

Depository system in  
india security system  
for investors  
economics essay



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Close to sixty three years of Independence, India has emerged to be one of the driving forces of the World Economy. However, with the recent setback of the Global Recession of 2007, a need had been felt to look into the existing structures of the Financial Institutions present. Consequently, a Committee was established by Securities and Exchange Board of India (SEBI), under the chairmanship of Bimal Jalan, former Reserve Bank of India (RBI) governor, in February 2010. It was setup with the view to underscore an important distinction between regulation and control, and to ensure that the former does not degenerate into the latter. The committee has also instituted an interesting term called the Market Infrastructure Institutions. The term 'marker infrastructure' denotes such fundamental facilities and systems serving the market.

As per the Report[1], Stock exchanges, depositories and clearing corporations are collectively referred to as securities Market Infrastructure Institutions (MIIs). They can be defined to be institutions providing basic, underlying framework or features for the market. Well functioning MIIs are the backbone of any economy, which in turn is directly proportional to the well-being of the economy. Infrastructure Institutions can be characterized by provision of essential services, offering networking services, exhibiting economies of scale, presenting sunk costs and operating natural monopolies.

[2]

## Introduction

Depositories form an important part of the securities Market Infrastructure Institutions in India.

As per section 2(e) of the Depositories Act, 1996, a 'depository' means a company formed and registered under the Companies Act, 1956 and which has been granted a Certificate of Registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992).

In simple words, a Depository is an organization which is similar to a bank. It holds the securities of investors in an electronic book entry form at their request and provides services related to transactions in securities with speed, accuracy and safety. It interacts with its clients through a 'Depository Participant' with whom the client is required to open a Demat Account.

A depository participant is defined in section 2(g) of the Depositories Act, 1996 as 'participant means a person registered as such under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992).'

An application for the grant of certificate of registration as Depository Participant is made to the Board Form E along with application fee as specified in Part A of the second schedule of the Depository Participant Regulations.

Public financial institutions, scheduled commercial banks, foreign banks operating in India with the approval of the Reserve Bank of India, state financial corporations, custodians, stock-brokers, clearing corporations /clearing houses, NBFCs and Registrar to an Issue or Share Transfer Agent complying with the requirements prescribed by SEBI can be registered as Depository Participants.

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## Evolution of Depository System in India

The growth in the Indian capital market both in number of transactions and the value of trade and resultant settlement of securities exposed the limitation of handling securities in the paper mode. Physical (paper) mode of holding securities was not only cumbersome and inefficient but also held numerous risks for the participant and led to dissatisfaction of issuers and investors alike. Due to limitations and problems associated it necessitated the setting up of depositories to move away from paper based holding of securities. Thus, Depository system was established to eliminate the inconvenience and confusion caused by the paper based trading and a scripless trading system came to be recognized.

The enactment of Depositories Act in August 1996 paved the way for introduction of Depository system in India. Following the notification of the SEBI (Depositories and Participants) Regulations, 1996, National Securities Depository Ltd (NSDL), a company sponsored by the NSE, IDBI and UTI was granted a certificate of registration as a depository on June 7, 1996. Some of the other shareholders are State Bank of India, HDFC Bank Limited, Deutsche Bank A. G., Axis Bank Limited, Citibank N. A. Standard Chartered Bank, The Hongkong and Shanghai Banking Corporation Limited, Oriental Bank of Commerce etc.

The higher shareholding (of at least 51%) by sponsors, including stock exchanges in depositories was permitted in the initial stages for facilitating the setting up of depositories.

Central Depository Services (India) Ltd (CDSL), the second depository, was promoted by Bombay Stock Exchange Limited (BSE) in association with Bank of India, Bank of Baroda, State Bank of India and HDFC Bank. BSE has been involved with this venture right from the inception and has contributed overwhelmingly to the fruition of the project. The initial capital of the company is Rs. 104. 50 crores. The list of major shareholders with effect from 5th July, 2010 is[3]:

Name of shareholders

Value of holding (in Rupees Lacs)

% Terms to total equity

Bombay Stock Exchange Limited

5, 663. 46

54. 20

Bank of India

582. 00

5. 57

Bank of Baroda

530. 00

5. 07

State Bank of India

1, 000. 00

9. 57

HDFC Bank Limited

750. 00

7. 18

Standard Chartered Bank

750. 00

7. 18

Canara Bank

674. 46

6. 45

Inter-depository transfer through on-line connectivity between CDSL and NSDL was established in 1999.[4]

Benefits of the Depository System

The main objective of the depository system is to maintain and safeguard the ownership and transfer records of securities in an electronic form.

Depository system eliminates the inconvenience and confusion caused by

the paper based trading. It is a safe and convenient way of holding securities and reduces the risks associated with certificates. In a depository system, the investors have the advantages like efficient settlements, lower costs and lower risks of theft.

It also facilitates immediate transfer of securities and no stamp duty is required on transfer of shares. Change in address recorded with Depository Participant gets registered with all companies in which investor holds securities electronically eliminating the need to correspond with each of them separately.

Also there is automatic credit into demat account of shares, arising out of bonus/split/consolidation/merger etc. A natural guardian is not required to take court approval for selling Demat securities on behalf of a minor.

Ease in portfolio monitoring since statement of account gives a consolidated position of investments in all instruments. Holding investments in equity and debt instruments in a single account is also another advantage of the depository system.

Features of Indian Depository System:

Dematerialization: There are two models for depository system across the world-dematerialization and immobilization. India has adopted the dematerialization model. India provides for a competitive multi-depository system. There can be various entities providing depository services. eg (NSDL and CDSL). The model adopted in India provides only for

Dematerialization of securities. Dematerialization is the process of

converting the physical form of shares into an electronic form and in short called Demat. Dematerialization of securities occurs when securities issued in physical form is destroyed and an equivalent number of securities are credited into the beneficiary owner's account.

The depositories can provide their services to investors through their agents called Depository Participants. These agents are appointed subject to the conditions prescribed under Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 and other applicable conditions. The participants and investors get their respective ID's which has a unique identification in the depository system. Any number of depository accounts can be opened.

After opening an account with the Depository Participant the investor should surrender the physical certificates held in his name to a depository participant. These certificates will be sent to the respective companies where they will be cancelled after dematerialization and will credit the investors account with the Depository Participant. The securities on dematerialization will appear as balances in the depository account. These balances can be transferred like the shares held in physical form. The securities in the Demat can again be converted into physical form which is called as dematerialization.

Dematerialization of shares is optional and the investor can hold shares in the physical form, however the investor will have to demat the shares if he wishes to sell or purchase the shares through stock exchanges.



Immobilization of securities is done by storing or lodging the physical security certificates with an organization that acts as a custodian – a securities depository. All subsequent transactions in such immobilized securities take place through book entries. The actual owners have the right to withdraw the physical securities from the custodial agent whenever required by them. In the case of IPO, a jumbo certificate is issued in the name of the beneficiary owners based on which the depository gives credit to the account of beneficiary owners.

**Fungibility:** Section 9 of the Depositories Act, 1996 states that securities in depositories should be in fungible form. In the depository system, the securities dematerialized are not identified by distinctive numbers or certificate numbers as in the physical environment. Thus all securities in the same class are identical and interchangeable. For example, all equity shares in the class of fully paid up shares are interchangeable.

**Registered Owner/ Beneficial Owner:** In the depository system, the ownership of securities dematerialized is bifurcated between Registered Owner and Beneficial Owner. For the securities dematerialized, NSDL is the Registered Owner in the books of the issuer, but ownership rights and liabilities rest with Beneficial Owner. All the rights, duties and liabilities underlying the security are on the beneficial owner of the security.

**Free Transferability of shares:** Transfer of shares held in dematerialized form takes place freely through electronic book-entry system.

**Legal Framework**

The depository business in India is regulated by:

a. The Depositories Act, 1996

It was enacted to provide for regulation of depositories in securities and for matters connected therewith or incidental thereto. It came into force from 20th September, 1995. It provides for the establishment of single and multiple depositories. Anybody to be eligible needs to be formed and registered as a company under the Companies Act, 1956 and seek registration with SEBI and obtain a Certificate of Commencement of Business from SEBI on fulfillment of the prescribed conditions.

b. The SEBI (Depositories and Participants) Regulations, 1996

SEBI on 6th May, 1996 issued SEBI (Depositories and Participants) Regulations, 1996 which apply to depositories and its participants. The Depositories Act requires that the registration of the depository, depository participant and custodian, is mandatory with SEBI.[5] These regulations also contain provisions for operations and functioning of depositories, for application and certificates used and schedule of fees for participants etc.

c. Bye-Laws of Depository

Depository is required to frame its bye-laws[6] with the prior approval of SEBI, consistent with the provisions of the Act and the regulations made by SEBI thereunder. However on non-compliance SEBI has the power to amend or revoke the bye-laws on its own.

d. Other Laws

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Apart from the above, Depositories are also governed by certain provisions of Companies Act, 1956, The Indian Stamp Act, 1899, SEBI Act, 1956, SCRA, 1956, Benami Transaction Prohibition Act, 1988, Income Tax Act, 1961, Bankers Book Evidence Act, 1891.

### Ownership Norms

#### Setting up of a Depository:

An application for the grant of a certificate of registration as a depository shall be made to the Board by the sponsor in Form A. A Sponsor (anchor investor), as per section 2 (g), SEBI (Depositories and Participants) Regulations, 1996, means any person or persons who, acting alone or in combination with another proposes to establish a depository and undertakes to perform the obligations of a sponsor under these regulations.

It is to be accompanied by the fee<sup>[7]</sup>and be paid in the manner specified thereof.<sup>[8]</sup>

The application should be accompanied by draft bye-laws of the depository that is proposed to be set up. The sponsor is to be from one of the mentioned categories:

(i) A public financial institution as defined in section 4A of the Companies Act, 1956 (1 of 1956);

(ii) A bank included for the time being in the Second Schedule to the Reserve Bank of India Act, 1934 (2 of 1934);

- (iii) A foreign bank operating in India with the approval of the Reserve Bank of India;
- (iv) A recognized stock exchange within the meaning of clause (j) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956);
- (v) A body corporate engaged in providing financial services where not less than seventy-five per cent of the equity capital is held by any of Securities and Exchange Board of India the institutions mentioned in sub-clause (i), (ii), (iii) or (iv) jointly or severally;
- (vi) A body corporate constituted or recognized under any law for the time being in force in a foreign country for providing custodial, clearing or settlement services in the securities market and approved by the Central Government;
- (vii) An institution engaged in providing financial services established outside India and approved by the Central Government;

The applicant is supposed to be a fit and proper person.[9]

Presently, sponsors are required to hold at least 51% of the equity share capital in the depository, either alone or together.[10]Also, no participant shall at any time, hold more than 5% of the equity capital of the depository[11]

No person other than a sponsor, whether 'resident in India', or not, shall at any time, either individually or together with persons acting in concert, hold more than 5% of the equity share capital in the depository.[12]

The expression “ person resident in India” shall have the meaning assigned to it in clause (v) of section 2 of the Foreign Exchange Management Act, 1999 (42 of 1999).

The expression “ Persons acting in concert” shall have the meaning derived from clause (e) of sub-regulation (1) of Regulation 2 of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

The combined holding of all persons resident outside India in the equity share capital of the depository shall not exceed, at any time, 49% of its total equity share capital, subject further to the following: ‘ the sponsor shall, at all times, hold at least 51% of the equity capital of the depository and the balance of the equity capital of the depository shall be held by its participants.’[13]

At present, the combined holding of all persons residing outside India in the equity share capital of an MII is capped at 49% subject to the following:

The combined holding through FDI[14]and FII[15]routes are capped at 26% and 23%, respectively.

FII can acquire the equity shares of an MII only through the secondary market.[16]

An FII cannot have representation on the board of an MII.[17]

After considering the application, if the Board is satisfied that the company established by the sponsor is eligible to act as a depository it may grant a

certificate of registration in Form B to the depository subject to the prescribed conditions like registration fee, redressing of grievances etc. A depository is required to make an application to the Board for commencement of business in Form C within one year from the date of issue of certificate of registration.

The SEBI (Depositories and Participants) Regulations, 1996, provides that: “the depository shall not carry on any activity other than that of a depository unless the activity is incidental to the activity of the depository”[18]

It is provided that a depository may carry out such activity not incidental to its activities as a depository, as may be assigned to the depository, by the Central Government or by a regulator in the financial sector, through the establishment of Strategic Business Unit(s), and by complying with other conditions specified by the Board.[19]

A ‘ Strategic Business Unit’ shall be an organizational unit of a company with its own mission, objectives and business strategy that is given the responsibility to serve the particular demands of one business area with appropriate technological, financial and other segregations.

It is provided that for the purposes of clause (d) and (e) no foreign entity, [20]individually and collectively either as a sponsor or as a participant or as a sponsor and participant together shall hold more than 20% of the equity capital of a depository.

**Board Composition**

The Board composition for the two main depositories in India can be summarized as follows:

a. National Securities Depository Ltd (NSDL)

Independent Directors: 5

Shareholder Directors: 5

MD/CEO: 1

b. Central Depository Services (India) Ltd (CDSL)

Independent Directors: 2

Shareholder Directors: 5

Whole time Directors: 1

The board structure for depositories is not subject to stringent norms. Only financial institutions/banks/stock exchanges, etc. can be sponsors of a depository and these are mostly nominated as shareholder directors. Further there have been no requirements for appointment of MD/CEO that have been prescribed for depositories.

#### Net Worth of Depositories

The net worth requirement for Depositories is 100 crores.

#### Disadvantages:

Prior to dematerialization there was almost a gap of three months between application date and listing of shares. Dematerialization has reduced this gap to a great extent. Current regulations prohibit multiple bids or applications by a single person. But the investors open multiple demat accounts and make multiple applications to subscribe to IPO's in the hope of getting allotment.

The recent IPO allotment scam proves that even a highly automated system is not the solution to prevent malpractices, if there is laxity. The scam of Yes bank and IDFC reveal the defect that investor banker fail to weed out multiple applications either direct or benami. eg. In the Yes Bank scandal thirteen investors had manipulated the allotment of shares by opening 7500 benami accounts and made profit in 1. 7crores. Eventually all the thirteen investors were banned from trading in bank shares immediately.

Lack of coordination between banks, DP's, brokers depositories, registrars and investment bankers and clarity of their roles has given rise to such problems. The depository system is complex and in need of greater supervision and control.

Thus is the working of the Depository system in India. The advantages of the depository system outweigh the disadvantages. Few changes in the complex system and specifications regarding the appointment of Board of directors need to be specified.