transferred by endorsement and delivery.
- **Cost-Effective Source of Funds:** Since it bypasses banks, CP is often a **cheaper source of short-term finance** than bank credit for highly-rated companies.

Commercial Paper emerged as an important money market instrument in India after being introduced by the RBI in 1990 as part of financial sector reforms, with the objective of enabling highly rated corporate borrowers to diversify their sources of short-term finance and reducing their dependence on bank credit. Since CP is unsecured, only companies, primary dealers and financial institutions with a sound financial position and a high credit rating are permitted to issue it, which protects investors from undue credit risk. The instrument is issued at a discount to its face value, and the investor's return is the difference between the discounted issue price and the face value received on maturity. CP can be issued in physical form as a promissory note or, more commonly today, in dematerialised form through depositories, which enhances its transferability and reduces settlement risk. Being a negotiable instrument, CP can be freely bought and sold in the secondary market before maturity, providing liquidity to investors such as banks, mutual funds, insurance companies and corporates with surplus funds. From the issuer's perspective, CP allows companies to raise funds at a rate that is often lower than the prime lending rate charged by banks, especially during periods of tight bank liquidity, making it a cost-effective and flexible instrument for meeting short-term and working capital requirements. However, because CP is unsecured, investors bear a degree of credit risk, which is mitigated primarily through the mandatory credit rating requirement and continuous monitoring by rating agencies. Overall, Commercial Paper has significantly deepened the Indian money market by providing an additional, market-based, low-cost avenue of short-term finance for corporates and a good investment option for institutional investors with idle short-term funds.

3. Certificate of Deposit (CD)

- **Meaning:** A Certificate of Deposit is a **negotiable, unsecured money market instrument** issued by banks and select financial institutions in dematerialised form against funds deposited for a specified period.
- **Issuer:** Issued by **scheduled commercial banks** (excluding regional rural banks) and select **All-India Financial Institutions**.
- **Maturity:** Issued by banks for a period ranging from **7 days to 1 year**; financial institutions can issue CDs for **1 year to 3 years**.
- **Nature:** CDs are issued **against funds deposited** with the bank for a fixed period, similar to a fixed deposit, but are **freely transferable**.

- **Discount Instrument:** Generally issued at a **discount to face value**, though they can also be issued at face value with interest paid on maturity.
- **Negotiability:** Unlike ordinary fixed deposits, CDs can be **traded in the secondary market** before maturity, offering liquidity to the holder.
- **Denomination:** Issued in a minimum denomination of **₹5 lakh**, and in multiples thereof.
- **No Premature Withdrawal/Lock-in:** Banks **cannot grant loans against CDs**, nor can they buy back their own CDs before maturity, though holders can sell them in the market.
- **Interest Rate:** The interest/discount rate on CDs is **market-determined**, based on demand and supply conditions and prevailing money market rates.
- **Investors:** Typically subscribed to by **corporates, mutual funds, provident funds, and other institutional investors** with short-term surplus funds.

Certificates of Deposit were introduced in India in 1989 to provide banks with an additional instrument for mobilising bulk deposits at market-related rates and to give investors a liquid, negotiable alternative to conventional fixed deposits. A CD essentially represents evidence of a deposit made with a bank, but unlike a normal term deposit, it is a marketable and transferable instrument, which means the holder is not required to wait until maturity to access funds — the CD can instead be sold to another investor in the secondary market. Since CDs are unsecured, banks issue them without any collateral, relying on their own creditworthiness, and consequently the interest or discount rate offered depends on the issuing bank's standing and prevailing market conditions. CDs are usually issued at a discount to their face value and redeemed at par, although interest-bearing CDs are also permitted under RBI guidelines. Because they are issued in large denominations, CDs are primarily subscribed to by institutional investors such as corporates, mutual funds, insurance companies, and other entities with sizeable short-term surplus funds, rather than by retail investors. From the bank's point of view, CDs provide a flexible tool to raise bulk deposits quickly, especially during periods when there is a shortage of liquidity or when banks wish to reduce their dependence on more expensive sources of funds. For investors, CDs offer a relatively safe, short-term investment option with better returns than a savings account and more liquidity than a conventional fixed deposit due to their tradability. Overall, Certificates of Deposit have added depth to the Indian money market by bridging the gap between the banking system's need for stable deposits and the investing community's need for liquid, low-risk, short-term investment instruments.

4. Call Money and Notice Money

- **Meaning:** Call Money refers to funds borrowed or lent for a **very short period, generally overnight (one day)**, mainly among banks and financial institutions to manage day-to-day liquidity mismatches.
- **Notice Money:** When funds are borrowed or lent for a period of **more than one day but up to 14 days**, it is referred to as Notice Money.
- **Participants:** Mainly transacted among **scheduled commercial banks, co-operative banks and primary dealers**; the RBI has progressively restricted access to non-bank participants.
- **Purpose:** Used by banks primarily to **meet their Cash Reserve Ratio (CRR)** requirements and other temporary liquidity shortfalls.
- **Unsecured Nature:** These are **uncollateralised/unsecured** borrowings and lendings between participants.
- **Interest Rate:** The interest rate is called the **call rate**, which is highly sensitive and fluctuates depending on the demand-supply position of funds in the banking system.
- **Most Liquid Segment:** Call and notice money is considered the **most liquid and sensitive segment** of the money market.

- **No Collateral Security:** Since there is **no collateral**, this segment is confined mainly to highly reputed institutions with mutual trust.
- **Barometer of Liquidity:** The call money rate is often used as a **barometer of short-term liquidity** conditions in the banking system and is closely watched by RBI.
- **Settlement:** Transactions are typically **settled electronically** through the Negotiated Dealing System (NDS) and Clearing Corporation of India Limited (CCIL).

The call money and notice money market forms the core of the Indian money market and is often described as its heart, since it is the segment through which banks manage their minute-to-minute and day-to-day liquidity requirements. Every bank is required to maintain a certain proportion of its deposits as cash reserves with the RBI under the Cash Reserve Ratio (CRR) mandate. On any given day, some banks may find themselves with a surplus of funds over and above their reserve requirements, while others may face a temporary shortfall. The call money market provides an efficient mechanism for banks with surplus funds to lend to those facing a shortage, generally on an overnight basis, and for notice money, for periods extending up to 14 days. Because these transactions are unsecured, participation is largely restricted to entities with strong creditworthiness and established relationships, primarily scheduled commercial banks, co-operative banks, and primary dealers, since the RBI has over time phased out participation by non-bank entities to reduce systemic risk in this segment. The interest rate prevailing in this market, known as the call rate, is extremely sensitive to short-term liquidity conditions and can fluctuate significantly within a single day depending on factors such as the outflow of funds for tax payments, government borrowing programmes, or festival-related cash demand. Because of this sensitivity, the call rate serves as an important indicator for the RBI to assess overall liquidity conditions in the banking system and to decide on appropriate monetary policy interventions, such as repo operations. Settlement of call and notice money transactions takes place electronically through the Negotiated Dealing System and is guaranteed by the Clearing Corporation of India Limited, which significantly reduces settlement risk. In essence, the call and notice money market ensures that the banking system as a whole remains liquid, stable, and able to meet its statutory and operational cash requirements smoothly on a continuous, day-to-day basis.

5. Commercial Bills (Bills of Exchange)

- **Meaning:** A Commercial Bill, or Bill of Exchange, is a **negotiable, self-liquidating instrument** used to finance credit sales of goods between a buyer and a seller.
- **Parties Involved:** Involves a **drawer** (seller/creditor), a **drawee** (buyer/debtor who accepts the bill), and a **payee** (who receives payment, often the drawer or bank).
- **Origin:** Arises out of a **genuine trade transaction**, i.e., the sale and purchase of goods on credit.
- **Maturity:** Typically has a **short maturity period, usually 30, 60, or 90 days**.
- **Self-Liquidating:** Considered self-liquidating because it is backed by an **actual movement of goods**, and payment is expected from the sale proceeds.
- **Discounting Facility:** The seller (drawer), instead of waiting for the bill to mature, can **discount it with a bank** and receive immediate funds, minus a discount charge.
- **Types of Bills:** Can be a **Demand Bill** (payable immediately on presentation) or a **Usance Bill** (payable after a specified period).
- **Documentary and Clean Bills:** May be a **Documentary Bill** (accompanied by documents of title to goods) or a **Clean Bill** (without supporting documents).
- **Rediscounting:** Banks that discount bills can further **rediscount them with other banks, financial institutions or RBI** to manage their own liquidity.
- **Legal Backing:** Governed by the **Negotiable Instruments Act, 1881**, which gives it strong legal enforceability.

Commercial bills, also known as trade bills or bills of exchange, are among the oldest instruments used to finance trade credit and are directly linked to genuine commercial transactions involving the sale of goods. When a seller sells goods to a buyer on credit, instead of waiting for the agreed credit period to lapse, the seller can draw a bill of exchange on the buyer, who accepts it by signing across its face, thereby creating a legal obligation to pay the specified amount on the due date. Once accepted, the seller has the option of holding the bill until maturity or, more commonly, discounting it with a commercial bank to obtain immediate funds, with the bank deducting an appropriate discount charge based on the prevailing discount rate and the remaining tenure of the bill. This discounting mechanism converts a trade receivable into ready cash for the seller well before the credit period actually expires, thereby easing working capital pressures. From the bank's perspective, discounting bills is an attractive short-term lending activity since the underlying transaction is backed by an actual movement of goods, making the bill relatively safer and self-liquidating in nature, because repayment is expected to come from the sale proceeds of the goods themselves. Banks that have discounted bills are not necessarily required to hold them until maturity; they can, in turn, rediscount these bills with other banks, specialised financial institutions, or with the RBI, thereby further improving their own liquidity position. Despite these advantages, the commercial bill market in India has historically remained underdeveloped compared to advanced economies, largely due to reluctance among trading parties to use bills, the dominance of open, unsecured trade credit practices, and stamp duty considerations. Nevertheless, commercial bills remain an important instrument in principle, since they directly link the money market to the real, productive trade and commerce sector of the economy, providing short-term finance exactly where it is needed — in the working capital cycle of buying and selling goods.

6. Repurchase Agreements (Repo and Reverse Repo)

- **Meaning:** A Repo (Repurchase Agreement) is a transaction in which one party **sells securities to another with an agreement to repurchase** them at a future date at a predetermined price.
- **Reverse Repo:** From the perspective of the party **purchasing the securities** with an agreement to resell them later, the same transaction is called a Reverse Repo.
- **Nature:** Essentially a **collateralised short-term borrowing/lending** transaction, since the securities act as collateral for the funds exchanged.
- **Tenure:** Repo transactions can range from **overnight to a few days**, though longer-term repos (term repos) are also used.
- **Monetary Policy Tool:** RBI uses the **Repo Rate and Reverse Repo Rate** as key tools to inject or absorb liquidity in the banking system under the Liquidity Adjustment Facility (LAF).
- **Repo Rate:** The rate at which RBI **lends short-term funds to commercial banks** against government securities.
- **Reverse Repo Rate:** The rate at which RBI **absorbs excess liquidity** from banks by borrowing funds against securities.
- **Eligible Securities:** Typically conducted using **government securities, treasury bills** and other approved securities as collateral.
- **Low Risk:** Since transactions are backed by **high-quality collateral**, repos carry very low credit risk.
- **Market Participants:** Mainly used by **banks, primary dealers, and RBI** to manage short-term liquidity in the financial system.

Repurchase agreements form a critical part of the money market and serve as the primary mechanism through which the Reserve Bank of India manages short-term liquidity in the banking system under its Liquidity Adjustment Facility. In a repo transaction, a bank or financial institution facing a temporary shortage of funds sells government securities to another party, typically the RBI, with a simultaneous agreement to repurchase the same securities at a later date at a slightly higher price, with the price difference representing the interest

cost, known as the repo rate. Conversely, when a bank has surplus funds and wishes to park them safely for a short period while earning a return, it can enter into a reverse repo transaction with the RBI, effectively lending funds against government securities as collateral and receiving the reverse repo rate as return. Because these transactions are fully backed by high-quality government securities as collateral, repos and reverse repos are considered extremely safe, low-risk instruments, and they involve minimal counterparty risk compared to unsecured instruments such as call money. The repo rate is one of the most important tools of monetary policy in India — whenever RBI wishes to inject liquidity into the system to encourage lending and reduce interest rates, it lowers the repo rate, making it cheaper for banks to borrow; conversely, to control inflation and tighten liquidity, RBI raises the repo rate. Similarly, the reverse repo rate acts as a floor for short-term interest rates, since banks would prefer to lend to RBI at the reverse repo rate rather than at a lower rate elsewhere. Besides RBI-related transactions, repo agreements are also actively used between banks, primary dealers, and other financial institutions to manage their own short-term surplus and deficit positions, backed by government securities held in their portfolios. The introduction and progressive strengthening of the repo market, including the development of the tri-party repo mechanism through the Clearing Corporation of India, has significantly enhanced the depth, safety and efficiency of the Indian money market, making it an indispensable tool for both monetary policy transmission and day-to-day liquidity management.

7. Banker's Acceptance (BA)

- **Meaning:** A Banker's Acceptance is a **time draft (bill of exchange) drawn on and accepted by a bank**, which guarantees payment of a specified amount on a specified future date.
- **Function:** Primarily used to **finance international trade transactions**, such as import and export of goods, by providing a payment guarantee.
- **Process:** An exporter draws a draft on the importer's bank; once the **bank 'accepts' the draft**, it becomes an unconditional obligation of the bank to pay on maturity.
- **Negotiability:** Once accepted, a BA becomes a **negotiable instrument** and can be bought and sold in the secondary money market before maturity, generally at a discount.
- **Maturity:** Typically has a **short maturity, usually ranging from 30 to 180 days**.
- **Credit Enhancement:** Since the **bank's creditworthiness backs the instrument** rather than the individual importer's, BAs carry low credit risk and are attractive to investors.
- **Discount Instrument:** BAs are generally **sold at a discount** to face value in the market, similar to commercial paper and treasury bills.
- **Facilitates Trade Finance:** Provides exporters with **assurance of payment** and importers with a convenient mechanism to defer actual cash outflow until maturity.
- **Global Usage:** Although more prevalent in international markets such as the USA, BAs are also used to a limited extent to finance **cross-border trade transactions in India**.

A Banker's Acceptance is essentially a specialised form of a bill of exchange that carries the added credibility of a bank's guarantee, making it one of the safer and more marketable money market instruments used mainly in the financing of international trade. The process typically begins when an exporter, having shipped goods to an overseas buyer, draws a time draft on the importer's bank as specified under a letter of credit arrangement. When the bank on which the draft is drawn formally 'accepts' it by stamping and signing across its face, the instrument transforms into a Banker's Acceptance, and the accepting bank becomes primarily liable to honour the payment on the specified maturity date, regardless of whether the importer eventually pays the bank or not. This substitution of the bank's credit standing for that of the individual importer significantly reduces the risk perceived by the exporter or any subsequent holder of the instrument, making Banker's Acceptances attractive, tradable instruments in the money market. Once accepted, the exporter need not wait until the maturity date to receive payment; the BA can be sold immediately in the secondary market at a discount to its

face value, thereby providing the exporter with immediate liquidity while transferring the credit risk (already minimal due to the bank's backing) to the buyer of the instrument, typically another bank, a money market fund, or a corporate treasury with short-term surplus funds. From the importer's perspective, the acceptance mechanism allows them to defer actual cash payment until the maturity date while still assuring the exporter of timely payment, which facilitates smoother international trade relationships. Because the ultimate obligor is a reputed bank, Banker's Acceptances are considered relatively low-risk instruments, and their yield generally falls between that of treasury bills and commercial paper, reflecting their intermediate risk profile. Although the Banker's Acceptance market is significantly more developed in economies such as the United States, where it has traditionally been an important tool for trade finance, the underlying concept and mechanism are also used, to a more limited extent, in facilitating and financing India's growing volume of international trade transactions.

8. Money Market Mutual Funds (MMMFs)

- **Meaning:** Money Market Mutual Funds are **mutual fund schemes that invest exclusively in money market instruments** such as treasury bills, commercial paper, certificates of deposit and repos.
- **Purpose:** Introduced to provide **individual and small investors** an opportunity to participate in the money market, which otherwise requires large minimum investments.
- **Regulation:** In India, MMMFs are regulated by the **Securities and Exchange Board of India (SEBI)** under mutual fund regulations.
- **Units:** Investors are issued **units** representing a proportionate share in the diversified portfolio of money market instruments held by the fund.
- **Professional Management:** The fund's portfolio is managed by **professional fund managers**, who select instruments based on safety, liquidity and yield considerations.
- **High Liquidity:** MMMFs generally offer **high liquidity**, allowing investors to redeem their units quickly, often within one working day.
- **Low Risk:** Since the underlying instruments are short-term and high quality, MMMFs are considered **relatively low-risk investment options**.
- **Diversification:** By pooling funds from many investors, MMMFs achieve **diversification** across multiple issuers and instruments, reducing concentration risk.
- **Returns:** Returns are generally **higher than a savings bank account** but lower than riskier long-term investment options.
- **Accessibility:** Allows **retail investors** to indirectly access the money market with relatively **small investment amounts**, unlike direct investment in instruments like CDs or CPs.

Money Market Mutual Funds were introduced in India in 1992 with the specific objective of extending the benefits of the money market to individual and small investors, who otherwise find it difficult to invest directly in instruments such as certificates of deposit, commercial paper or treasury bills due to their large minimum denominations and the need for specialised market knowledge. An MMMF pools together the savings of a large number of investors and uses this pooled corpus to invest in a diversified portfolio of short-term, high-quality money market instruments, thereby allowing even small investors to indirectly enjoy the safety, liquidity and reasonable returns associated with the money market. The fund is managed by professional fund managers who continuously monitor market conditions, credit quality of issuers and interest rate movements to construct and rebalance a portfolio that seeks to optimise the trade-off between safety, liquidity and yield. One of the biggest advantages of MMMFs for individual investors is diversification — since the pooled corpus is invested across a range of instruments issued by different entities, the risk associated with the default of any single issuer is significantly reduced compared to a direct investment in a single instrument. Additionally, most MMMF schemes offer very high liquidity, permitting investors to redeem their units on short notice, often on

the same day or the next working day, making these funds an attractive parking ground for short-term surplus cash for both retail investors and corporates. In terms of returns, MMMFs typically offer yields that are higher than a regular savings bank account, since they are directly linked to prevailing short-term money market rates, while still maintaining a much lower risk profile compared to equity or long-term debt mutual funds. In India, these funds are regulated by SEBI under the mutual fund regulations, which prescribe the permissible investment universe, credit quality standards, and valuation norms to protect investor interests. Overall, Money Market Mutual Funds have played a significant role in democratising access to the money market, channelling small, scattered individual savings into the organised financial system, and thereby contributing to the overall depth and efficiency of the Indian money market.

Primary and Secondary Market of Capital Market

The capital market, which deals in medium and long-term funds, is broadly divided into two interconnected segments — the primary market and the secondary market. While the primary market is concerned with the issue of new securities, the secondary market provides a platform for trading in securities that have already been issued. Both segments are explained in detail below.

Primary Market (New Issue Market)

- **Meaning:** The Primary Market, also called the **New Issue Market (NIM)**, is the segment of the capital market where **companies and the government raise fresh capital** by issuing new securities directly to investors for the first time.
- **Direct Flow of Funds:** Funds raised in the primary market **flow directly to the issuer** (company or government), unlike the secondary market where funds move between investors.
- **Main Function:** Facilitates **capital formation** by converting savings of investors into productive investment through new securities.
- **Methods of Raising Capital:**
 - **Public Issue/IPO:** Offering shares to the **general public for the first time** through a detailed prospectus disclosing all material information.
 - **Further Public Offer (FPO):** An **already listed company** issuing additional new shares to the public to raise further capital.
 - **Rights Issue:** Offering new shares to **existing shareholders** in proportion to their current shareholding, usually at a price lower than the market price.
 - **Private Placement:** Selling securities directly to a **select group of institutional or high-net-worth investors** rather than to the public at large.
 - **Preferential Allotment:** Issue of shares/convertible securities to a **specific set of investors** at a price determined as per SEBI pricing guidelines.
 - **Offer for Sale (OFS):** Existing large shareholders, often **promoters**, sell their holding to the public through the stock exchange mechanism.
 - **Bonus Issue:** Issue of **additional free shares** to existing shareholders out of the company's accumulated reserves, in proportion to holding.
 - **Intermediaries Involved:** Involves **merchant bankers, underwriters, registrars, and lead managers** who assist in the entire issue process.
 - **Regulation:** The primary market in India is regulated by **SEBI**, which mandates disclosure norms, pricing guidelines and investor protection measures.

The primary market represents the very source through which fresh capital enters the corporate and government sectors of the economy, making it foundational to the process of capital formation. When a company wishes to raise long-term funds for setting up a new project, expanding existing operations, modernising plant and machinery, or repaying high-cost debt, it approaches the primary market rather than the secondary market, since only a new issue of securities results in the actual inflow of fresh funds to the issuer. The most well-known method of raising capital in the primary market is the Initial Public Offer (IPO), through which a private company offers its shares to the general public for the first time and becomes a publicly listed entity; an already-listed company seeking additional capital, on the other hand, uses a Further Public Offer (FPO). Companies that prefer to raise capital from their own existing shareholders, without diluting control to outside investors, use a Rights Issue, wherein new shares are offered in proportion to the existing shareholding, generally at an attractive discounted price. Alternatively, companies may resort to

Private Placement or Preferential Allotment, under which securities are issued to a select set of institutional investors or promoters rather than to the public, allowing for a quicker and more cost-effective fundraising process, though subject to SEBI's pricing and disclosure norms. In an Offer for Sale, it is not the company but existing large shareholders, frequently the promoters themselves, who sell a part of their holding to the public through the stock exchange platform, thereby increasing public shareholding without the company itself raising fresh capital. A Bonus Issue, though it does not raise fresh funds, is also considered a primary market activity since it involves the issue of new shares, funded out of the company's reserves, to existing shareholders. The entire process of a public issue is a complex and heavily regulated exercise involving several intermediaries: merchant bankers and lead managers who structure and manage the issue, underwriters who guarantee subscription, and registrars who handle the allotment and refund process, all operating under the strict regulatory framework prescribed by SEBI to ensure adequate disclosure of information through the prospectus and protection of investor interests against fraudulent or unfair practices. In essence, the health and vibrancy of the primary market is a key indicator of investor confidence and the pace of capital formation and industrial development within an economy.

Secondary Market (Stock Market)

- **Meaning:** The Secondary Market, also called the **Stock Market or Stock Exchange**, is the segment of the capital market where **already-issued securities are bought and sold** among investors.
- **No Direct Fund Flow to Issuer:** Unlike the primary market, transactions in the secondary market **do not result in fresh funds flowing to the company**; they merely represent a change in ownership of existing securities.
- **Major Exchanges in India:** The two principal stock exchanges are the **Bombay Stock Exchange (BSE)** and the **National Stock Exchange (NSE)**.
- **Regulator:** Regulated by the **Securities and Exchange Board of India (SEBI)** to ensure fair, transparent and orderly trading.
- **Provides Liquidity:** Enables investors to **convert their securities into cash quickly**, thereby providing marketability and liquidity to investments.
- **Continuous Price Discovery:** Prices of securities are **continuously determined** through the interaction of demand and supply during trading hours.
- **Electronic/Online Trading:** Trading is conducted through **registered brokers/sub-brokers** using screen-based electronic trading systems, and increasingly via online/mobile trading platforms.
- **Dematerialisation:** Securities are held and transferred in **electronic (demat) form** through depositories such as NSDL and CDSL, eliminating risks associated with physical certificates.
- **Market Indices:** Performance of the secondary market is tracked through indices such as the **Sensex (BSE)** and **Nifty (NSE)**, which reflect overall market sentiment and economic health.
- **Types of Orders/Segments:** Includes the **cash/equity segment** for delivery-based trading and the **derivatives segment** (futures and options) for hedging and speculation.
- **Settlement System:** Trades are settled through a **clearing corporation** on a T+1 (trade date plus one day) basis in India, ensuring timely and guaranteed settlement.

The secondary market performs the vital function of providing continuous liquidity and marketability to securities that have already been issued in the primary market, thereby completing the overall capital market mechanism. Once a company's shares or a government's bonds are issued and allotted to investors in the primary market, these securities are subsequently listed on a recognised stock exchange, where investors can freely buy and sell them among themselves without any direct involvement of the issuing company. This ability to exit an investment whenever needed is precisely what makes the secondary market so important, since investors are far more willing to subscribe to new issues in the primary market when they know that a

liquid, transparent secondary market exists where they can sell their holdings conveniently at a fair, market-determined price. In India, the two dominant stock exchanges — the Bombay Stock Exchange, which is Asia's oldest exchange, and the National Stock Exchange, which pioneered electronic and screen-based trading in the country — together account for the vast majority of secondary market trading activity. Trading today takes place almost entirely through electronic order-matching systems accessed by investors through registered stockbrokers via online or mobile trading applications, a significant change from the earlier open-outcry trading floors. The dematerialisation of securities, facilitated through depositories such as the National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL), has eliminated the risks of theft, forgery, and delay associated with physical share certificates, and has made the transfer of ownership virtually instantaneous. The secondary market also enables continuous price discovery, since the prices of listed securities fluctuate constantly during trading hours based on the changing expectations, information and sentiment of buyers and sellers, and these prices are aggregated into broad market indices such as the Sensex and the Nifty, which serve as barometers of overall market and economic sentiment. Besides the cash or equity segment, where actual delivery of shares takes place, the secondary market also includes a well-developed derivatives segment comprising futures and options contracts, which are used by market participants for hedging against price risk as well as for speculative purposes. All secondary market transactions are settled through a clearing corporation, which acts as a central counterparty guaranteeing settlement and thereby eliminating counterparty risk, with the current settlement cycle in India being T+1, meaning trades are settled one working day after the trade date. Through these functions — providing liquidity, continuous valuation, transparency, and safety of transactions — the secondary market not only benefits individual investors but also strengthens the overall efficiency and credibility of the primary market and the capital market as a whole.

STUDY MATERIAL

SEBI • BSE • NSE

Regulator and Stock Exchanges of the Indian Securities Market

Introduction | Structure | Objectives | Functions | Limitations

Compiled Notes for Commerce, Finance & Competitive Exam Aspirants

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How to use these notes: Each of the three bodies — SEBI, BSE, and NSE — is covered under five consistent heads: Introduction, Structure, Objectives, Functions, and Limitations. This structure mirrors how these topics are typically asked in commerce and finance examinations, making the notes easy to revise section by section.

1. SEBI

SECTION 01

Securities and Exchange Board of India — Apex Regulator of the Securities Market

1.1 Introduction

The Securities and Exchange Board of India (SEBI) is the apex regulatory authority for the securities and capital market in India. It was first set up in 1988 as a non-statutory body and was later granted statutory powers on 30 January 1992 through the SEBI Act, 1992. SEBI's creation was prompted by the rapid growth of the Indian capital market in the 1980s, which exposed investors to malpractices such as price rigging, unofficial premiums on new issues, and delays in share transfers. Headquartered in Mumbai, with regional offices in New Delhi, Kolkata, Chennai, and Ahmedabad, SEBI today regulates stock exchanges, intermediaries, mutual funds, credit rating agencies, and listed companies. Its overarching mandate, as stated in the preamble to the SEBI Act, is to protect the interests of investors in securities, promote the development of the securities market, and regulate that market.

1.2 Structure

SEBI is a statutory body corporate with perpetual succession, functioning under the overall administrative control of the Ministry of Finance, Government of India. It is managed by a board consisting of a Chairman and several whole-time and part-time members.

- **Chairman** — appointed by the Central Government, provides overall leadership and policy direction.
- **Whole-time Members** — usually two to three, each overseeing specific departments such as market regulation, corporate finance, or investigation.
- **Government Nominees** — typically two members nominated by the Union Government, often from the Ministry of Finance.
- **RBI Nominee** — one member nominated by the Reserve Bank of India to ensure coordination between monetary and securities regulation.
- **Independent Members** — part-time members with expertise in law, finance, accountancy, or economics.

Below the board, SEBI operates through specialised departments — including the Market Regulation Department, Corporation Finance Department, Investment Management Department, and the Integrated Surveillance Department — supported by the Securities Appellate Tribunal (SAT), an independent quasi-judicial body that hears appeals against SEBI's orders.

1.3 Objectives

- **Investor protection** — safeguarding the interests of both individual and institutional investors against fraud and unfair trade practices.
- **Market development** — creating an environment conducive to the mobilisation of resources through the securities market and encouraging fair competition.
- **Regulation of intermediaries** — ensuring that brokers, merchant bankers, registrars, and other intermediaries operate under a code of conduct.
- **Balancing self-regulation and statutory control** — allowing the securities industry a degree of self-governance while retaining statutory oversight.
- **Reducing malpractices** — curbing insider trading, price manipulation, and other unfair trade practices relating to the securities market.

1.4 Functions

SEBI's functions are broadly grouped into three categories: protective, regulatory, and developmental.

- **Protective functions** — prohibiting fraudulent and unfair trade practices, checking insider trading, promoting fair disclosure norms, and running investor-education and awareness programmes.
- **Regulatory functions** — registering and regulating stock brokers, sub-brokers, merchant bankers, and portfolio managers; registering and regulating mutual funds and collective investment schemes; regulating takeovers and acquisitions of companies; and conducting inquiries and audits of exchanges and intermediaries.
- **Developmental functions** — promoting investor education and training of intermediaries, permitting flexible and innovative methods of capital issue, and encouraging the growth of self-regulatory organisations.

In addition, SEBI drafts and enforces regulations under the SEBI Act — such as the Listing Obligations and Disclosure Requirements (LODR) Regulations and the Prohibition of Insider Trading Regulations — that govern how listed companies and market participants must behave.

1.5 Limitations

- **Resource and manpower constraints** — the scale of India's securities market has grown far faster than SEBI's staff strength, stretching its supervisory capacity.
- **Slow enforcement** — investigations and adjudication of complex cases, particularly those involving insider trading or accounting fraud, can take years to conclude.
- **Overlapping jurisdiction** — regulatory boundaries with the RBI, Ministry of Corporate Affairs, and IRDAI sometimes overlap, especially in hybrid financial products.

- **Limited control over unlisted markets** — SEBI's writ runs mainly over listed and to-be-listed entities, leaving large parts of private and unlisted capital activity outside its direct reach.
- **Frequent regulatory changes** — the pace of amendments, while responsive, can create compliance uncertainty for market participants.

2. BSE

SECTION 02

Bombay Stock Exchange — Asia's Oldest Stock Exchange

2.1 Introduction

The Bombay Stock Exchange (BSE), established in 1875, is Asia's oldest stock exchange and one of the oldest in the world. It began as an informal gathering of stockbrokers under a banyan tree in Mumbai and was formally organised as 'The Native Share and Stock Brokers' Association.' BSE was granted permanent recognition under the Securities Contracts (Regulation) Act, 1956, in 1957, making it the first stock exchange in India to receive such recognition. Its benchmark index, the SENSEX, comprising 30 financially sound and actively traded companies, is widely tracked as a barometer of the Indian economy. BSE demutualised and corporatised its structure in 2005, separating ownership, management, and trading rights in line with SEBI norms, and it became a publicly listed company on its own platform in 2017.

2.2 Structure

As a demutualised entity, BSE is governed by a Board of Directors comprising a mix of shareholder-elected directors, public interest directors, and the Managing Director & CEO, with no single trading member allowed to dominate the board. This separates commercial ownership from trading operations, reducing conflicts of interest.

- **Board of Directors** — sets overall policy and strategic direction, subject to SEBI oversight.
- **Clearing Corporation** — the Indian Clearing Corporation Limited (ICCL) handles clearing and settlement of trades executed on BSE.
- **Trading members** — SEBI-registered brokers who execute buy and sell orders on behalf of clients through BSE's electronic trading platform, BOLT (BSE On-Line Trading).
- **Listed companies** — over five thousand companies are listed on BSE, spanning large-caps, mid-caps, small-caps, and SME enterprises.
- **Depository linkage** — BSE interfaces with depositories such as NSDL and CDSL for the dematerialised holding and transfer of securities.

2.3 Objectives

- **Efficient price discovery** — providing a transparent and liquid marketplace where securities are fairly priced through the interaction of buyers and sellers.
- **Capital formation** — enabling companies to raise long-term capital through public issues and further offerings.

- **Investor confidence** — maintaining robust listing, disclosure, and surveillance standards to protect investors.
- **Market development** — widening the base of investors and listed companies, including through the BSE SME platform for smaller enterprises.
- **Technological modernisation** — continuously upgrading trading infrastructure to match global standards of speed and reliability.

2.4 Functions

- **Providing a trading platform** — BSE offers an electronic order-matching system (BOLT) for equities, derivatives, currency derivatives, debt instruments, and mutual funds.
- **Listing securities** — laying down eligibility norms and disclosure requirements for companies seeking to list their shares.
- **Clearing and settlement** — ensuring trades are settled on a T+1 basis through its clearing corporation, reducing counterparty risk.
- **Index maintenance** — computing and maintaining benchmark and sectoral indices, chiefly the SENSEX, used by investors and fund managers as performance yardsticks.
- **Market surveillance** — monitoring trading patterns to detect price manipulation, circular trading, and other irregularities, in coordination with SEBI.
- **Investor services** — operating an Investor Protection Fund and grievance-redressal mechanisms for disputes between investors and trading members.

2.5 Limitations

- **Lower trading volumes** — in equity derivatives and cash-market turnover, BSE has historically trailed NSE, affecting liquidity in some counters.
- **Legacy perception** — despite substantial modernisation, BSE is sometimes viewed as slower to innovate than its younger, more aggressively marketed rival.
- **Concentration in a few counters** — trading activity is often concentrated in a relatively small set of large-cap stocks, leaving many listed SME and small-cap shares illiquid.
- **Technology outages** — like all electronic exchanges, BSE remains exposed to occasional system disruptions that can halt trading temporarily.
- **Dependence on market sentiment** — as with any exchange, BSE's trading volumes and revenues fluctuate with broader economic and market cycles, outside its direct control.

3. NSE

SECTION 03

National Stock Exchange — India's Largest Exchange by Turnover

3.1 Introduction

The National Stock Exchange of India (NSE) was incorporated in 1992 and commenced operations in 1994, established on the recommendation of the Pherwani Committee to bring transparency, modern technology, and nationwide reach to Indian equity trading. It was the first exchange in India to offer a fully automated, screen-based electronic trading system, replacing the earlier open-outcry method and allowing investors across the country equal and instantaneous access to the market. NSE was also India's first demutualised exchange from inception, with ownership, management, and trading membership kept separate from the outset. Its flagship index, the NIFTY 50, tracks the performance of fifty large, liquid companies across sectors and is one of the most widely referenced benchmarks of the Indian economy. Headquartered in Mumbai, NSE is regulated by SEBI and today ranks among the largest exchanges in the world by number of trades in equity derivatives.

3.2 Structure

NSE operates under a corporate governance structure with a Board of Directors comprising public interest directors, shareholder directors, and the Managing Director & CEO, ensuring no single entity or trading member can control the exchange.

- **Board of Directors** — responsible for overall governance and strategic policy, functioning under SEBI's regulatory supervision.
- **National Securities Clearing Corporation Limited (NSCCL)** — NSE's clearing corporation, which guarantees settlement of trades and manages counterparty risk.
- **Trading members** — SEBI-registered brokers connected to NSE's electronic trading engine, the National Exchange for Automated Trading (NEAT).
- **Market segments** — separate segments for equity (Capital Market), equity and currency derivatives (Futures & Options), debt, and mutual funds.
- **Depository linkage** — close integration with the National Securities Depository Limited (NSDL), which NSE helped establish, alongside CDSL, for dematerialised settlement.

3.3 Objectives

- **Nationwide access** — providing a single, uniform trading platform accessible to investors in every part of the country through satellite and electronic connectivity.

- **Transparency** — ensuring fair and transparent price discovery through an anonymous, order-driven electronic system.
- **Efficient settlement** — achieving fast, secure clearing and settlement cycles to reduce risk for market participants.
- **World-class technology** — matching global exchanges in trading speed, system capacity, and reliability.
- **Broadening market participation** — encouraging retail, institutional, and foreign portfolio investment across a wide range of products.

3.4 Functions

- **Electronic trading platform** — operating NEAT, a fully automated screen-based system for trading in equities, derivatives, currency derivatives, and debt securities.
- **Listing and disclosure** — setting eligibility criteria for companies to list and enforcing continuous disclosure obligations.
- **Clearing and settlement** — through NSCCL, NSE guarantees trade settlement, largely eliminating counterparty default risk for market participants.
- **Risk management** — employing margining systems, circuit breakers, and real-time surveillance to contain excessive volatility.
- **Index services** — computing and licensing indices such as the NIFTY 50 and its sectoral variants, used globally for benchmarking and as the basis for index funds and derivatives.
- **Derivatives leadership** — NSE pioneered equity derivatives trading in India in 2000 and today accounts for the bulk of the country's futures and options turnover.

3.5 Limitations

- **Technology dependence** — heavy reliance on electronic systems makes NSE vulnerable to outages, as seen in occasional trading halts caused by technical glitches.
- **Regulatory and governance lapses** — past incidents, including the co-location and algorithmic trading controversy, exposed governance weaknesses that drew SEBI penalties.
- **Concentration risk in derivatives** — the exchange's dominance in futures and options trading has drawn regulatory concern about excessive retail speculation.
- **High-frequency trading concerns** — the speed advantage available to well-resourced algorithmic traders has raised questions about a level playing field for smaller investors.
- **Market volatility exposure** — as India's largest exchange by turnover, NSE is highly sensitive to global cues, capital flows, and macroeconomic shocks.

4. Comparison

SECTION 04

BSE vs NSE — Key Differences at a Glance

4.1 BSE vs NSE at a Glance

Parameter	BSE	NSE
Established	1875	1992 (operations from 1994)
Benchmark Index	SENSEX (30 stocks)	NIFTY 50 (50 stocks)
Trading System	BOLT	NEAT
Clearing Corporation	Indian Clearing Corporation (ICCL)	National Securities Clearing Corporation (NSCCL)
Known For	Oldest exchange in Asia; broad SME listings	Highest derivatives turnover globally
Regulator	SEBI	SEBI

4.2 How They Relate to SEBI

SEBI acts as the overarching regulator for both BSE and NSE. Neither exchange can independently change listing rules, margin requirements, or introduce new products without SEBI approval. Both exchanges also function as Self-Regulatory Organisations (SROs) — they enforce trading discipline and member conduct at the first level, with SEBI providing statutory backing, appellate oversight through the Securities Appellate Tribunal, and the final word on investor protection matters. This layered structure — SEBI at the apex, with BSE and NSE as the primary trading venues beneath it — forms the backbone of India's securities market ecosystem.

End of study material. These notes summarise publicly available information on SEBI, BSE, and NSE for educational and exam-preparation purposes.