Management of Fixed Income Securities
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Module # 07
Lecture # 31
Issuance and Trading Mechanism of Corporate Securities

So, in the previous class we discussed about the certain types of corporate bonds which are issued in the Indian corporate bond market and as well as the US bond market. We discussed both the short-term and long types of bonds that are issued in these two markets, which are considered as one of developed markets and as well as the emerging market. Today, we will be discussing this issuance and trading mechanism of corporate securities. How are those corporate bonds issued in this particular market?

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So, the concepts that will be discussed in today's class basically will deal with the 2 types of markets which are existing with respect to corporate bonds. One is as you know that we have a primary market, which means whenever the first-time particular bonds are issued and the other type of market is the secondary market. Where once the bond has bonds listed in the market, how does the trading of those kinds of securities are taking place?

So, that's why the trading mechanism of corporate securities in the secondary market and what is the issuance procedure of the corporate bonds in the primary market. So, these are the 2 broad things what we are going to discuss in today's class.

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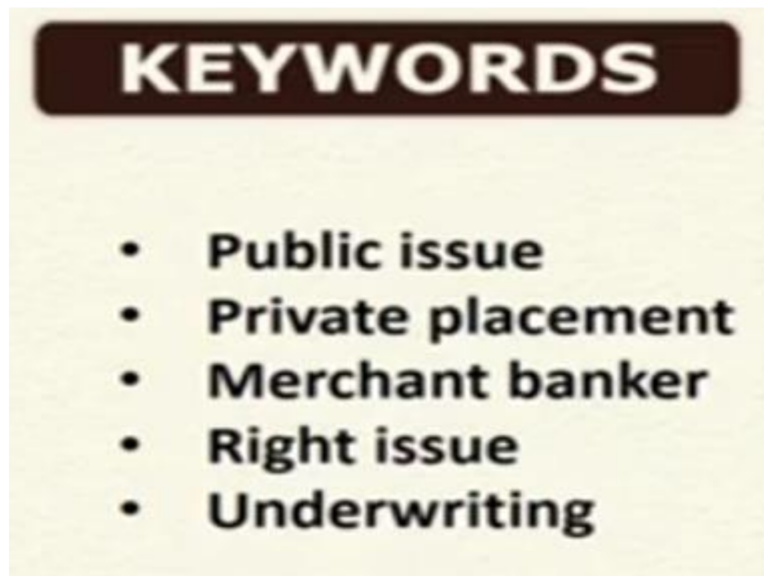

So, the keywords that you will come across in this particular class are like public issue, private placement, merchant banker, right issue and underwriting. So, this kind of concept is what generally we use in the trading of the corporate bonds in the different markets that basically you will be coming across in today's session.

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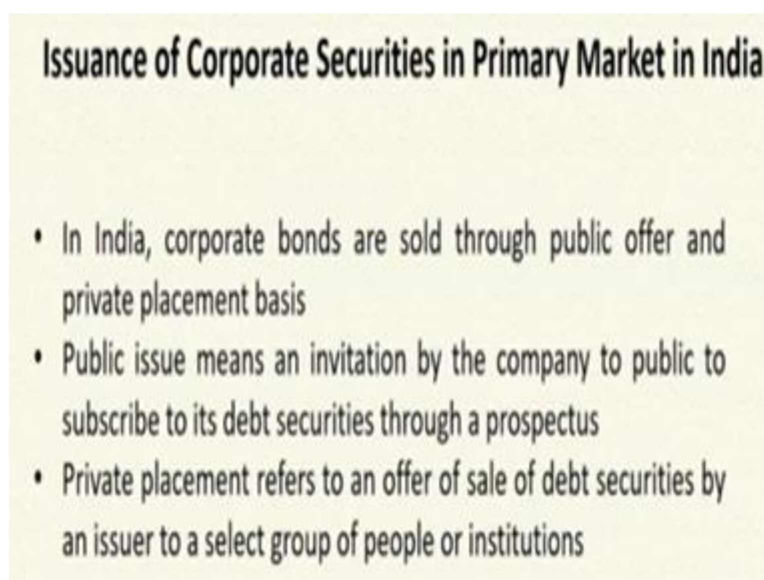

So, let us see that first of all we have to explain a certain kind of process with respect to the primary market. So, how are the corporate bonds are issued in the primary market in India? Then we can move towards the issuance procedure of the corporate bonds in the US market. So, whenever the corporate bonds are issued in the primary market there are 2 ways the bonds can be issued. One is through the public offer, the other is the private placement.

So, there are 2 ways the bonds can be raised or one can be issued in the primary market of a particular corporate bond market. So, what do you mean by the public issue? The public issue means, basically we the companies go to the public to raise the funds by issuing the bonds. So, in this case, what basically, we can say? That the company basically makes the invitation to the public to subscribe those bonds what they are going or they are planning to issue and how basically they issue those particular bonds through the prospectus.

Through a prospectus, the particular bonds are issued to the public or the companies go to the public to raise the funds. But if you talk about private placement, private placement is basically the offer of the sales of the debt by any of the issuers generally, always made to some select group of people or the select group of institutions. So, it is not available or is not applicable to the common public.

It is only applicable to some select group of investors and the companies decide to whom they are going to issue that particular bond to raise the money or to raise the capital. So, that is the basic difference between the public issue and the private placement. So, let us see that how the corporate bond market issuance of the bonds is taking place through this public issue. Then we can move towards the discussion on private placement.

(Refer Slide Time: 05:22)

Public Issuance Process

- All public issues of debt to be listed in stock exchanges
- The offer document should be approved by the stock exchange, where it is to be listed
- The process starts with the appointment of Merchant Banker
- Merchant banker evaluates the objectives of fund raising and structure of the instrument on the basis of issuer's profitability and cash flow analysis
- The structure of instruments include type of redemption pattern, options of interest payment, class of investors, timing of the issue etc.

So, whenever you talk about the public issuance process. First of all, you see that the basic objective of the public issue is the particular issues of the debt to be listed on the stock exchanges. It was not there before in the stock exchanges; the trading was not taking place in the stock exchanges. So, once the public issuance procedure will be over, the particular stocks can be traded in the secondary market.

So, the basic objective of the public issue is basically that the particular debt should be listed on the stock exchange. Then what happens here? The company basically goes for an offer document and that offer document should be approved by the stock exchange, where it is to be listed. So, in the stock market, you might have the idea that the initial prospectus or the offer document that they make has to be approved by the securities and exchange board of India.

But in the case of the bonds, the approval is not necessary from the SEBI, but the approval should be sort from the stock exchange, where the particular bond is going to be listed. So, the first is the offer document should be approved by the stock exchange where it is to be listed. Then what happens? The process basically will start; it is just like a book-building process what we follow whenever we raise the IPOs in the stock market.

So, in the case of the bond market in India, the particular process will start with the appointment of a merchant banker. Generally, the merchant bankers are the investment banks. So, once the particular company who is issuing this particular bond will appoint the merchant banker. Then the initial process will start. Then what will this merchant banker will do? The merchant banker

basically will evaluate the characteristics of the particular bond and what are those things are basically the evaluate.

First of all, they will see what the objective of the fundraising is. Why is the company basically issuing the debt? How that particular money which will be raised through this particular debt issuance are going to be utilized? So, what is the objective of the fundraising and the structure of that particular instrument which will be decided or which will be evaluated on the basis of the issuer's financial conditions right.

That means they will look at the company's profitability, look at the cash flow position in a particular company. Then accordingly they will evaluate whether the company is really in a position to raise that particular money through that issuance of the bond and whether the company is able to fulfill all the requirements from the investment perspective. That actually they have to evaluate first.

Once the merchant banker is appointed, they will go through or they will analyze these aspects; and how to define the structure of the instrument? Already all of you are aware of that. The structure of instruments basically includes the type of redemption pattern, the option of the interest payment that means whether the interest basically will be paid annually or it will be paid semi-annually or it will be paid at the end of the maturity.

So, all kinds of options they will look at; the class of the investors. What kind of investors are you targeting? Whether the investors you are targeting; the institutional investors or it is a combination of institutional investors and the retail investors and all these things and as well as the timing of the issue. When the particular company is going to issue that particular bond? So, here what basically you have observed, there is a big role the merchant banker plays in terms of the public issuance of the corporate bonds.

(Refer Slide Time: 10:34)

Public Issuance Process Cont...

- The issuer has to obtain the credit rating for the issue from credit rating agency and disclose the same in offer document
- The issuer has to appoint one or more debenture trustees in accordance with the companies act
- Once the approval is obtained from stock exchange, it is marketed to the investors
- The time line for listing of debt securities is six days for all public issues of debt securities
- Right issue refers to an offer of new debt securities to the existing holders of issuer's debt securities

So, once this evaluation process is done then what will happen next things that the issuer has to obtain a required credit rating for that particular issue from the credit rating agency. That means, depending upon the rating of that particular bond, the yield and the price of the particular bond are generally determined. The particular rating will provide the riskiness of that particular bond.

How much credit exposure the particular bond has or how much credit risk is involved with respect to that particular issue? So, that thing basically can be judged from the rating what the particular issue is getting. So, all of you know that the rating agencies again will look at the financial position of the company, then their debt repayment capacity and all types of things have to be checked open.

Some of the factors are internal and some of the factors are external. So, after that the rating agency will give the rating to that particular issue and once the rating will be received from the credit rating agency, that rating will be mentioned in the offer document. What is the rating of that particular bond then what will happen? The issuer has to appoint one or more debenture trustees. In the previous class we have discussed that because most corporate bonds are unsecured bonds.

So, in that place, the debenture trustees basically will play a significant role in more or less the security or the guarantee we can get from the Debentures trustees. So, these Debentures trustees are basically approved by the securities and exchange board of India. So, once the credit rating is

received, then after that the issuer has to appoint one or more Debentures trustees in accordance with the Companies Act.

Now, we are going through the Companies Act, 2013. On the basis of the Companies Act, 2013, they will always look for appointing one or more Debentures trustees; then what will happen? All these formalities are over, all the processes are over, then final approval will be sought from the stock exchange and then it will be marketed to the investors. This particular instrument or this particular issue will be marketed to the potential investors who are eligible to invest in that type of issue.

So generally, the timeline also has been fixed. What is the timeline? The timeline is basically for a listing of the debt securities is 6 days for all public issues of the debt securities. So, within 6 days that particular issue has to be listed on the stock exchange. So, all those kinds of bidding process have to be over within those particular 6 days period. So, this is basically a common public issue, more or less it is very much closely related to the book-building process what we follow whenever we go for the issuance of the IPOs in the stock market.

Then we have another issue which also works in terms of the public issue, so that is called the right issue. What is the right issue? The right issue is basically a kind of offers which are only given to the holders of the issuer’s debt securities or who are those investors who are already existing or they are already investing in that particular company, they are holding a certain amount of bonds what the company has issued before. The right issues basically are related to them.

The public issue whenever you talk about, there we may have a certain kind of concept like anybody can also start the investing in that particular company for the first time. But whenever it is a right issue, then those issues are only offered to the existing holders of the issuer's debt securities. So, that is basically what we call the right issue.

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Private Placement Process

- Debt securities are offered to select group of investors
- All information about the issue to be given in the Private Placement Memorandum
- All the issuance to be made through electronic book mechanism for transparency and better price discovery
- All the stock exchanges can act as electronic book provider (EBP) and can provide platform for placing bids ensuring safety, secrecy, integrity and retrievability of the data
- The issuer has to obtain the credit rating from the credit rating agency and file a self disclosure document with the exchange

Then we have a private placement. What is the private placement process? Here the debt securities are offered to select group of investors. Even if they are existing shareholders, if it is a right issue maybe you can. It is only open to the existing shareholders which are there in the company. But if it is a private placement, then the debts or the instrument what the particular company is trying to raise or trying to issue in the particular market.

So, that is only applicable or only available to the select group of investors. So, the company will decide to whom they want to basically sell that particular security or from whom they want to raise the capital for their investments. So, what will happen in that case? All the necessary information about the issue to be given to the private placement memorandum. There is a concept called the private placement memorandum.

The company will prepare that memorandum and that all those information related to that particular issue will be mentioned there and that information has to be provided to all those select groups of investors, to whom the company is targeting and all the issuance has to be made through the electronic book mechanism for transparency and the better price discovery. All those kinds of activities which is going to happen with respect to this private placement process that has to be always carried through or always will be carried out through this electronic book mechanism.

Because the electronic book mechanism will increase the transparency and the price discovery of that particular bond will be better in that case. So, all the stock exchanges can act as the electronic book providers that we call electronic book providers or in short, we call EBP and they can provide the platform for placing the bids, ensuring safety, secrecy, integrity and at any point of time the data can be retrieved.

The retrievability of the data is quite important in that case. That means the data is not missed out. At any point in time, the data can be retrieved. So, the stock exchange has act as an electronic book provider and they provide the platform for the bidding, maintaining all kinds of things like safety, security, secrecy, integrity and all these things. Again, in the private placement case also, the issuer has to obtain the credit rating from the credit rating agency which is required or what they basically are eligible to get.

And after that, they file a disclosure document with the stock exchange. What we can say is the rating they have and accordingly what should be the characteristics of the particular bond instrument those things will be disclosed to the stock exchange. So, the rating is quite important in the private placement case also.

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Private Placement Process Cont...

- All participants are required to enroll with EBPs prior to entering into the bidding process
- Exchanges provide unique codes to each participants which can be used to participate in EBP platform
- The minimum bid lot is Rs. 10 lakh and in multiples of Rs. 10 lakh thereafter
- In case of NBFC and Housing Finance Companies the minimum bid lot is Rs. 1 crore and multiples of Rs. 10 lakh thereafter

Then all the participants in this particular private placement market have to require to enroll themselves with the EBP's prior to entering the bidding process. Before they participate in the bidding process before they go for the bidding of all those debt instruments, they have to enroll

themselves with the stock exchange or this electronic book provider. So, all those exchanges provide the codes to their participants which can be used to participate in this EBP platform.

So generally, all those participants like all those investors who are inclined to participate in this particular market will be given a particular code by the stock exchanges or by the EBP and they can use that code for all types of transactions and all types of trading process. So, the minimum bid is 10 lakhs or the multiple of the 10 lakhs thereafter. But if you look at the non-banking financial companies (NBFC) and the housing finance companies (HFC) the minimum bid lot is 1 crore or and the multiples of 10 lakhs thereafter.

The minimum is 1 crore and after that, if you want to increase it can be 1 crore 10 lakhs, 1 crore 20 lakhs like that. So, there are some kinds of regulations with respect to the minimum amount of investments what the investors are trying to make. So, that is basically your private placement process, what generally we see in the Indian corporate bond market.

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Private Placement Process Cont...

- In case of open bidding the bid information such as bid value, bid rate/price except bidder's name is available to the market during bidding window
- In case of closed bidding the same information is disclosed post bidding
- Only the cumulative bidding amount is displayed to the eligible participants during the bidding period
- The issuer has to disclose the estimated cut-off yield to the EBP at least one hour before the opening of the bidding of the issue

Then after that what happens? If the particular issues are reissued or in case of reissuance, the issuer has to specify the ISIN number. What is the ISIN number? It is called the International Securities Identification Number of the existing security whatever they are holding and the accrued interest as on the day of paying for the reissued securities. That actually also they have to specify and the bidding is done in the case of reinsurance on a clean price basis.

Already, we have discussed that thing. In the beginning, you might have remembered, we have a clean price and we have a dirty price or the full price what we call it. So, whenever the particular private placements are carried out in the case of the reissuance process, the bidding has to be done with a clean price only. So, the total price is your clean price plus the accrued interest. So, that particular thing has to be kept in the mind whenever the reissuances are happening with respect to the private placement market.

The particular information memorandum has to disclose the mode of bidding, either it is an open mode or it is a closed mode or and the manner of allotment whether it is uniform. Already we have discussed these things before in the auction process. Uniform price-based auction and multiple price-based auctions and how the allotment is going to be made whether it is uniform yield basis or multiple yield basis and the settlement cycle.

The memorandum has to disclose all the information with respect to the mode of the bidding, the manner of allotment, the manner of settlement and the settlement cycle. All that information has to be given there. Then in the case of open biddings, just now we said that close bidding or open bidding. What do you mean by this open bidding? In the case of open bidding, the bid information is like the bid value or build yield.

Except for the bidder's name, the bidder's name will not be mentioned there. These are available to the market during the bidding window. So, that is called the open bidding process. But in case of the closed bidding, the same information will be disclosed in the post-bidding process. So, in the open bidding case, the bid value, bid rate and all these things will be available in the market during the bidding window; whenever the bidding is going on, but in case of the closed bidding, this information will only be available after the bidding is over. So, the cumulative bidding amount is displayed to the eligible participants during the bidding process and finally, the issuer has to disclose the estimated cutoff field to the EBP or the stock exchange at least 1 hour before the opening of the bidding of the issue. So that is the regulation that basically we have to keep in mind.

(Refer Slide Time: 25:49)

Private Placement Process Cont...

- Successful bids are determined by the EBP on yield-time priority basis
- It notifies the successful bidders about the total amount, details of pay-in account, pay in date and cut-off time
- Once the bidding window closes, the EBP gives out the aggregate volume data that includes yield/coupon/price, amount with oversubscription, total bids received, ratings, category of investor

So, the successful bids are determined by the EBP on yield-time priority basis and it will notify the successful bidders about the total amount, details of the paying account, paying date and cut-off time and all these things. Once the bidding window closes, the stock exchange gives out the aggregate volume data, which includes the yield/coupon/price, amount with over subscription, total bids received, ratings and category of investor, all types of investors will be available, once this bidding window is closes.

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Primary Market for Corporate Bond in USA

- In the primary market in USA, bonds are sold either (i) Open Market (ii) Private Placement
- Open market sales are handled through investment bankers who will either:
  - Underwrite the issue: Investment banker agrees to buy at a set price and then hopefully sell at a higher one.
  - Form an underwriting syndicate
  - Use best effort to sell the bond at the best price
  - Provide a standby underwriting agreement
- The way company chooses to offer an issue to the public depends (i) the size of the issue (ii) the risk of a price decrease during the time the issue is being sold

Then, if you look at the primary market of the corporate bond in the US more or less it is the same process. We call it the public issue, but they call it an open market and we have a private placement. The open markets in the US are handled through the investment bankers like the

merchant bankers, who will either underwrite the issue, that means the investment banker agrees to buy at a set price and then hopefully set at a higher one and they can also form an underwriting syndicate, it's not necessary to single underwriter will be there.

Maybe a syndicate of underwriters may be there in that case. They use their best effort to sell the bonds at the best price and provide a stand-by underwriting agreement. So, underwriting agreement means the particular issue is not subscribed then one particular company has to subscribe to that particular issue. So, the way the company chooses to offer an issue to the public that generally depends on the size of the issue and the risk of a price, decreases during the time the issue is being sold. So, these are certain factors they will consider.

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Underwriting Issues

- Investment bank underwrites the issue, buying the issue at an agreed-upon price and selling it in the market at higher price, this agreement is referred to as *firm commitment*
- Difference in price is known as the price spread or floatation cost (approximately 1%)
- *Underwriting risk*: Rates increase (bond prices decrease) in the market between the time the investment banker buys the bonds and sells them

So, already I told you what you mean by the underwriting issues? The investment bank basically, the underwrites the issue, buying the securities at an agreed-upon price and selling it in the market at a higher price. The agreement generally is referred to as the firm commitment. So, the difference in the prices is basically known as the price spread or the floatation cost. Approximately, it is around 1% in the US market. But there is a risk involved that is called the underwriting risk.

If the rates increase, then obviously the bond price will decrease in the market between the times the investment banker buys the bond and sells them. So, that risks the underwriter takes or the investment banker takes. So, that is called the underwriting issues.

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Procedures for Issuing Bonds

- Preparing indenture
- Registration with the Securities and Exchange Commission
- Issuing a preliminary prospectus called a *red herring*
- Forming selling group: Investment banker (wholesaler and other dealers)
- Selling issue through selling group

So, like India they prepare the indenture or the agreement, register themselves with the securities and exchange commission in the US, issue the preliminary prospectus, what they call the red herring and form the selling group like investment bankers like a wholesaler and the other dealers and sell this particular issue through this selling group. The selling group basically plays the role in that particular case.

(Refer Slide Time: 29:46)

SEC Rule 415: Shelf-Registration Rule

- ***Rule 415***, known as the `***shelf registration rule***', allows a firm to register an inventory of securities of a particular type for up to two years.
- The firm can then sell the securities whenever it wishes during that time – the securities remain on the shelf.
- To minimize costs, a company planning to finance a number of projects over a period of time could register a large issue and then sell parts of the issue at different times.

So, they have a rule called Rule 415. So, that is called the shelf registration rule. So, this basically allows a firm to register on inventory of securities of a particular type for up to 2 years. The firm can sell the securities whenever it wishes during that time and always the securities

remain on the shelf. It is basically to reduce this cost and this tedious process which generally we follow for these ones.

So, to minimize the cost a company planning to finance a number of projects over a period of time could register a large issue and sell the parts of the issue at different times. So, that is the benefit what the issuer can get through this particular role.

(Refer Slide Time: 30:44)

Private Placement Process in USA

- In USA also an alternative to selling securities to the public is to sell them directly to institutional investors through a ***private placement***.
- Because they are sold through direct negotiation with the buyer, privately placed bonds usually have *fewer restrictive covenants* than publicly issued ones, and they are *more tailor-made* to both the buyer's and seller's particular needs.
- One of the disadvantages of privately placed bonds was their lack of marketability due to the absence of an active secondary market
- Under the SEC Act of 1933, firms could only offer securities privately (which did not require SEC registration) to investors deemed sophisticated – insurance companies, pension funds, banks, and endowments.

Coming back to the private placement process in the US, it is through the private placement market they can do it. They are sold through direct negotiation with the buyer, then the privately placed bonds usually have fewer restrictive covenants, than publicly issued ones, and they are more tailor made to both buyers and seller's perspective. But, one of the disadvantages of the privately placed bonds was the lack of marketability due to the absence of the active secondary market for that.

So, under the SEC Act of 1933 the firms only offer securities privately to investors who are deemed or who are basically known as sophisticated investors like insurance companies, pension funds, banks and all these things. Anybody cannot be a participant in the private placement market.

(Refer Slide Time: 31:59)

Private Placement Process in USA

- In 1991, the SEC adopted Rule 144A under SEC Act 1933. Under this rule, issuer could sell unregistered securities to one or more investment bankers who could resell the securities to 'qualified investment buyers' (QIBs). QIBs could then sell freely with each other in securities that had not been registered.
- The adoption of ***SEC Rule 144A*** eliminated some of the restrictions on the secondary trading of privately placed bonds by institutional investors. SEC Rule 144A created a secondary market for privately placed bonds.
- Privately placed bond are exempt from SEC registration because they do not involve a pubic offering.

Then further in 1991, they have adopted the 144A rule and under this rule what basically will happen, the issuer could sell the unregistered securities to one or more investment bankers who could resell those securities to the qualified institutional buyers. And the qualified institutional buyers can sell freely with each other that have not been registered. So, this particular rule eliminated some of the restrictions on the secondary trading of the privately placed bonds and created a secondary market for that. And the privately placed bonds are exempt from the SEC registration, because they do not involve a public offering.

(Refer Slide Time: 32:53)

Private Placement Process in USA

- The adoption of SEC Rule 144A in 1990 allows secondary trading of privately placed bonds amongst qualified institutional investors. The liquidity of the private placement market has improved with 144A.
- Not all private placements are Rule 144A placements. Some Rule 144A private placement issues are underwritten just like publically issued bonds (bigger firms).
- Many privately placed issues are for smaller, less well-known companies (medium-size companies). This market competes with corporate bank loan market.

So, this rule creates a secondary market and many privately placed issues are for the smaller and less known companies also have started participating in this particular market and this market competes with the corporate bank loan market in the US.

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Secondary Corporate Bond Market Mechanism in India

- Generally done through OTC through brokers and reported on exchange reporting platforms
- The lot size for trading in bonds is Rs. 1 lakh
- All OTC trades in corporate bonds have to be reported within 15 minutes of deal closure on the reporting platform of stock exchanges which is then consolidated and disseminated on the FIMMDA website
- The corporate bond trades are settled on a Delivery Versus Payment (DVP-I) basis at participant level through Clearing Corporation of stock exchanges

So, coming back to the secondary market, the secondary market bonds basically if you talk about, they are generally done through the OTC market and the lot size of trading is around 1 lakh. And all the OTC trades transactions have to be reported within 15 minutes of the deal closure on the reporting platform of the stock exchange which can be consolidated and disseminated on the FIMMDA website. And the corporate bond trades are settled on delivery versus payment basis at participant level through the clearing corporation of the stock exchange that is in India.

(Refer Slide Time: 34:04)

Secondary Corporate Bond Market Mechanism in USA

- The principal secondary market for corporate bond is the OTC market.
- The OTC market has been conducted by dealers who take positions in bonds to fulfill buy and sell orders.
- Today the market is more transparent due to Trading Reporting and Compliance Engine (TRACE).
- There has also been a transition from traditional trading toward electronic trading.
- Many corporate bonds are held by institutional investors who tend to hold bonds to maturity. As a result, the secondary market for some bonds can be relatively thin

If you look at the secondary bond market in the US that is also dominated by the OTC market and here the OTC market has been conducted by dealers, who take the positions in bonds to fulfill the buy and sell orders. Today the market is more transparent due to a trading reporting and compliance engine that is called trace and there has been a transaction from traditional trading towards electronic trading.

So, many corporate bonds, if you look at them, are held by the investors up to maturity; that's why the secondary market for some bonds can be relatively thin. Because they are holding the bonds up to the maturity there are no transactions before the maturity or less amount of transactions are happening before the maturity.

(Refer Slide Time: 34:53)

Secondary Corporate Bond Market Mechanism in USA

- Corporate bond trading primarily takes place in the OTC market via dealers, but there is a transition to electronic trading
- ***Multi-Dealer Systems*** allow customers to execute trades from multiple quotes. The system displays the best bid or offer prices of those posted by all dealers. The participating dealers usually act as the principal in the transaction.
- ***Single-Dealer Systems*** allow investors to execute transaction directly with the specific dealers desired.
- ***Cross-Matching System*** brings dealers and institutional investors in an electronic trading network that provides real-time period cross matching.
- ***Auction System*** allows market participants to conduct electronic auction of securities in early stages.

So, they have a multiple dealer system, multi dealer system which allows the customers to execute trades from multiple courses. The system will display the best bids or offer prices of those posted by all dealers and the participating dealers usually act as the principal in these particular transactions. They can also have a single dealer system; this system basically allows the investors to execute the transactions directly with the specific dealers.

Then they have a cross matching system that brings dealers and institutional investors in an electronic trading network and that provides the real time period cross matching. An auction system allows the market participants to conduct the electronic auction of securities in early stages. So, these are the different process or different systems which work in the secondary bond market corporate bond market in the US.

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CONCLUSIONS

- In India, corporate bonds are sold through public offer and private placement basis. In USA also bonds are sold either (i) Open Market (ii) Private Placement
- Open market sales are handled through investment bankers
- The principal secondary market for corporate bond is the OTC market.

So, what basically we have discussed here, that the corporate bonds are sold through public offer and the private placement basis. In the US also bonds are sold either through open market or private placement. Open market sales are handled through the investment bankers and the principal secondary market for the corporate bond is the OTC market. But; that market is not very developed because most of the bonds basically the investor holds up to the maturity.

So, these are the references that you can go through for a detailed idea on this. Thank you.

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