DEPARTMENT OF COMMERCE AND FINANCIAL STUDIES BHARATHIDASAN UNIVERSITY, TIRUCHIRAPPALLI – 620024

MBA (Financial Management)

COURSE CODE: FMCC3/24
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Scheme of Presentation Unit III

- Meaning of Secondary Market
- Role of Secondary Market
- Difference between Primary Market and Secondary Market
- Role of Stock Exchange
- Screen Based Trading, NEAT, Contract Note
- Equity Investment
- Debt Instrument and its feature
- Segments in the Debt Market
- Participants in the Debt Market

Unit III
Secondary Market

Secondary Market

1. Meaning of the Secondary Market: The secondary market is where previously issued securities (such as stocks, bonds, and other financial instruments) are traded between investors. Unlike the primary market, where new securities are issued, the secondary market involves buying and selling among investors, with the company not directly involved.
2. There are two main types of secondary markets: exchange-traded markets and over-the-counter markets.

- Exchange-traded markets, such as the New York Stock Exchange (NYSE) and the Nasdaq Stock Market, have centralized trading locations,
- over-the-counter markets, such as the bond market, have decentralized trading locations.

Role of the Secondary Market

- **Liquidity:** It provides liquidity to investors by allowing them to buy and sell securities quickly.
- **Price Discovery:** The continuous buying and selling of securities helps in determining their market value based on demand and supply.
- **Efficient Allocation of Capital:** It helps allocate funds to more productive investments by reflecting the true value of companies and securities.
- **Investment Flexibility:** Investors can adjust their portfolios according to market conditions or personal financial goals.

Functions of The Secondary Market

The secondary market is where the major chunk of stock trading happens. This basically functions as a platform that gives the opportunity to the masses to invest in company stocks. The secondary market also functions as an enabler of active, continuous trading that helps keep assets liquid and price variations in check. That being so, the secondary market also serves as a medium for investors to generate quick cash by selling off the shares they own.

In helping discover prices of shares based on demand and supply, the secondary market functions as a medium of price determination.

The secondary market also functions as an organized place where investors can invest their money in market securities with some sort of regulatory safety net in place. The secondary market, in a way, reflects the state of the economy of a nation.

How does the secondary Market work?

Investor Places an Order:

An investor who wants to buy or sell a security places an order through a stockbroker. Orders can either be market orders (executed at the current price) or limit orders (executed only when the security reaches a specific price).

Broker Submits the Order:

The broker transmits the order to the stock exchange through electronic trading platforms like **NEAT** (National Exchange for Automated Trading) or similar systems.

Order Matching:

The stock exchange's trading system matches buy and sell orders. If there is a corresponding buy order for a sell order (and vice versa), the trade is executed.

Trade Execution:

Once a match is found, the trade is executed. The investor purchasing the security becomes the new owner, while the seller receives payment for the shares.

The stock exchange records the transaction, and both parties receive confirmation of the trade.

Clearing and Settlement:

After the trade, clearinghouses (like the **National Securities Clearing Corporation Limited (NSCCL)** in India) facilitate the settlement. They ensure that the buyer receives the securities and the seller gets the payment.

Settlement typically occurs **T+2**, which means two days after the trade date.

Contract Note:

The broker issues a **contract note** to the investor, which details the trade, including price, quantity, time of transaction, and any brokerage fees. This document serves as a legal record of the trade.

Types of Secondary Markets

Secondary market is a place where a majority of stock trading happens. It is of two types: the Stock Exchange market, and the Over-The-Counter market. Let's understand both these markets in detail.

The Stock Exchange

Stock exchanges are secondary markets of a massive scale that a high percentage of the population participates in for trading. In India, the best examples of secondary markets are the National Stock Exchange and the Bombay Stock Exchange.

Secondary markets are associated with uncompromising regulations regarding market securities, making them a place with low counterparty risks. However, this increases the fees, transaction costs and commissions associated with them. Most of the market indices you see (like Nifty 50 or S&P 500) can be found listed in the secondary markets.

The stock exchange assists trading in secondary market, acting as a guarantor.

Over-The-Counter Market

The over the counter secondary market is a place where the stock exchange is not involved. This is a platform where investors trade among themselves with the shares that they own. Since there is no regulatory authority or compulsion involved with this manner of trading, the counterparty risks in over the counter trading are typically high. Also, there is no standardization of share prices, since it varies from one owner to another (the buyer and the seller directly deal with each other regarding all terms and conditions of a trade contract).

Advantages of Secondary Market Transactions

Secondary market transactions offer several advantages for investors, issuers, and the overall financial system. Here are some of the key advantages:

1. Liquidity

The secondary market provides liquidity for investors by allowing them to easily buy and sell previously issued securities. This makes it easier for investors to adjust their portfolios in response to changing market conditions and allows them to access cash, if needed, quickly.

2. Price discovery

The secondary market facilitates price discovery by allowing investors to trade securities based on the supply and demand dynamics of the market. This helps to ensure that securities are priced efficiently and that investors receive fair value for their investments.

3. Transparency

Secondary market transactions are often transparent, with information about the securities, the issuers, and the trading volume readily available to investors. This helps to ensure that investors are well-informed and can make informed decisions about their investments.

4. Risk transfer

The secondary market allows investors to transfer risk by buying and selling securities. For example, an investor who owns a stock and is concerned about a potential market downturn can sell the stock to another investor, thereby transferring the risk to the new owner.

5. Capital raising

It can also facilitate capital raising by allowing companies to issue new securities to raise funds from investors. This can be done through follow-on offerings or secondary offerings.

6. Diversification:

It provides investors with a wide range of investment opportunities, which allows them to diversify their portfolios and potentially earn higher returns.

Disadvantages of the Secondary Market

While there are many advantages to the secondary market, there are also some potential disadvantages that investors should be aware of.

1. Volatility

The secondary market can be volatile, with prices of securities fluctuating rapidly in response to changes in market conditions, investor sentiment, and other factors. This can create uncertainty and make it difficult for investors to predict the value of their investments.

2. Market manipulation

The secondary market is vulnerable to market manipulation, such as insider trading or other fraudulent activities, which can distort prices and harm investors.

3. **Counterparty risk**

In secondary market transactions, investors are exposed to counterparty risk, which is the risk that the other party to the transaction will not fulfil their obligations. This can be particularly problematic in over-the-counter (OTC) markets where there is no central clearinghouse to guarantee trades.

4. Limited access

Some secondary markets may be limited to certain types of investors, such as accredited investors or institutional investors, which can limit access for individual investors.

5. Regulatory risk

Secondary market transactions are subject to regulation by government authorities, and changes in regulations can affect the functioning of the market and the value of securities.

6. Price discrepancies

The price of a security on the secondary market may not always accurately reflect its underlying value or prospects, which can create discrepancies and misalignments between market prices and fundamental values.

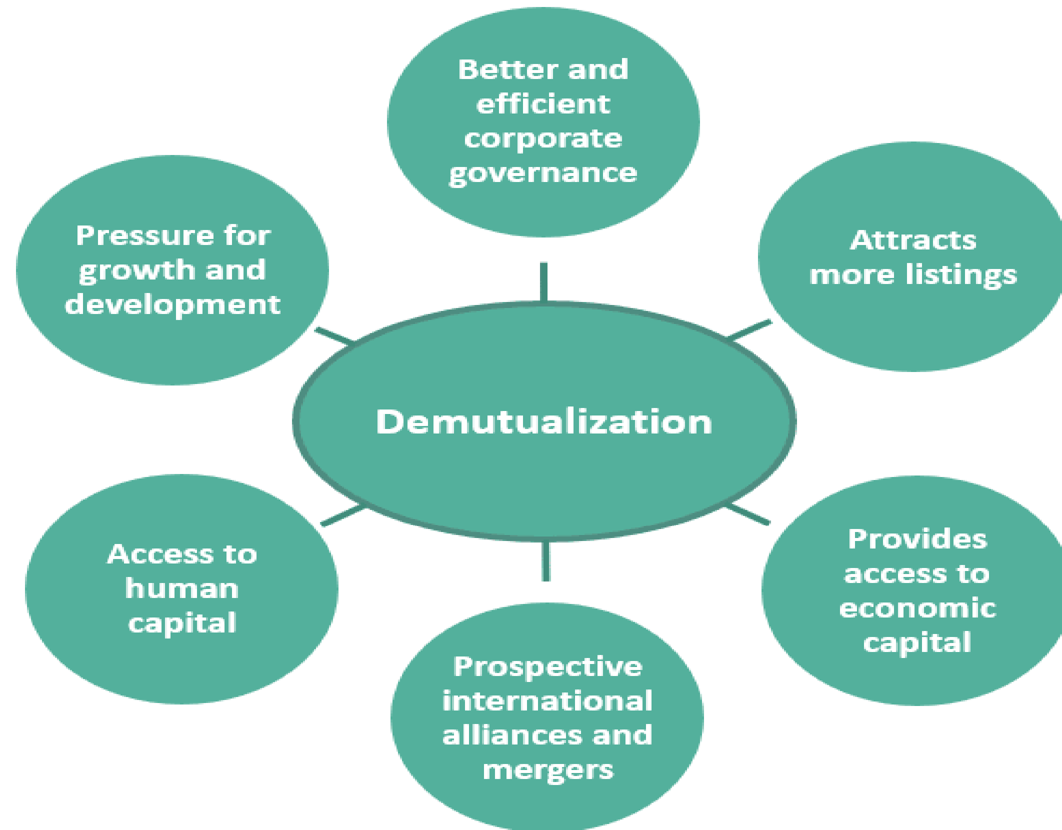
Meaning of Stock Exchange

A stock exchange is an important factor in the capital market. It is a secure place where trading is done systematically. Here, the securities are bought and sold per well-structured rules and regulations. Securities mentioned here include debenture and shares issued by a public company that is correctly listed on the stock exchange, debenture and bonds issued by government and municipal and public bodies.

Demutualization

- Demutualization is a process by which a private, member-owned company, such as a co-op, or a mutual life insurance company, legally changes its structure, to become a public-traded company owned by shareholders.
- Demutualization occurs when a company structured as a mutual company transitions to a stockholder corporation.
- The most common place where demutualization happens is among companies in the life insurance sector.
- Several methods exist for demutualization, but in all cases, policyholder customers are replaced as owners by shareholder investors.

Advantages of Demutualization



Types of Demutualization

1. Full demutualization

In full demutualization, the mutual company converts entirely into a public share company. Eligible policyholders will be compensated in the form of cash, newly issued shares of common stock, or policy credits in exchange for their membership interests.

2. Sponsored demutualization

In a sponsored demutualization, the mutual company is also fully converted into a public share company. Again, like full demutualization, all policyholders are compensated. The difference is that mutual ownership is essentially bought by a single stock parent corporation, not the original mutual company.

Instead of receiving stock certificates from the original mutual company, policyholders will receive stock certificates in the new parent company instead. Risk and liability are transferred entirely to the new parent company.

Stock Trading

Stock trading involves the buying and selling of shares in a certain company. If you own certain stocks and shares of a company, it translates to you owning a piece of the firm. A professional or an individual who trades on behalf of a financial firm will be known as a stock trader. Stock traders are broadly classified into three categories - informed, uninformed, and intuitive traders.

A few of the most common traders include swing traders, day traders, momentum traders, and buy and hold traders.

Advantages of Stock Trading

An individual trader will buy and sell via brokerage or an agent. On the other hand, institutional traders are mostly employed by investment companies. Stock traders provide liquidity to the markets, and employ several methods and styles for defining their strategies. Stock trading has two main types - individual stock trading and institutional stock trading.

Stock traders are different from stock investors. Stock traders trade equity securities, whereas stock investors utilize their own funds to purchase securities. The stock investor's primary goal is to produce interest income or to profit from the increase in value, also termed as capital gains.

Importance of Screen-Based Trading

1. Accessibility
2. Speed and Efficiency
3. Lower Cost
4. 24/7 Access
5. Advanced Tools
6. Order Types
7. Research and Education

Screen-Based Trading

Market Volatility: Rapid market fluctuations can increase the risk of losses.

Technology Risks: Technical glitches or internet outages can disrupt trading activities.

Emotional Trading: The convenience of screen-based trading can make it easier to engage in impulsive or emotional decisions.

Educational Requirements: Investors need to understand the complexities of the market and the risks involved in screen-based trading.

National Exchange for Automated Trading

A screen-based trading platform used by the National Stock Exchange of India (NSE). This system provides a platform for investors to buy and sell securities, such as stocks, bonds, and derivatives, in a fully automated and transparent manner.

Automated Trading: Orders are executed electronically, ensuring speed and efficiency.

Transparency: All trades are visible to participants, promoting fair pricing.

Price Time Priority: Orders are matched based on the best price and then by time priority.

Variety of Products: Investors can trade a wide range of financial instruments.

Features of Neat Trading:

- **Automated Trading:** Orders are executed electronically, ensuring speed and efficiency.
- **Transparency:** All trades are visible to participants, promoting fair pricing.
- **Price Time Priority**: Orders are matched based on the best price and then by time priority.
- **Variety of Products:** Investors can trade a wide range of financial instruments.

Benefits of Neat Trading:

- **Accessibility:** Traders can access the market from anywhere with an internet connection.
- **Cost-Effective:** Lower transaction costs compared to traditional methods.
- **Speed:** Orders are executed quickly, reducing the risk of price fluctuations.
- **Efficiency**: The automated system streamlines the trading process.

Contract Note

A contract note is a document issued by a broker or dealer to a client after the execution of a trade in securities. It serves as a confirmation of the trade and provides essential details about the transaction, including:

Trade Date: The date the trade was executed.

Security Details: The name, symbol, and quantity of the security traded.

Price: The price at which the trade was executed.

Brokerage: The fees charged by the broker for executing the trade.

Taxes: Any applicable taxes, such as securities transaction tax or stamp duty.

Total Amount: The total amount due or payable, including the price, brokerage, and taxes.

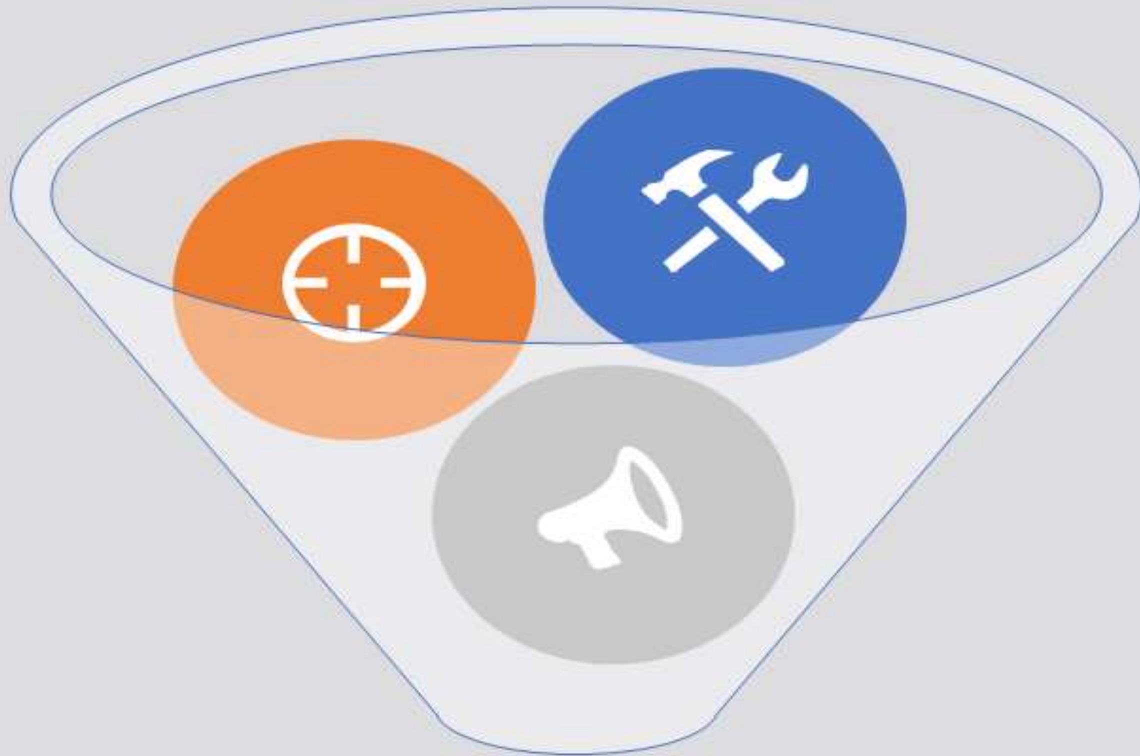
Settlement Date: The date on which the trade will be settled, typically T+2 days (two business days after the trade date).

Account Details: The client's account number and other relevant details.

Importance of Contract Notes

- Confirmation
- Record Keeping
- Legal Documentation
- Tax Purposes
- Regulatory Compliance
- Electronic Delivery
- Review and Verification
- Dispute Resolution

Products Dealt In Secondary Markets



Equity Instrument

- Equity instruments (stock or share) allows the investor to buy an ownership stake in the company.
- Equity refers to the Net Worth of the company. It is the source of permanent capital.

Debt Instrument

- Debt instruments are tools an individual, government entity, or business entity can utilize for the purpose of obtaining capital.
- Debt instruments provide capital to an entity that promises to repay the capital over time.

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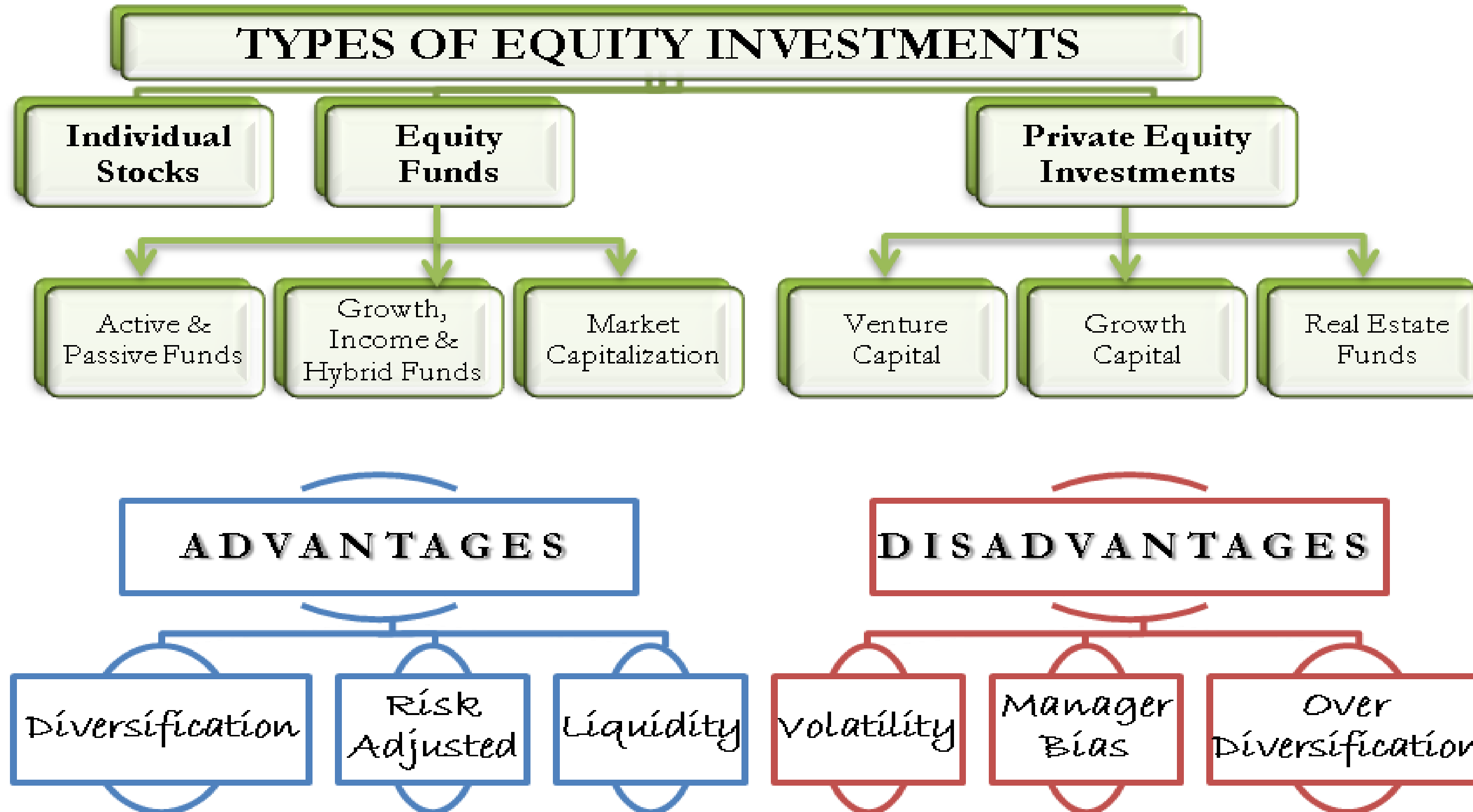
EQUITY INVESTMENTS are nothing but buying into the stocks and shares of companies. Retail, as well as institutional investors, invest into equity for a number of reasons. The most common among them is to harness the sharp price rise in a short period of time categorizing such investments. Equity represents the ownership funds of the company. Therefore, the investor becomes a direct party to all profits and losses of the company proportionately.

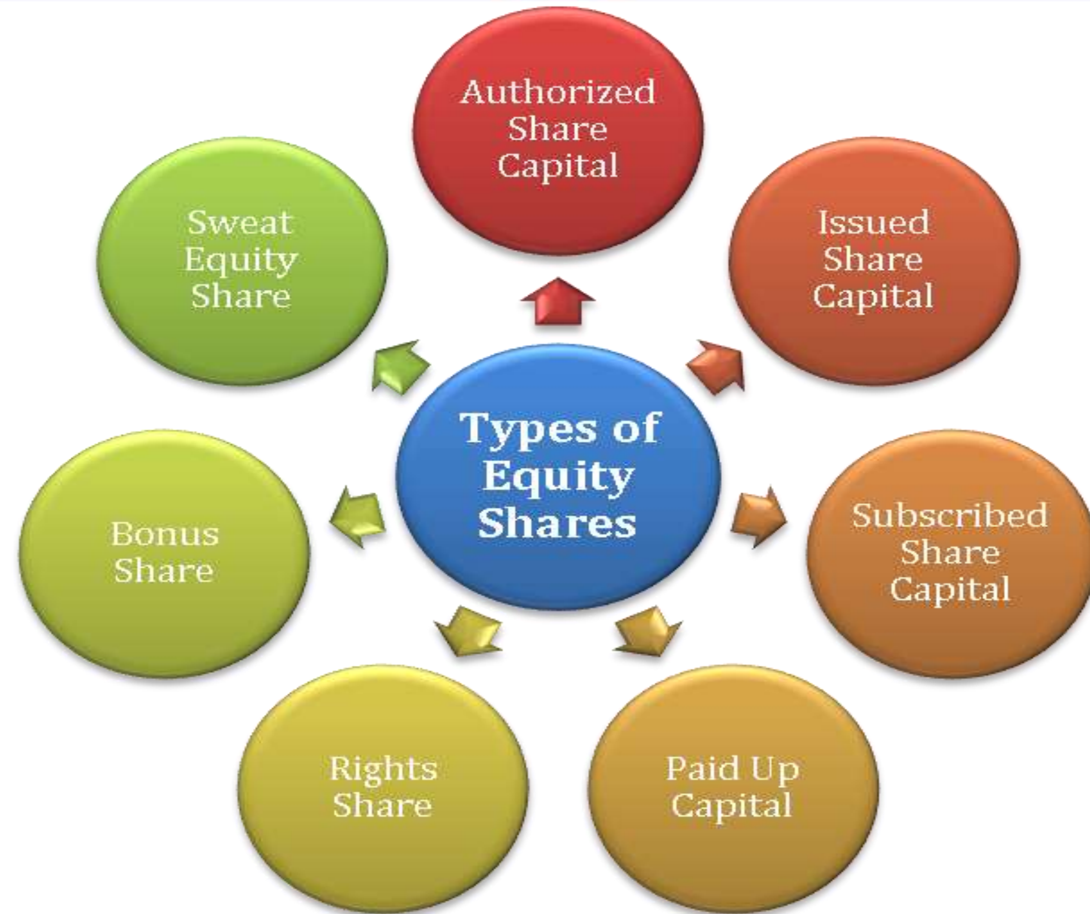


Equity Shares :

They are categorized under long-term sources of finance because legally they are irredeemable in nature. For an investor, these shares are a certificate of ownership in the company by virtue of which investors are entitled to share the net profits and have a residual claim over the assets of the company in the event of liquidation.

Various Prices of Equity Shares

- Par or Face Value
- Issue Price
- Share Premium and Share at Discount
- Book Value
- Market Value



Why Should You Invest in Equity Shares?

Investing in best equity shares has the following benefits, such as –

- High Income
- Hedge Against Inflation
- Portfolio Diversification

<u>What are the Risks Associated with this Investment?</u>

Equity share market tends to be the most volatile segment in a stock market, profoundly affected by minor fluctuations.

Returns on equity investments are paid out after all other company obligations have been met.

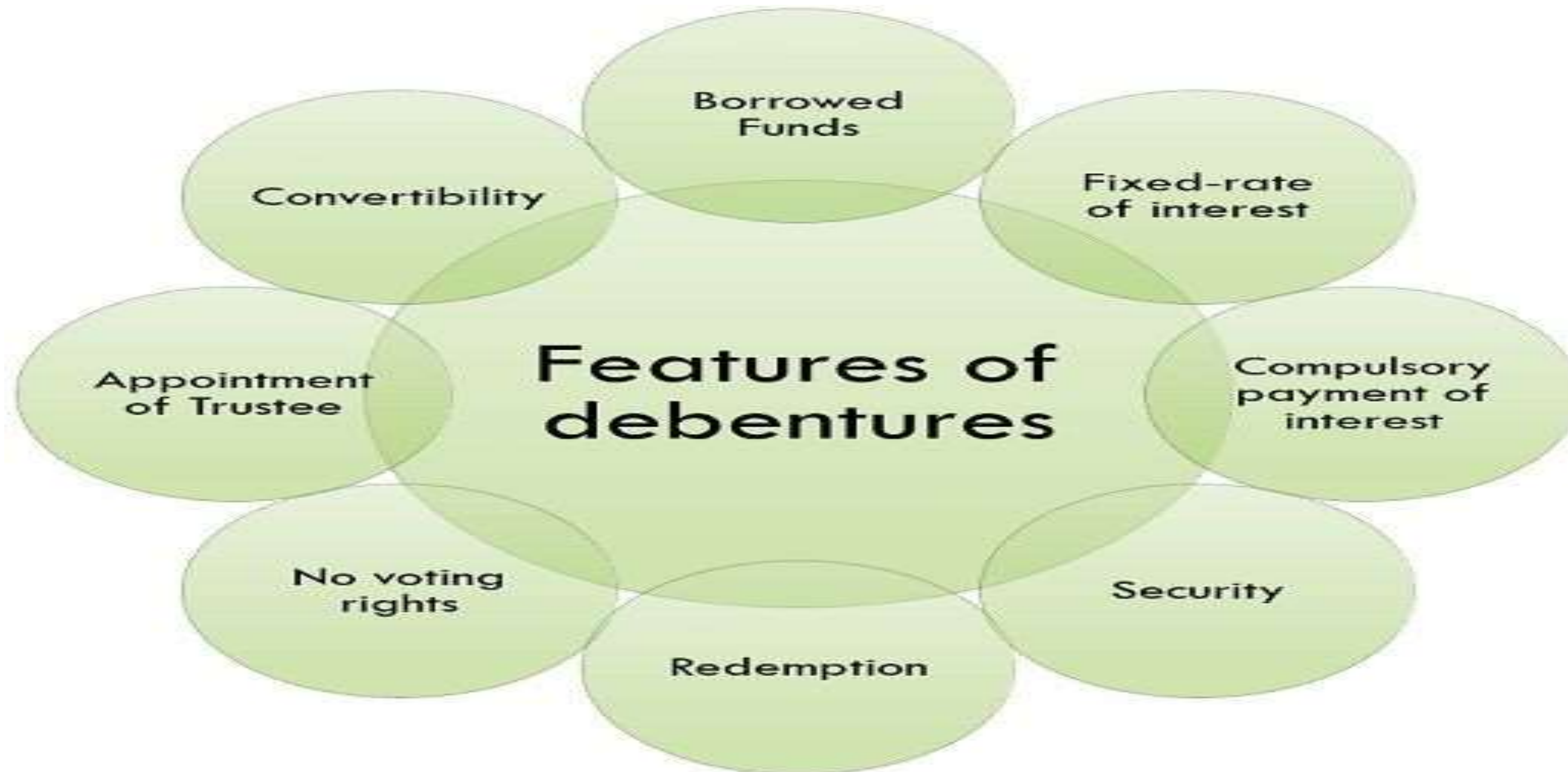
During a market downturn, the production cycle of a business is affected, thereby reducing profits generated by a business.

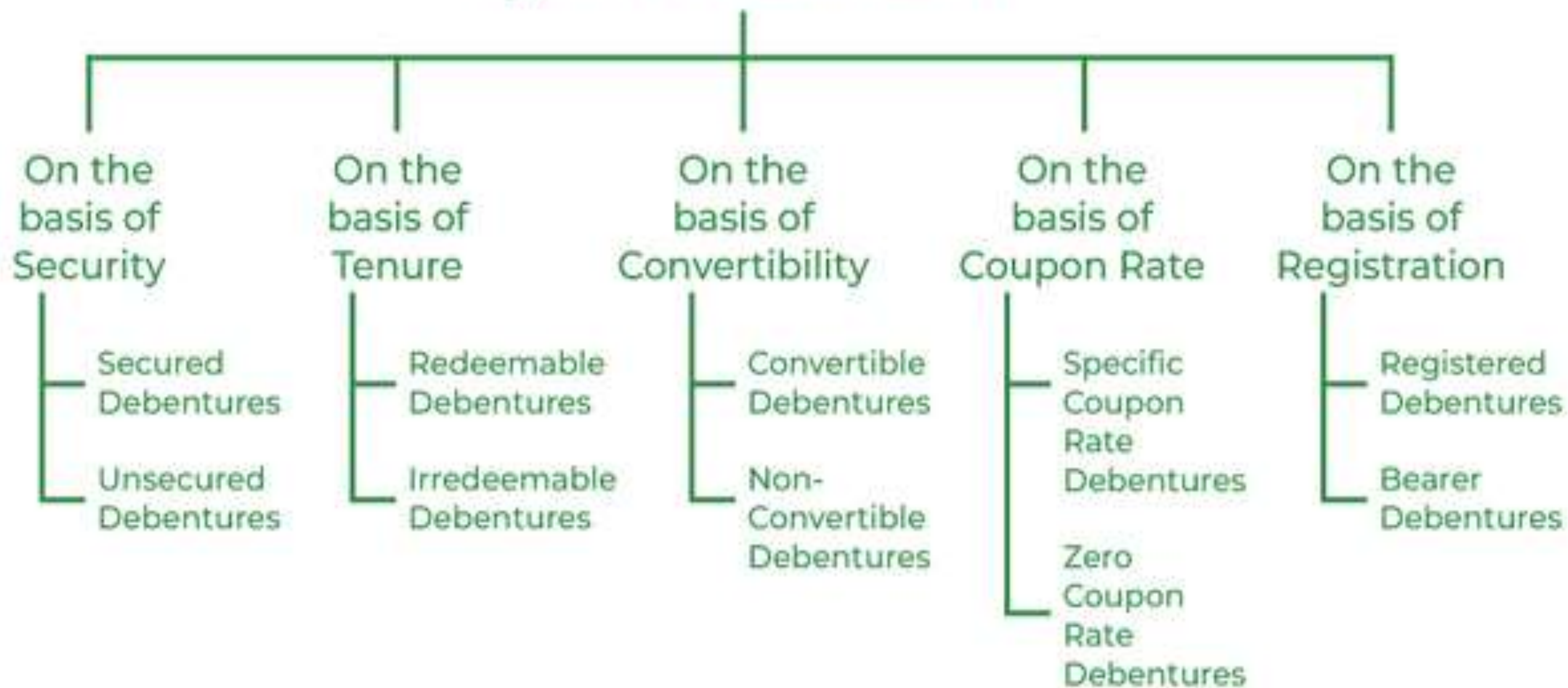
This lower share of profit is used up to meet all existing liabilities before funds are disbursed to as equity investment returns. Thus equity markets tend to be adversely affected during market downturn.

Also, equity investments tend to rise in value over time. Thus, if funds are kept locked-in for an extended period, the value of the same is bound to increase manifold in the future, thus ensuring substantial wealth accumulation of investors through capital gains.

Debenture

A debenture is used to issue loans by governments and companies. The loan is issued at a fixed interest depending upon the reputation of the companies. When companies need to borrow some money to expand themselves they take the help of debentures.




Types of Debentures
On the basis of Security
Secured Debentures
Unsecured Debentures
On the basis of Tenure
Redeemable Debentures
Irredeemable Debentures
On the basis of Convertibility
Convertible Debentures
Non-Convertible Debentures
On the basis of Coupon Rate
Specific Coupon Rate Debentures
Zero Coupon Rate Debentures
On the basis of Registration
Registered Debentures
Bearer Debentures

Central Government
Corporates
RBI
Insurance Companies
SEBI
Participants in Indian Debt Markets
Provident & Pension Funds
Primary Dealers
Mutual Funds
Banks
Financial Institutions

Thank You

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