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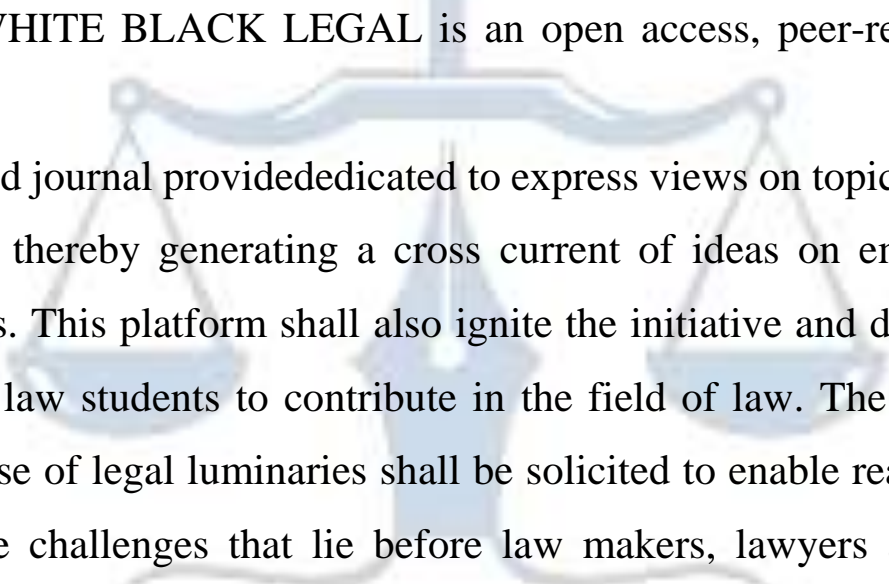


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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

# **OVERVIEW OF CAPITAL MARKET INSTRUMENTS**

AUTHORED BY - ANKITA ROY CHOWDHURY  
& PRITAM CHATTOPADHYAY

## **Abstract**

This article presents a comprehensive analysis of capital market instruments, crucial tools for mobilizing long-term funds to drive economic growth. Covering equity, debt, and derivative instruments, it explores how each category serves different financing objectives, appealing to diverse investor profiles based on their risk-return preferences. The article also delves into the historical evolution, liquidity, regulatory framework, and technological innovations shaping modern capital markets. Additionally, it highlights the benefits and limitations of these instruments in terms of liquidity, accessibility, and capital formation. By examining these instruments' roles within the financial system, this article underscores their importance in fostering stability, facilitating price discovery, and promoting economic progress.

## **Keywords**

Capital market instruments, equity securities, debt securities, derivatives, financial system, liquidity, regulatory framework, risk management, technological innovation, economic growth

## **Introduction**

Capital markets are also markets in which long-term securities are bought and sold, primarily securities with a maturity longer than one year. Indeed, these markets are important in the economy to act as ways of sourcing for capital by firms, government among others. Capital markets as these funds support expansion, innovation and job creation through financing through equity and through debt financing (Megersa, 2020). These markets also help governments to raise funding resources for infrastructure, education, health care and other social services, which all supports economic growth. Some of the main capital instruments in capital markets are shares, bonds, and future.

Such securities include stocks, more specifically equity securities that enable users to



participate in corporate revenues and gains (Parameswaran, 2022). Bonds are fixed income securities that offer a life fixed amount to the holders allowing organizations to finance their operations under an obligation to make specified payments at specified future times. Options and futures for instance, are Derivatives which have their value derived from a correspondent financial asset; and their main use is for hedging or speculative purpose.

Combined, these instruments generate a pluralistic and a more balanced capital market environment that provides several opportunities to investor depending on their appetite for risk, return and objective of their investment, thereby fostering capital formation and market liquidity in the economy.

### **Historical Background**

Generally, capital markets can be traced back to ancient societies wherein simple prelude to today's capital markets took place in Mesopotamia, ancient Greece and Rome. They had elementary credit, and contract arrangements as well as outgrowths of financiers, traders, and merchants, establishing a basis for organized markets (Bozik, and Güvenilir, 2020).

Capital markets also formed more structure in the 17th century; particularly, the first stock exchange, the "Amsterdam Stock Exchange", was formed in 1602 by the Dutch East India Company (Carlos, and Quinn, 2024). This was the first time share in a stock exchange was created where people could actually purchase stakes in a company and could sell those stakes to others; people could thus share in the profits of large projects thus not having to risk the entire business. It then evolved and expanded to establishment of other big stock exchanges: "London Stock Exchange in 1801" and "New York Stock Exchange (NYSE) in 1792".

Then, in the late twentieth and early twenty-first-century digital trading and globalization transformed capital markets (Knell, 2021). There was development of the electronic trading platforms Hence investors were able to trade in the securities using the internet from any part of the world. This change was instrumental in floating the market for funds and made it possible for individuals to invest and also destroyed regionality of investment. Globalization that took place also helped in the the flow of capital across the borders and the linking of world financial markets that has helped the organisations and investors in various locations to mobilise capital from around the world and also help them to manage risks in this diversified global markets.

Today's capital markets are complex and global financial trading systems that support the economy's liquidity, effectiveness and accessibility to many participants worldwide.

## **Types of capital market Instrument**

### *1.1 Equity Instrument*

The eligible equity instruments are mainly the stock, which gives ownership in a firm. When buyers begin to invest in the shares, they own part of the institution, they are offered some percentage of the profits, which can be in form of dividends. Equity securities also help organizations to expand capital and avoid debt business undertakings to their holders and investors.

There are two main types of equity instruments: "Common stock and preference stocks", it is seen that Common stock provides shareholders with a right to vote which normally entitles them to one vote per share in most vital organizational decisions. Yahoo also means that common stockholders have a right to receive dividend but not a fixed amount since the amount depends of financial performance of the company (Kanakriyah, 2020). In case of liquidation, common shareholders are in the last positions in the hierarchy of claimants to the company's assets after all the creditors and preferred stockholders.

While Preferred stocks pays fixed dividends that are usually higher than of common stock, shareholders are paid before holders of common stock in the event of winding up (Guerard Jr, *et al.*, 2021). Majority of preferred stocks do not include the shareholders' voting right benefits although they provide fairly stable and predetermined revenue returns. These equity instruments mean that the investors can decide on whether to have potential growth, earnings stability, and diversified participation in management.

### *1.2 Debt Instrument*

Debt securities, particularly bonds, refer to the facility extended by buyers to sellers in the form of loans. While debt is not a stake in the company; investors receive contractual obligations from the issuers to pay back the borrowed sum of money (principal) plus fixed interest.

There are many kinds of debt securities like "National authorities issue Government bonds" and are comparatively safe because they are backed up by the state; such bonds are used for

funding public initiatives. “Corporate bonds” are used by firms to finance working capital, capital expenditures or for the purpose of refinancing; most of these come with relatively high yields due to the higher risks attached to them as compared to government bonds. Municipal bonds, issued by local governments or municipalities, are frequently free from federal taxes, which is especially appealing to the individuals, who effectively pay a high amount of taxes. So, for example, foreign bonds that are bonds issued by foreign parties offer diversification but have country risks and exchange risks (Fabozzi, and Fabozzi, 2021).

Every kind of debt security offers a fixed return to investors and an anticipated cost of capital to firms, and therefore are indispensable in capital markets for both financing needs and risks management.

### *1.3 Derivatives*

Derivatives are financial products whose value tends to fluctuate with an underlying instrument such as stocks, bonds, gold, a particular rate, or a currency (Busu, 2022). Derivatives are not stocks or bonds, but financial contracts in which both parties agree to build their financial worth future expectation of assets price fluctuation, without one party owning a stake in the other. Derivatives can therefore be of benefit to the parties in the management of risks, to secure future price for the product and get a more advantageous position in the market.

There are several types of derivatives that can be easily identified in the market today. Options allow the holder to have a call or put with regard to an asset that they can exercise within a stated time at a set price. Buying is enabled through call options while selling through put options helping investors earn from expected price changes or to brace for loss making occurrences (Kevin, 2024).

Futures are trading contracts that require the buyer and the seller to obtain a specific amount of an asset at a specified price on a specific date, in the future. Forwards are similar to futures contracts but can be individually negotiated thus provide more flexibility but involve considerably higher credit risk than futures contracts (Mondello, 2023).

There are cash flow transactions where one party receives cash and another party gives cash which is used to hedge interest rate or currency risks these are known as Swaps. For instance, in the interest rate swap, one party might swap the fixed rate for a variable rate in order to

counterbalance fluctuation in a particular area. Collectively, they serve a very important purpose of the capital markets, as tools for risk management and speculation, and for diversifying an investment portfolio.

### **Key features and Characteristics**

#### *1.4 Liquidity and accessibility*

Market liquidity in capital markets can be defined as the ability to buy or sell instruments with little or no effect on the asset's prices (Tripathi, and Dixit, 2020). It is seen that there is high liquidity when there are adequate number of buyers and sellers in the market so that the transactions are done promptly and at a standardized price. It is also seen that the stock markets tend to be more liquid than bond, especially those of well-established large companies that enjoy high levels of trading. This has benefited from a technological revolution that has made it easier for people to get access to securities through online trading company thus allowing investors from all over the world to trade at any one time. While electronic trading, mobile applications, and even algorithmic trading have opened up capital markets to the general public as never before, making investing convenient and possible side by side with institutions.

#### *1.5 Risk and Return*

Capital market instruments involve different forms of risk and reward which forms a base for investment. Equity instruments such as common stock tend to have higher risk because they are price risky but not risky–return risky, giving investors the possibility of attracting more returns in forms of capital gains and dividends (Brabenec *et al.*, 2020). Fixed income securities, for instance, bonds have lesser risk than equity if they are issued by reliable government though they usually have lower yields. Derivative tools are considered to be high-risk products because they are both leveraged and intricate; profiting from such is possible, yet so is losing a considerable amount of money. People who invest decide on the type of instrument they are going to use depending on the risk factor and the amount of money it is wished to be gained or lost.

#### *1.6 Regulation and Transparency*

The role of the regulation cannot be underlined, especially while strengthening the equity stability of capital markets with grown prevalence rates. Some key regulators like the U.S. “Securities and Exchange Commission (SEC)” that set rules and monitor the activities that aim at reducing fraud, risky practices, and protect the investors. Regulations demand a firm to



unveil its financial status and performance, enabling investors to make sound decision on investment (Su, 2020). However, by making public such important information, the market is developed and made more confident due to the enhanced access to similar information by all the parties involved. Also, rules are constructed to guarantee that brokers and specimens of investment firms were ethical so that the threats of manipulating the market and specialties of inside trading would be eliminated.

## **Role in the financial system**

### *1.7 Capital formation*

Capital markets are very important in any country since they facilitate transfer of savings to where they are needed most. These include capital market instruments including stocks, bonds where those with excess funds advance capital that business people and governments require for new projects and expanded operations. This process called capital formation enable firms to access external sources of finance for expansion, apart from internally generated retained profits or banks (Braun, and Deeg, 2020). The development of any business venture means job creation and increase in productivity and the overall economy. Besides, the money received by governments through capital markets is used to finance constructions, education and social needs which in return support the growth of an economy.

### *1.8 Price Discovery*

Capital markets provide another equally essential function — price discovery in which value of financial instruments is fair value based on supply and demand (Schofield, 2021). The point when buyers exchange securities with sellers is when they convey their expectations for how a company will perform in the future, or what economic conditions may impact an asset's value. One specific example of this occurs when investors start to expect good things to come from a company: its stock price should go up, whereas bad things should lead to a drop in the price. Price discovery allows the investors to decide what is the best time to sell or invest and enables to know what is the risk or opportunity of the market.

### *1.9 Risk Transfer*

Derivatives such as options, futures, and swaps, allow risk transfer, but mostly through the capital markets (Chance, and Brooks, 2021). These instruments help parties hedge against, or preclude themselves from, taking specified risks – such as interest rate, currency exchange rate

or commodity price fluctuations. Suppose, for example, a company's lifeblood is imported goods and futures contracts can be used to lock in prices, decreasing the risk of cost increases falling to an unacceptable level. Just as investors can use options to help protect against potential losses in their portfolios by shifting the risk on these people who don't want the risk and put those people who can handle the risk, capital markets stabilise the financial system by providing businesses and investors an option to protect their positions and support long term planning.

### **Advantages and Disadvantages of Capital Market Instruments**

Capital market instruments are long-term financial securities, typically with maturities exceeding one year, issued by corporations, governments, and other entities to fund substantial capital projects such as infrastructure, expansion, or acquisitions. Broadly classified into debt and equity instruments, these tools each serve different financing objectives and investment outcomes.

Debt instruments, like bonds and debentures, obligate the issuer to pay a fixed or variable interest rate and return the principal amount at maturity. These instruments offer the advantage of predictable income streams for investors through regular interest payments, and they carry a higher claim on assets than equity in the event of issuer insolvency. Issuers benefit from debt instruments because interest payments are often tax-deductible, reducing the overall cost of capital. However, they face risks, including the possibility of default on interest or principal payments, which can damage creditworthiness and reputation. Additionally, debt instruments expose issuers to interest rate risk; if rates increase, the value of the debt falls, complicating refinancing efforts or secondary market sales.<sup>1</sup>

Equity instruments, such as stocks and preferred shares, represent ownership stakes, allowing investors to benefit from the issuer's profits and asset growth. For issuers, equity financing offers greater flexibility as it does not mandate repayment or regular payments, and it spreads risk by sharing ownership with investors. However, equity is generally more expensive than debt due to dividend expectations and the dilution of ownership. Investors face higher risk with equity compared to debt, as they stand last in line for repayment during liquidation but may

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<sup>1</sup> Caroline Ghosn, Capital Market: Capital Market: How to Access the Long Term Sources of Funds for Capital Expenditure Projects , Faster Capital , Available at- <https://fastercapital.com/topics/advantages-and-disadvantages-of-different-capital-market-instruments.html>, Last Accessed on 21.10.2024 at 1:45 P.M.

earn substantial returns if the company performs well.

In practice, government and corporate bonds are common examples. Government bonds, like US Treasury bonds, are often seen as safe investments with high demand, making them highly liquid with a low risk of default. On the other hand, corporate bonds, issued by private companies for business expansion or research, carry higher risk but typically offer greater returns. Prominent examples include bonds from firms like Apple or Tesla, which appeal to investors willing to take on increased risk for potentially higher yields.

Each type of capital market instrument has advantages and disadvantages for issuers and investors, making them integral to diverse financial strategies for achieving various long-term objectives.

### **Regulatory Framework of Capital Market Instrument**

Regulatory bodies are essential institutions created by the state to oversee and regulate specific areas where people and organizations interact, such as banking, insurance, pension funds, and capital markets. These frameworks are critical for ensuring stability and growth in any economy. In the capital market, strong regulation directly impacts economic development by encouraging investor participation, which in turn supports economic expansion. Regulatory bodies create a sense of security and structure, making the capital market a favorable place for investors. Courses on capital markets and their regulatory frameworks help students understand these regulatory structures and their ongoing development.

India's regulatory landscape for capital markets has evolved, positioning the country as a key player with one of the world's most advanced equity issuance markets. The Securities and Exchange Board of India (SEBI) is the primary authority for regulating capital markets, including equity and debt securities. SEBI was established in 1988 and was granted autonomous powers in 1992, making it responsible for overseeing the market and ensuring fair practices. Other regulatory bodies like the Reserve Bank of India (RBI), the Insurance Regulatory and Development Authority (IRDA), and the Pension Fund Regulatory and Development Authority (PFRDA) manage specific areas within the financial sector. The RBI, for instance, regulates credit and savings, while IRDA and PFRDA oversee insurance and pension products, respectively.

Additionally, quasi-regulatory bodies like the National Bank for Agriculture and Rural Development (NABARD) and the National Housing Bank (NHB) play vital roles. NABARD supervises rural banking, while NHB manages housing finance. Various central ministries, especially the Ministry of Finance, also influence regulatory policies, working closely with these bodies.

To improve coordination among regulators, the Financial Stability and Development Council (FSDC) was set up in 2010. It addresses inter-agency disputes, enhances cooperation, and promotes financial sector development. The primary objectives of these regulatory bodies include ensuring financial stability, protecting consumers, maintaining market confidence, and reducing financial fraud. While India's regulatory bodies are robust, adapting policies to the evolving market environment is essential for progress, and understanding this regulatory framework is key for anyone interested in capital markets.<sup>2</sup>

### **Role of Technology in Capital Market Instruments**

Capital markets have long connected investors with businesses seeking funds, fostering growth and wealth creation. However, technology is revolutionizing the structure and accessibility of capital markets in India, making trading more efficient, transparent, and user-friendly. The traditional trading floors crowded with brokers have transformed into sophisticated online platforms where algorithms, artificial intelligence (AI), and blockchain power investment and trading activities, significantly altering the landscape.

Technological advancements like AI, blockchain, and robo-advisors play a central role in India's capital market today. AI-driven platforms use machine learning to analyze massive datasets, providing personalized investment insights. Blockchain technology, known for supporting cryptocurrencies, now also ensures secure, transparent transactions within the capital market by eliminating intermediaries and reducing fraud. Robo-advisors, accessible 24/7, leverage algorithms to offer customized portfolio advice, catering to diverse investor needs, including those new to investing. The rise of fintech startups has further democratized investment opportunities through user-friendly mobile apps, allowing people to trade on-the-go using platforms like Moneycontrol and Opstra. In 2021, nearly 20% of trades were made on

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<sup>2</sup> Imarticus, The Evolving Regulatory Framework in Capital Markets, Imarticus Learning, Available at- <https://imarticus.org/blog/the-evolving-regulatory-framework-in-capital-markets/>. Last Accessed on 20.10.2024 at 5:30 P.M.



mobile devices, and Algo-based trading has increased trading volumes significantly by offering speed and accuracy.

As capital markets become more digitally integrated, regulatory frameworks play a pivotal role in maintaining stability and investor confidence. The Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI) oversee this evolving ecosystem, ensuring compliance with security standards to mitigate cyber risks. However, India's rapid growth in digital finance presents challenges, including the need for cybersecurity, equitable digital literacy, and competition from fintech firms that rival traditional banks. Yet, these challenges are balanced by opportunities for financial inclusion. Initiatives like Digital India and the Pradhan Mantri Jan Dhan Yojana promote broader access to financial services, even in rural areas.

With a market projected to grow to \$1 trillion by 2030, India is on the path to becoming a global fintech powerhouse. Technology is making capital markets more accessible and inclusive, and a thorough understanding of these dynamics is essential for anyone aspiring to enter the financial sector.<sup>3</sup>

### **Innovations in Capital Market Instruments**

India's capital markets have historically been the bridge connecting investors with businesses needing funds. However, technology and innovation are now rapidly transforming the way these markets operate, providing new ways to invest, manage risk, and enhance market efficiency. With advancements in AI, blockchain, and fintech, the capital market has become far more dynamic, accessible, and diversified than ever before.

One significant development is the rise of tokenized assets, where physical items like real estate or commodities are converted into digital tokens on blockchain networks. This allows investors to purchase fractional ownership in high-value assets, increasing accessibility and liquidity. Cryptocurrency exchanges, another innovation, enable the trade of digital assets with enhanced features like decentralized finance (DeFi) protocols, making the exchange of value more efficient and secure. Innovations in exchange-traded funds (ETFs) have introduced smart-beta

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<sup>3</sup> Imarticus, How Technology is Reshaping Capital Markets in India, <https://imarticus.org/blog/how-technology-is-reshaping-capital-markets-in-india/>, Imarticus Learning, Last Accessed on 19.10.2024 at 11:40 A.M.

and thematic ETFs, which cater to specific investment strategies and themes, thus broadening the scope of options available to investors.

Peer-to-peer (P2P) lending platforms are another notable innovation, removing traditional banks from the lending equation to directly connect lenders and borrowers. This model allows lenders to earn better returns while offering borrowers lower interest rates. Robo-advisors, powered by AI, have made investment management accessible to retail investors by providing automated, personalized financial guidance at a fraction of traditional advisory costs. Super-apps, already popular in Asia, are gaining traction in India as well. These all-in-one platforms provide services from banking to investing within a single interface, meeting various financial needs seamlessly.

This wave of innovation is supported by regulatory frameworks that ensure stability and protect investors. The Securities and Exchange Board of India (SEBI) oversees these instruments, maintaining transparency and enforcing standards for investor protection. However, challenges remain. As India embraces digital finance, cybersecurity, data privacy, and digital literacy are becoming essential considerations for sustainable growth.

Ultimately, these innovative capital market products and technological integrations are not only transforming India's financial landscape but also enhancing financial inclusion. For students or future finance professionals, understanding this evolving ecosystem is critical, as technology continues to reshape investment options and broaden the reach of capital markets across India.<sup>4</sup>

### **Conclusion**

India's capital market instruments have become increasingly sophisticated, driven by innovation and regulatory support, to meet the needs of a diverse and expanding investor base. These instruments, ranging from traditional stocks and bonds to modern-day exchange-traded funds (ETFs), tokenized assets, and peer-to-peer lending, play a crucial role in mobilizing capital for economic growth. Regulatory bodies like the Securities and Exchange Board of India (SEBI) ensure these instruments operate within a stable, transparent framework, protecting investor interests while fostering market expansion. Technological advancements,

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<sup>4</sup> Ravi Kumar Singh, Innovations in Capital Market for Institutions and retail customers, Medium, Available in - <https://medium.com/capital-markets-2030/innovations-in-capital-market-for-institutions-and-retail-customers-acb8a3f4e980>, Last Accessed on 18.10.2024 at 10:12 A.M

especially in digital finance, blockchain, and artificial intelligence, have opened up new pathways, making the capital markets more accessible and inclusive than ever. As India continues to balance innovation with regulation, its capital markets are poised for significant growth, creating opportunities for both seasoned and new investors while driving the country's economic progress forward.

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