

STRUCTURE OF THE INDIAN DEPOSITORY SYSTEM

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ABSTRACT

This study is an attempt to understand the structure of the depository system in India i.e. NSDL and CSDL. The traditional stock trading system involves dealing in share certificates with enormous paper work, obtaining an approved certificate in the name of the buyer, which is complex and time-consuming and also involves several problems not only of bad deliveries of shares but also the loss of certificates of stocks in transition. In that system, shareholder's securities are maintained electronically by converting physical securities into an electronic form through a process called "dematerialisation" of share certificates and facilitating transactions electronically without involving any share certificates or transfer deed. On the basis of this study we can understand the basic structure, functions of depository system, benefits of depository system and facilities given by depository system in India.

KEYWORDS: *Depository Participants, Dematerialization & Rematerialization and Demat Account.*

Introduction

A significant development of the twentieth century particularly in its later part is expansion of financial market world over which mostly was driven by globalization, technology, innovations and increasing trade volume. India has not been exception with the largest number of publicly traded companies with a large number of investors and an increasing number of transactions. However, this continuous growth in activities increased problems associated with stock trading. Most of these problems arose from the intrinsic nature of paper negotiation and liquidation, such as theft or loss of share certificates. This system requires the processing of large amounts of paper, resulting in higher costs and inefficiencies. The process of purchasing shares through stock exchanges for obtaining certificates duly registered in the name of the buyer was indeed quite complex and tedious and had many problems. An increasing number of investors in the capital market have increased the possibility of being hit by bad delivery. The costs and time spent by brokers in dealing with these poor deliveries tend to be greater because of the geographical distribution of customers. The increase in transaction volumes has led to an exponential increase in back office activities, limiting the growth potential of brokers. The difficulties encountered by investors (in remote areas of major metros) during transactions also limit the opportunities available to them, especially when they participate in auctions. The physical form of holding and trading securities has also been a bottleneck for the broker community in capital market transactions. Investor risk exposure also increased as a result of this paper trading. Some of these risks were: delay in the transfer of shares, possibility of falsifying various documents resulting in bad deliveries, litigation, etc., and possibility of theft of share certificates, prevalence of fake certificates on the market, mutilation or loss of stock certificates during transaction. The system of security operations was therefore not as beneficial for investors as it should be. In this scenario, dematerialized trading under a deposit system is certainly a welcome initiative. This popular financial service first appeared in Germany. The Indian government has decided to put in place a fully automated, technology-based model trading system that could offer screen-based trading and warehousing as the ultimate answer to all these reforms. That is why the Indian government announced the Depository Ordinance in 1995. However, both Houses of Parliament passed the Depository Act in 1996. The unprecedented success of the introduction of the custodian concept on Indian capital markets is reflected in the successful response between negotiations and settlement.

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Definition of Depository

A depository is a system in which it holds securities (i.e. shares, debentures, bonds, government securities, investment fund units etc.) of stockholder in computerized form at the requisition of the stockholders via registered depository participant. It further indulges services connected to business dealings in securities. "A Depository is a file or a set of files in which data is stored for the purpose of safe keeping or identity authentication", defined by Germany Depository.

In India, the Depositories Act, 1996 defines a depository to mean "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 Exchanges Board of India Act, 1992".

Depositories Act, 1996

The Depositories Act, 1996 provides for the creation of securities deposits to ensure the free transferability of securities with speed, accuracy and security by:

- Making securities easily exchangeable subject to specific exceptions;
- Dematerialization of the securities in the depository way; and
- Maintaining ownership records in a book-entry form.

To simplify the settlement process, the law provides for the electronic transfer of ownership of securities through book entry. The law made the transferable securities of all companies freely transferable according to the depository method, limiting the company's right to exercise discretion when transferring securities. Other requirements with regard to the procedure and the transfer provisions in the Companies Code have also been dispensed with

Legal Framework

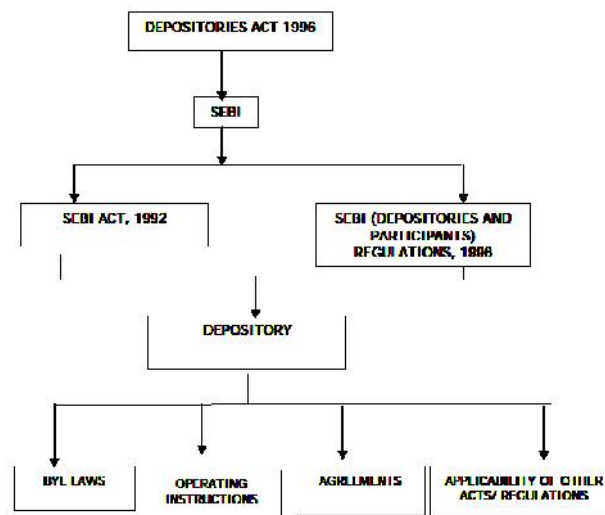
In India depositories are governed under the following legal framework:

- The Depositories Act, 1996
- SEBI (Depositories and Participants) Regulations, 1996
- Companies Act, 1956
- Securities and Exchange Board of India Act, 1992
- Prevention of Money Laundering Act, 2002

In addition to the above laws and regulations, the following rules apply to the business and activities of a custodian.

- Bye Laws of the depository
- Operating Instructions of the depository

The schematic diagram of legal framework of regulation of depositories is shown below:



As a result, the Indian Government promulgated the Depository Act 1996 to establish depository services in India. The depository system is based on the concept of paperless trading because the actions of a depository system are held in the form of electronic accounts, i.e. dematerialized form. There are currently two such depository in India; namely, National Securities Depository Ltd (NSDL) and Central Depository Services Ltd (CSDL). The NSDL was established as the first depository company in the country, sponsored by the Trust of India Unit.

NSE, SBI, HDFC Bank and City bank and by Board of Director as a public limited company. The Mumbai Stock Exchange (BSE) in association with BOI, BOB, SBI and HDFC Bank promoted CSDL as the second depository in India for trading in the securities in the computerized or e- form, by the name of Central Depository Services Ltd (CSDL). The major objective of these depositories is the growth of paperless trading, protection to the individual investor's engagement in the depository and to enhance liquidity.

Literature Review

This section covers the review of literature of some of the important studies, research papers and articles on the various aspects of depository system.

Shah (1996) highlighted that resolution of the single vs. multiple depositories, immobilization vs. dematerialization and role of capital adequacy norms for the custodians which is helpful in quick implementation of depository system in India.

Aggarwal and Dixit (1996) expressed their views about the legal framework for depository system in India. They also explained the benefits of the paperless trading, responsibilities of depository or participants and eligibility criteria, etc.

Sarkar (1996) analyzed the implications of the scrip less trading and share transfer based on book entry merely due to the existence of the depository ordinance 1995.

Hurkat and Ved (1999) discussed the role of depository system in many advanced countries in the stock and capital markets the world over. They also analyzed the services offered by NSDL, dematerialization, re-materialization, trading and fee or charges, comparison of a bank and a depository for the benefits of the depository.

Ravi Shah (2002) highlighted that NSDL and CSDL have changed the face of the Indian capital market. The move from an account period settlement in paper form only to a T+3 settlement in pure electronic form has been achieved in a record span of few years, whereas it took anywhere between 10-20 years in most of the developed countries.

Schmiedelet. al.(2006) analyzed the existence and extent of economies of scale in depository and settlement systems. The study indicated the existence of significant economies of scale but degree of such economies differs by settlement, institution and region.

Kanan (2008) highlighted that dematerialization has certainly brought about lot of improvement in the investment habits in our country and is bane for the companies and has created havoc in maintaining the members register and in conducting the members meeting.

Sultan Sing (2011) tried to study the factors affecting the decision making of the investors in depository system. Most of the investors are of the view that shorter settlement period, safety of securities with the depositories, attitude of the staff available with the DPs, timely services provided by the DPs to the investors, reduction in transaction cost, repatriation of sales proceeds of shares/debentures by NRIs are some of the factors which affects the decision making of the investors in depository system.

Most of these studies highlights specific aspects of DPs, to illustrate the legal framework (Aggarwal and Dixit, 1996; Atin Kumar Das, 2011), need for DPs in India (Sarkar, 1996), performance of DPs (George, 1996; Hurkat and Ved, 1999; Schmiedelet. al., 2006), benefits of DPs (Gurusamy, 1996), functions of NSDL & CSDL (Ravi Shah, 2002) etc. But there lacks a definite and comprehensive coverage of entire working procedure and functions of DPs in India in a single article. This paper aims to provide a single article window for the same with following objectives:

Objectives of the Study

- To study the meaning, organizational frame work and benefits of depository system.
- To study the working system of depository in India.

Depository System

• Concept of Depository System

The traditional stock trading system involves dealing in share certificates with enormous paper work, obtaining an approved certificate in the name of the buyer, which is complex and time-consuming and also involves several problems not only of bad deliveries of shares but also the loss of certificates of stocks in transition. In that system, shareholder's securities are maintained electronically by converting physical securities into an electronic form through a process called "dematerialization" of share certificates and facilitating transactions electronically without involving any share certificates or transfer deed. Here, the transfer of securities takes place by means of e-book entries. The Depository system provides various other direct and indirect benefits as under:

- Substandard deliveries are almost eliminated.
- Risks associated with physical certificates such as loss, theft, mutilation of certificates, etc. are eliminated.
- It eliminates the processing of huge amounts of paperwork involved in the preparation of transfer documents and the submission of transfer documents and share certificates to the company.
- There will be immediate transfer and registration of your shares (at the end of every settlement cycle, which is 4 working days i.e. T+3) and you need not have to suffer bog down on due to processing time.
- It leads to faster settlement cycle and faster realisation of sale proceeds.
- The payment of company benefits such as rights, bonuses, etc. will be faster.
- The stamp duty on the transfer of securities, which corresponds to 0.25% of the commission on the transfer of shares in physical form, does not apply and you may incur expenditure towards service charges of the Depository Participant.
- There may be a reduction in interest rates on loans made by various banks for liens on dematerialized securities.
- There may be a reduction in brokerage fees for trading dematerialized securities.
- There could be reduction in transaction costs in dematerialised securities as compared to physical securities.
- Availability of periodical status report to investors on their holding and transactions.

• Constituents of Depository System

The depository system comprises of:

- Depository.
- Depository Participants.(DPs)
- Companies/Issuer.
- Investors/Beneficial Owner.

Depository

The custodian works as a securities bank, where dematerialized physical securities are traded and held. This facilitates a faster, risk-free and cheap settlement. The depository is very similar to a bank and performs many activities that are similar to those of a depository:

- allows the redemption and withdrawal of securities from a depository through the "demat" and "remat" process,
- retains the assets of investors in electronic form,
- settlement effects of securities traded in stock exchange mode,
- carries out settlement of trades not done on the stock exchanges (off market trades).
There are currently two depositories in India i.e.
- NSDL: National Security Depository Limited.
- CDSL: Central Depository Services (India) Limited

National Securities Depository Limited

During a period of approximately nine years, investors switched to the electronic settlement system. The National Securities Depository Limited (NSDL) plays a central role in this change. The NSDL

launched a depository Certification Program in May 1999 to provide quality service to the depository users. This certification is performed using the NCFM infrastructure created by NSE and is called "NSDL depository module". The program aims to certify whether a person has sufficient knowledge of the depository business to serve investors. Participating custodians must designate at least one qualified person for the certification program in each of their service centers. This manual is intended to help candidates prepare for the certification program. National Securities Depository Limited is the first custodian to be established in India. It was created on December 12, 1995.

The Industrial Development Bank of India (IDBI) - the largest development bank in India, Unit Trust of India (UTI) - the largest Indian Investment Fund and the National Stock Exchange (NSE) - the largest stock exchange in India, sponsored the establishment of the NSDL and registered on the initial capital. The NSDL began operations on November 8, 1996.

Central Depository Securities Limited

A custodian facilitates the holding of securities in e-form and permits securities transactions to be processed through a custodian (DP) who, as agent of the custodian, provides custodial services to investors. According to SEBI guidelines, financial institutions, banks, custodians, investment dealers, etc. are eligible to act as DPs. The so-called "beneficial owner" investor must open a dematerialized account via each DP for the dematerialization of his holdings and the transfer of securities. Investor account balances included and managed with CDSL can be obtained via the DP. The DP must periodically provide the investor with an account statement with details of the securities and transactions held.

The depository system effectively removes paper-based certificates that tend to be fake, forged, counterfeit resulting in poor delivery. CDSL offers an efficient and immediate transfer of security. CDSL has been developed by Bombay Stock Exchange Limited (BSE) in collaboration with leading banks such as State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Union Bank of India and Centurion Bank. CDSL was created for the purpose of providing practical, reliable and secure deposit services at an affordable cost to all market participants.

Depository Participants (DPs)

Like brokers, who act on behalf of a client in the stock market, the depository participant is their representative in the depository system. Financial institutions / banks / custodians / stockbrokers, etc. can become DP as long as they meet the necessary requirements and guidelines set by SEBI. DP serves as a liaison between the investor and the company through NSDL / CDSL to dematerialization of the shares and other electronic transactions. DP offers different services regarding your holding, such as

- Maintenance of the balances of the securities accounts
- Enable yielding (dematerialization) and withdrawal (rematerialization) of your securities from and to the depository.
- Delivering and receiving shares in your account on your instructions. Hence, shares bought by you on a stock exchange can be received directly in your account and similarly those sold by you can be delivered on your instructions.
- Keeping you updated with regard to status of your holdings periodically.

Companies/Issuer

The issuer is the co. which issues the securities. A register shall be kept to record the names of the owners of securities and registered depositories. The issuer sends a list of shareholders who choose the depository system. Only those companies can issue listed securities.

Investor/Beneficial Owner

The effective beneficiary is the person whose name is registered as such in the depository. This means a person who sells and buys securities issued by companies and whose securities are registered with the depository in the form of an entry in the book. It has all the rights and obligations associated with the values.

Facilities Provided by the Depository System

- Dematerialization
- Rematerialization
- Electronic settlement of stock exchange transactions related to depositories.
- Pledge / mortgage on dematerialized securities.

- Electronic credit of publicly allocated securities, rights, bonus issue.
- Nomination facility.
- Freezing of accounts De-mat, so that debts from dematerialization are not allowed.
- Services related to change of address, nomination, mandate, transfer, etc.
- Other services, namely keeping debt instruments in the same demat account.
- Use the securities landing/ loan facility, etc.

Dematerialization

This is the process of converting physical or certified shares into electronic. Therefore, when a shareholder uses the dematerialization function, the company collects shares through the depository system and deposits the same number of shares on the account in electronic form.

Dematerialization Process

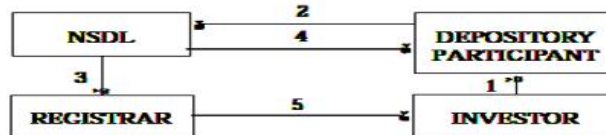


- Investor surrenders certificates for dematerialization to DP.
- DP informs the storage of requests through the system.
- DP sends the certificate to the registrar.
- Registrar validates the dematerialization requisition from depository.
- After dematerialization, the registrar updates the account and informs the depository of the dematerialization agreement.
- The depository updates the account and informs the DP.
- The DP updates his account and notifies investors

Rematerialization

Rematerialization is the opposite of dematerialization. This refers to the process of issuing physical securities, not securities held electronically in the form of accounting entries with depositories.

Rematerialization Process



- Beneficial owner requests for dematerialization.
- DP informs the storage of requests through the system.
- Depository validates rematerialization requisition to the registrar. The registrar updates the account and prints the certificate.
- The depository updates the account and informs the DP.
- Registrar dispatches certificates to investor.
- **Pledging Dematerialized Shares:** Dematerialized shares can be pledged; In fact, this is more advantageous than pledged share certificates. Once the loan is repaid, the promise can be closed by indicating to the DP via a standard format. The pledgee receiving the reimbursement, as well as the request to close the commitment, will give instructions to his DP accordingly. Even insured values can be pledged.
- **Initial Public Offers:** Credits for public offers can be received directly on a demat account. A provision will be included in the public application form of the eligible depositories to indicate how the values are to be attributed to the applicant. One is to indicate the DP customer account number, name and ID number. All investor allowances are credited to the required account.

- **Receipt of Cash/non-cash Benefits:** When a corporate event such as a rights, bonus or dividend for a particular security is announced, the custodian provides the Registrar with the details of all clients with electronic holdings in that security from the date of registration. The registrar then calculates the business benefits owed to all shareholders. Payment of cash benefits, such as dividends / interest, will be made directly by the Registrar. In the case of non-cash benefits, the custodian will credit the securities rights directly to the depository accounts of all customers who have opted for the electronic allocation on the basis of the information provided by the registrar.
- **Equity Loans and Borrowings:** Through the securities account, securities in dematerialized form can easily be lent / borrowed. Securities may be loaned or borrowed electronically through an authorized intermediary who has opened a special "intermediary" account with a DP. Instructions should be given to DP via a standard format (available from DP) to deposit securities with the intermediary. Similarly, to borrow securities from the intermediary, you must indicate to DP via a standard format (available with your DP).
- **Transfer of Securities:** The transfer of securities due to death, insanity, bankruptcy, insolvency or any other legal way that the transfer is also possible in the depository system. In case of transmission, the applicant must complete a transmission request form (available from the DP), along with valid documents.
- **Freezing an Account with DP:** If you do not want to perform a transaction in your account at any time for security reasons (you can inform one's DP accordingly). DP will ensure that this investor's account is completely frozen until further notice.

Demat Account

The Demat account is a safe and convenient way to hold securities, just like a bank account for funds. Today, a settlement of nearly 99.9% (shares) takes place only in dematerialized mode. It is therefore advisable to have a Beneficiary Owner (BO) account for trading on the stock market.

Benefits Of Demat Account

- A safe and easy way to hold stocks (equity and debt).
- Transactions with physical securities are more expensive than transactions with dematerialized securities (just as transactions via a bank machine are more expensive than ATM transactions). As a result, the costs that apply to an investor are lower for each transaction.
- Securities can be transferred immediately upon instruction.
- Increase in liquidity, securities can be sold at any time during trading hours (between 9:55 AM and 3:30 PM each business day) and payment can be received within a very short time.
- No stamp duty.
- Risks such as counterfeiting, theft, bad delivery, transfer delays, etc., related to physical certificates, are eliminated.
- Pledging over a short period.
- Less paperwork and transaction costs.
- Nomination facility.
- Any change of address or bank account can be transmitted electronically to all companies in which an investor holds securities, without having to inform them separately.
- Securities are transferred by the DP itself, so it is not necessary to correspond with the companies.
- Bonus shares, split, consolidation, merger, etc. are automatically credited to the demat account of the investor.
- Shares allocated in public issues are credited directly to the account of the investor.

Opening a Demat Account

To trade in electronic form, you must open a Demat account with a DP of your choice. An investor who already has shares in physical form must ensure that the account is opened with the same set of names as indicated on the share certificate; otherwise, a new account may be opened by the investor depending on the desired model.

How to open a Demat Account?

- For opening Demat account, you need to select a DP and fill up the account opening form and submit it along with necessary documents and a recent passport size photograph.
- The DP will provide you with the rules and regulations and terms and conditions for opening the account along with the charges incurred for the same.
- A member from the DP will contact you for In-Person Verification and check the details provided by you in the account opening form.
- Once the application is processed, the DP will provide you with an account number and client ID.



Documents Required for Opening an Demat Account

- **Proof of Identity (POI)**

List of eligible documents as proof of identity:

- PAN card with a valid photograph. This is a mandatory requirement for all applicants except those specifically exempted from obtaining a PAN (listed in section D).
- Unique identification number (AADHAAR) / Passport / voter identification card / driver's license.
- Identity card / photo document of the applicant, issued by one of the following authorities: central / national government and its services, legal / regulatory authorities, public sector enterprises, planned concerning business banks, governmental financial institutions, institute affiliated to universities, professional organizations such as ICAI, ICWAI, ICSI, etc., To their members; and credit / debit cards issued by banks.

- **Proof of Address (POA)**

List of documents accepted as proof of address: (* Documents with an expiry date must be valid at the date of submission.)

- Passport / voter ID card / ration card / registered rental agreement or sales contract for residence / driver's license / building maintenance invoice / copy of insurance.
- Utility bills such as telephone bill (land line only), electricity bill or gas bill - are not older than 3 months.
- Statement of account / bank passbook - No more than 3 months old.
- Self-declaration by the judges of the High Court and the Supreme Court, indicating the new address of their own account.
- Proof of address issued by one of the following: Manager of planned commercial banks / planned cooperative banks / multinational foreign banks / Gazetted officer / notary public / elected representatives of the Legislative Assembly / Parliament / documents issued from a government or legal authority.
- Identity card / photo document of the applicant, issued by one of the following authorities: central / national government and its services, legal / regulatory authorities, public sector enterprises, planned concerning business banks, governmental financial institutions, institute affiliated to universities, professional organizations such as ICAI, ICWAI, ICSI, etc., To their members.

- For FII / secondary account, the power of attorney given by the FII/ sub-account must be given to the custodians (duly notary and / or apostille or consular) who give the registered address.
- A proof of address on behalf of the spouse can be accepted.

Exemptions / clarifications relating to PAN (sufficient number of supporting evidence documents to collect these requests)

- In the case of transactions undertaken on behalf of the central government and / or the national government and by court-appointed officials, for example: official liquidator, court receiver, etc.
- Investors living in the state of Sikkim.
- Exempt United Nations entities and multilateral agencies from paying taxes / filing income tax returns in India.
- SIP investment funds upto Rs. 50,000 p.a.
- For institutional clients, i.e. FIIs, MFs, VCFs, FCVIs, Scheduled commercial banks, multilateral and bilateral development finance institutions, State industrial development companies, insurance companies registered with IRDA and public financial institutions within the meaning of Section 4A of the Companies Act 1956, the custodian will verify the PAN card data with the original PAN card and provide duly certified copies of the verified PAN data to the intermediary.

List of Persons Authorized to Certify/Attest the Documents

- Notary Public, Gazetted officer, manager of a scheduled commercial / cooperative bank or multinational foreign banks (Name, Designation and the seal must be affixed to the copy).
- In the case of Non Residents Indian, authorized executive of overseas divisions of scheduled concerning business banks registered in India, Notaries, Court Magistrate, judges and Indian embassies / consulates of the client's country of residence have the authority to certify the documents.
- In addition to these documents, your depository participant or broker may ask you to provide additional proof of identity, address and income. After all the documents have been sent, verified and examined by the competent department, your account will be opened.

Conclusion

On the whole, my research on the study of the structure of the depository system in India was very helpful and enlightening, because I had the opportunity to learn a lot about the capital market. I got to know the process of dematerialization, rematerialization, opening a Demat account, and how customers understand services related to the depository system

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