

DEPOSITORY SYSTEM IN INDIA

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With increasing liberalisation and globalisation of the Indian economy since the early nineties, the Indian capital market has witnessed an unprecedented growth in both activity and volume of business. In order to develop the basic infrastructure for settlement of securities and the paperwork associated with it, the Central government has enacted the Depositories Act, 1996 which came into force on September 20, 1996. The Act has paved the way for introducing scripless/paperless trading in India. In this paper, an effort has been made to examine the main features, mechanism and future prospects of the depository system in India.

1. INTRODUCTION

With liberalisation of the Indian economy in the nineties, the capital market has witnessed an unprecedented growth in volume of business. The amount of capital raised in the new issue market has gone up substantially. The number of new issues has gone up, trading volume in stock exchanges has grown manifold, and markets have become institutionalised with the entry of foreign institutional investors (FIIs) and mutual funds.

However, such growth has not been accompanied by the needed supporting infrastructure to handle the growing volume of paperwork in the market. The main drawback or bottleneck in the Indian capital market is existence of paperbased settlement of transactions which involves physical movement of the scrips.

The present system of transfer of securities is grossly inefficient as every share transfer is required to be accompanied by physical movement of shares (paper) certificates to the company concerned for registration. The process of physical movement of

scrips often takes much longer than two months as stipulated in Section 113 of the Companies Act, 1956.

Often, a significant portion of the transactions ends up as bad delivery due to faulty completion of paperwork, mismatch of signatures on transfer deeds with the specimen signatures in the records of the issuing company and other procedural lapses. Significant time involved in effecting transfer of ownership impounds substantial volume of shares at any given time leading to lower trading volumes.

Investors also face problems on account of loss of share certificates, forgery and mutilation. Time involved in printing of securities, their safe custody and dispatch adds to the cost of servicing.

With the entry of FIIs, this problem has compounded since the number of shares dealt with by them run into millions every day. They have been facing difficulties in getting the shares transferred fast in bulk. Owing to the difficulties encountered in physical transfer of shares, they have been preferring the GDR route.

Thus, with substantial increase in the volume of business in the stock exchanges in India during the recent years, the existing system of settlement of transactions has resulted in a paperwork gridlock posing serious obstacles to the growth and development of the capital market. Hence, there is a need to replace the existing clearing and settlement system which involves physical movement of scrips with a new and modern depositories system.

In order to provide a legal framework for the establishment of depositories in India, the Central government has enacted the Depositories Act, 1996. Guidelines have also been framed by SEBI in this regard.

The lead in respect of setting up depositories is taken by National Securities Depository Limited (NSDL). It has been jointly promoted by NSE, IDBI and UTI. NSDL earns the distinction of being the first depository to be registered in the country. It was registered with SEBI on June 7, 1996 and became operational on November 8, 1996. NSDL is expecting 100 companies to offer their services for scripless trading by the year end. Forty companies have already signed an agreement with NSDL for dematerialisation (see Box I and Box II).

The depository system will be successful only if most players including the small investor populace in the markets accept it and participate in it. However, investors have apprehensions about efficacy and functioning of the system. Their fear may be attributed to lack of conceptual knowledge of the system and the common belief that 'Possession is synonymous with ownership'.

The objective of this paper is to highlight the main features of the depository system and its functioning in India. It explains the mechanism of the depository system in

BOX I : Companies Registered with NSDL

Asian Paints
Indo Gulf Fertilisers and Chemical Corporation Ltd.
Larsen and Toubro
Dabour India
Hindalco
Dena Bank
Indian Rayon and Industries Ltd.
Hindustan Organics Chemicals Ltd.
Great Eastern Shipping Company
Jindal Strips
Bank of Baroda
Steel Authority of India Ltd.
HDFC Bank
IFCI
Cochin Refineries
Oswal Agro
Reliance Industrial Infrastructure
Gujrat State Fertilisers and Chemicals Ltd.
Jindal Petrochemicals
Oswal Chemicals

Box II : Depositories in Pipeline

Depository by Bombay Stock Exchange
Depository by Federation of Indian Stock Exchanges (FISE) in association with IFCI. FISE is a federation of 18 stock exchanges.

Section II. Section III presents the legal framework. Finally, Section IV evaluates the depository system.

II. FEATURES AND MECHANISM OF DEPOSITORY SYSTEM

The depository system records the ownership details of securities in computerised

book entry form in place of security certificates. The depository system is also called as the book entry transfer system. The term *book entry transfer* refers to transfer of securities in exchange for payment by book entry on ledgers of depository without physical movement of scrips.

Main Features

- (1) Securities held in depository mode will be dematerialised. Dematerialisation means that share certificates are defaced or destroyed.
- (2) Investors have been given the choice of either continuing with the existing system of holding physical securities or opting for depository mode. Such freedom can be exercised at the time of initial offer of security or at any subsequent time. Investors will also have the freedom to switch over from depository mode to non depository mode or *vice versa*. While the securities within the depository will be dematerialised and recorded electronically, securities outside the depository can continue to be in certified form.
- (3) Securities held in depository mode will be fungible which means that they will cease to have distinctive numbers. This implies that all the certificates of same security will become interchangeable and the investors lose the right to obtain the exact certificate they surrender at the time of entry into depository. It is like withdrawing money from bank without bothering about distinctive number of currencies.
- (4) A depository must have a net worth of Rs. 100 crores.

- 5) The depository would not render the services directly but through its agents called participants. The only link between investors and the depository is through investors' representatives in the depository system who trade on behalf of investors. The depository will maintain ownership records in the name of each participant who, in turn, will maintain necessary records in the name of investors.

Anybody to be eligible for providing depository services must be formed and registered as a company under the Companies Act and seek registration with SEBI and obtain a certificate of commencement of business from SEBI. As per the guidelines, stock exchanges, banks (domestic and foreign) and financial institutions are qualified to set up a depository. Participants will be custodians, stock brokers, banks (domestic and foreign), public financial institutions, clearing houses of stock exchanges and non banking financial services companies.

Dematerialisation

The process of dematerialisation is illustrated in Figure 1.

Investors opting to join the depository are required to enter into an agreement with one or more participants. There will also be an agreement between the depository and the issuer. The investor will have to open an account with the depository participant. The investor will inform the participant the details of certificate of security to be dematerialised and will surrender the certificate. The participant will maintain the records of security received and will confirm to the depository that an agreement has been entered into with the investor.

The participant will furnish to the issuer or its registrar and transfer agent the details

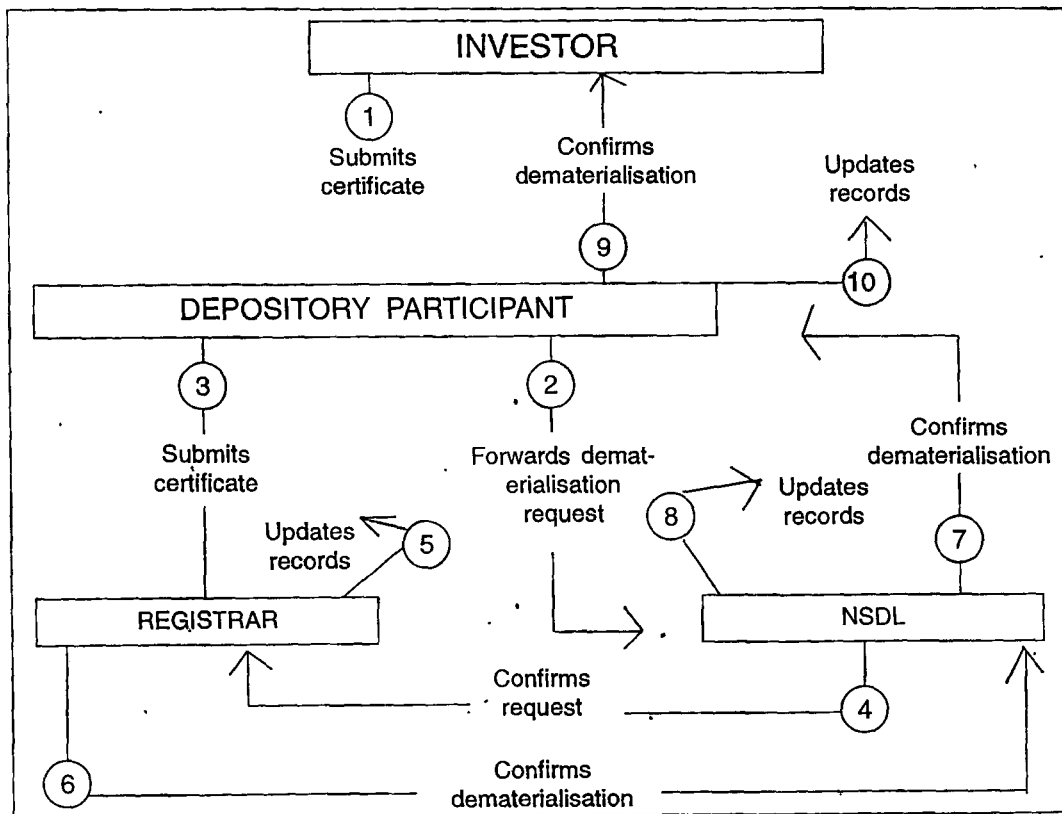
of agreement along with the certificate of security. The registrar and transfer agent will verify the validity of security certificate as well as the fact that dematerialisation request has been made by the person recorded as a member in its register of members. After verification the certificate will be dematerialised. The issuer will substitute in its records the name of depository as registered owner of securities and will send a certificate to this effect to the depository.

On receipt of such information, the depository will enter in its records the name of investor as beneficial owner as well as the

participant from whom it has received intimation and will send an intimation of the same to the participant who in turn will inform the investor and will issue a statement of account.

Now, the depository will become registered owner in the books of the issuer and the investor will become beneficial owner in the books of depository. As registered owner, the depository will have the right to effect the transfer of securities but will not have any voting rights or economic rights (dividend, bonus, etc.) associated with the security. The beneficial owner will continue to enjoy all the rights and benefits and be

Figure 1 : Dematerialisation Process



Source : Gupta (1996).

subject to all liabilities in respect of security held in depository on its own behalf. Further, the beneficial owner has a right to be indemnified by the depository for any loss caused to him due to the negligence of depository or participant.

Rematerialisation in Case of Exit

The investors opting to exit from the depository will be allowed to do so and claim share certificates from the company by getting their name substituted as regis-

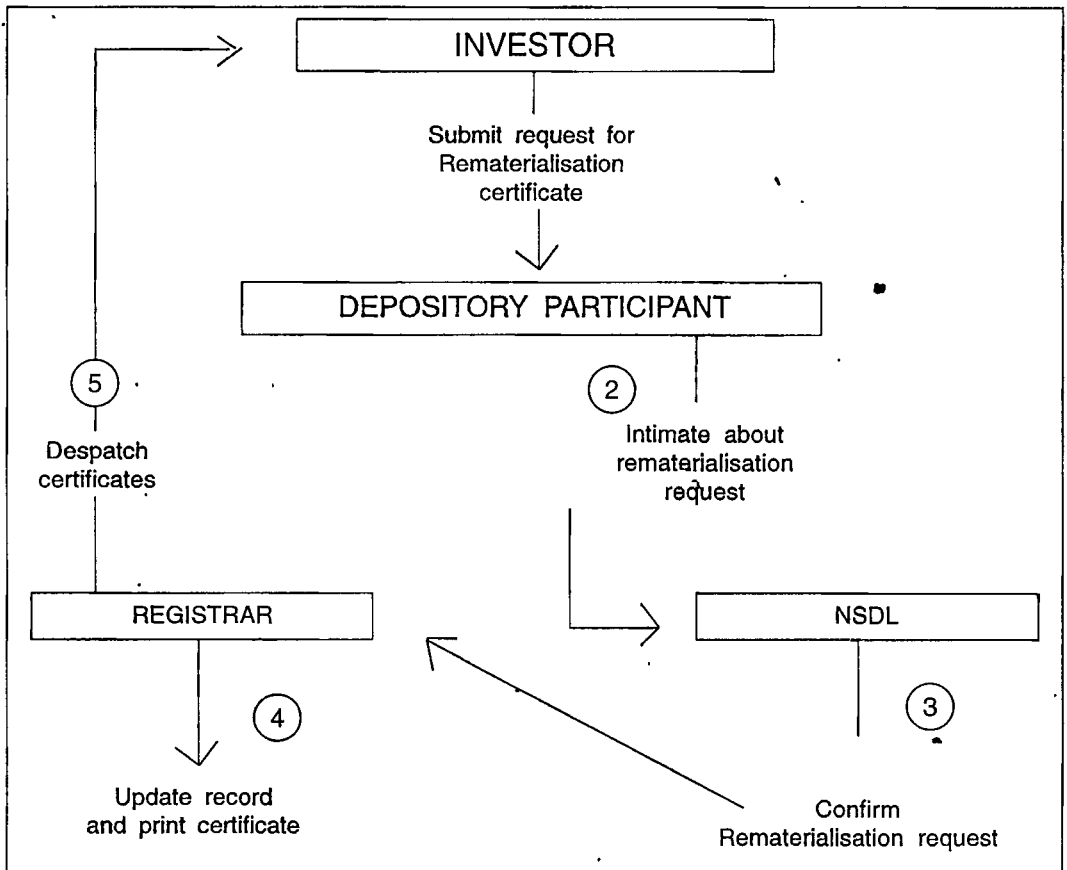
tered owner in place of the depository. The issuer will issue the certificate within thirty days of receipt of intimation from the depository (see Figure 2).

III. LEGAL FRAMEWORK

Transfer of Securities

(a) *The shares and debentures of a public company (listed as well as unlisted) have been made freely transferable*

Figure 2 : Rematerialisation Process



Source : Gupta (1996).

Section 22A of the Securities Contract Regulation Act, 1956 which empowers a listed public company to refuse to register transfer of shares on any of the grounds mentioned therein has been omitted. A new Section 111A has been inserted in the Companies Act, 1956 to govern the transfer of shares and debentures in a public company. According to this section, the transfer has to be effected immediately by the concerned depository or company. The depository would effect the transfer on receipt of suitable intimation that a purchase transaction has been settled. For the securities outside the depository mode, the transfer would be effected on the basis of transfer deeds as provided in Section 108 of the Companies Act.

The transferee in both the modes will enjoy all the rights and obligations associated with the security immediately.

(b) Power to Apply to Company Law Board (CLB)

If it is felt that the above mentioned transfer has contravened any provisions of the SEBI Act 1992 or regulations made thereunder or provisions of the Sick Industrial Companies (Special Provision) Act (SICA) 1985, then within two months of such transfer, an application can be made to CLB by the concerned company, depository, participant, SEBI or investor to determine if contravention has taken place. After inquiry, if the CLB is satisfied of contravention, it can direct the company or depository to rectify ownership records of security. However, before completion of inquiry, the CLB can suspend voting rights in respect of securities so transferred, but economic rights cannot be suspended under any circumstance.

In the case of private company and deemed public company, provisions of

Section III of the Companies Act relating to appeal to CLB will apply.

(c) Right to Further Transfer Securities

While dispute is pending before CLB, the transferee can further transfer the security and such further transfer will entitle the transferee to all voting rights unless the voting rights have also been suspended by CLB.

Exemption from Payment of Stamp Duty

Transfer of shares within depository will not attract stamp duty. At the time of entry into depository, no stamp duty will be paid on transfer of shares even though the registered ownership changes from investor to depository.

Depository and Participant Not Liable to Pay Capital Gains Tax

For Income tax purposes, the depository as well as participants will not be liable to pay capital gains tax in respect of securities held in depository and transacted from time to time since securities are held on behalf of the beneficial owner. In case of change in beneficial ownership, only the beneficial owner shall be chargeable to capital gains tax and not the registered owner.

Compulsory Dematerialisation

The Companies Bill 1997 has made it mandatory for companies making an initial offering of over Rs. 100 million to issue only dematerialised shares. This compulsory dematerialisation is expected to give a major boost to dematerialisation.

IV. EVALUATION

Benefits

The depository system would go a long way in eliminating the gigantic paperwork and

reduce the time and cost of processing securities. The system is expected to benefit the investors, issuers, securities intermediaries and the country at large.

Benefits to Investors

Investors would be spared of systematic problems like bad deliveries, delayed registration of transfer, non transfer, loss of share certificates, forged share certificates, theft, etc. There will be greater safety as compared to physical handling of securities.

The depository will help in increasing the marketability and liquidity of securities. Investors will be able to trade securities immediately after allotment without waiting for receipt of share certificate. The system entitles the transferee to all rights immediately on settlement of purchase transactions.

Exemption from payment of stamp duty will encourage the investors to lodge shares for transfer immediately.

Institutional investors can also save on space as there is no need to store large number of share certificates.

Problem of trading in odd lot shares will not arise as the minimum trading lot is one share. Right now, the odd lot shares are traded at a discount. Minimum trading lot of one share will facilitate trading in shares of any denomination and size at the same prices which are available to market lot holders.

Benefits to Issuers

Issuers will save substantially in printing and distribution costs in new issues.

Issuers will have up to date knowledge of shareholders' names and addresses. The depository will inform the company of the

shareowners and the company will distribute the benefits as is being done today. Up to date record will eliminate the need for long book closure. It will also help in enforcement of regulations relating to limit on investment by FII's and non residents. Further, this information will be available for provisions relating to takeovers.

Paper management will be substantially reduced. This will improve internal systems effectively.

There will be improved ability to attract institutional investors without having to incur the expenses of issuance in overseas market.

Benefits to Securities Intermediaries

Greater profits from increased trading volumes, reduced operational cost per transaction and reduced risk can be experienced.

Efficiency will increase as paperwork will be eliminated to a large extent.

They can service more clients easily and diversify into more markets and segments.

Benefits to the Country

The country will benefit as the depository system will yield place to a more liquid and efficient capital market. Settlements in stock would be quicker, transparency would improve further, and liquidity will improve substantially. It will go a long way in mobilising resources from the public and bring savers to capital market. To some extent, it will also curb generation of black money in stock markets. Efficient post trade systems with reduced transaction cost will increase competitiveness in international capital markets. It would attract FII's and fund managers by providing efficient and risk free environment. This would make global trading possible.

Problems

Under the depository system, the security certificate is surrendered to the issuer who cancels it and substitutes in its records the name of depository as registered owner in place of investors. Thus, the tangible evidence of ownership of securities is dematerialised and recorded in computer records which are vulnerable to technical failures. The entry of virus in the computer may lead to total failure of the system and erase all records. It will create a great problem as in the absence of any tangible proof of ownership of securities it will be difficult to find the true owners.

The technical snags in the form of frequent breakdowns can hamper trading to a large extent. Further, safety of transactions could be at stake by fraudulent action of some participants by misrecording beneficial ownership. Many companies feel that unless the software of NSDL is safe it would not be worthwhile to opt for the depository system. Further, investors would not be willing to part with their security certificates for some depository receipt.

Some amendments proposed by the Depositories Act in other Acts can also lead to problems. The Depositories Act provides for omission of Section 22A of the Securities Contracts Regulation Act, 1956. This is a section which vests powers with the management of companies to refuse transfer of shares effectively, and veto power to prevent takeovers and changes in the composition of board of directors. The implications of scrapping this section are that promoters would have very little chance of preventing a takeover. A door has been left for anyone to walk into the management room. It is felt that provisions of this section should be retained and the company as well as the depository should have a right to refuse transfer of securities

where such a transfer is in contravention of any law or is prohibited by any order of the court.

Section IIIA inserted in the Companies Act has been made applicable to all public companies including unlisted public companies. However, unlisted public companies are treated for all practical purposes on a par with private and deemed public companies in respect of transfer of shares, and have their own provisions in articles of association in respect of transfer of shares. There does not seem to be any logic for treating them at par with listed public companies. Provisions of this section should be made applicable to only listed public companies and Section III should be made applicable to all private companies, deemed public companies and unlisted public companies.

In case the company does not get timely information about the transfer of securities, then it will be difficult to take necessary action against the violation.

There is no suggested remedy if the application for rectification of register of members could not be made within the time specified.

While a dispute is pending before the CLB, shares can be further transferred and economic rights are not affected. The issue is how the CLB will resolve the dispute when the disputed owner keeps on changing.

The method of payment of stamp duty in case of securities other than shares has not been specified.

Future Prospects

Though the depositories are a boon for the stock markets, the small investors will take some time before rushing to open their

accounts. For effective implementation of the system, a psychological change in the minds of investors is a must. The common investor is used to have physical securities and would feel uncomfortable in parting securities with the depository. It will take some time for individual investors to shed this attitude. However, institutional investors, with their scrip holding of over 50 per cent, would definitely prefer the system.

In order to popularise the system, the concept should be explained to general investors through extensive use of electronic and print media. Awareness should be created about the benefits of the depository functions and the system of electronic book keeping. Various stock exchanges can launch investor education programmes.

Besides this, the depository itself should have adequate systems and safeguards to prevent manipulation of records and transactions. Like the banking system, the depository will have to create an aura of safety and stability. Then, as in the case of a bank account, investors will be reassured with just computer printouts of their assets. Building this confidence and bringing the Indian investor community to participate in the depository system will be the existing and future depositories' greatest challenge.

For the present, the business of depositories would be limited to institutional investors. Long term investors who want capital appreciation and dividend can remain outside the system. But as the system gets stabilised, they are also likely to accept the same.

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