

# **Unit – 2**

## **Depository System**

## Introduction

- Is a system of dematerialisation of share certificate scripless trading in which transactions in securities take place through book entry method without the physical delivery of securities.
- Introduced in 1996.
- Problems faced before 1996  
Delay in transfer of securities, fake certificates, mismatch in signature, delay in delivery of securities after allotment, certificates in transfer, Mutilation of certificates, Long settlement cycles, lot of paper work, etc.
- Resulted in large scale entry of foreign institutional investors.

## **Need for Depository system in India**

- Large scale irregularities in the securities market
- Time consumption in allotment and transfer of securities
- Increased volume of transaction
- Mounting fiscal deficit – Attract foreign investment
- Problems associated with dealing with physical securities

Depositories Act was passed in 1996 to start Depository services in India.

## **Objectives of Depository system**

- To reduce the time for transfer of securities
- To avoid the risk of settlement of securities
- To enhance liquidity and efficiency
- To reduce the cost of transaction for the investor
- To create a system for the central handling of the securities
- To compete with global standards
- To provide service infrastructure in a market.

## **Functions/Role of Depositories and their services**

- Ensures free transfer of securities with speed accuracy and
  - De-materialises the securities in the depository mode
  - Provides for maintenance of ownership records in a book form
  - Name of the depository appears in the records of the issuer
  - Name of the actual owner appears in the records of the depository
  - Owner of the securities can avail all the rights and liabilities associated with the securities.
  - Assist in opening an account with a depository through a depository participant
- 
- Transfers securities through book entry only.

# Advantages

## To the Nation

- Growing and more liquid capital market with reduced transaction costs
- Increase in competitiveness in the international market place
- Improve prospects for privatisation of public sector
- Restoration of faith in the capital market
- Reduction in the delay in registration
- Reduction in the risk associated with loss, mutilation, theft and fraud
- Greater liquidity from speed in settlement
- Greater opportunity for investment is offered to new investors
- Faster receipt of benefits and rights resulting from corporate action
- Protection of shareholders rights from timely communication by the issuer
- Reduced transaction cost through greater efficiency

## To Issuers

- Up-to-date knowledge of the shareholders names and addresses
- Savings in costs of new issue from reduction in printing and distribution cost
- Increased efficiency of registrars and transfer agents
- Better facilities for communication with shareholders conveying benefits of corporate actions and information notices
- Improved ability to attract international investors

## **To Securities intermediaries**

- Less risky settlement with implementation of collateral based system
- Greater profits from increased trading volume made possible by automated systems with reduced operational costs
- Improved cash flow from not having funds tied up for long periods
- Elimination of forgery and fraud with reduction in settlement errors and bad deliveries
- Opportunities for development of retail brokerage business
- Opportunity for development of more sophisticated custodial services which can be offered to the smaller investors
- Standardised communication between depositories, registrars and other intermediaries
- Ability to arrange pledges without movement of physical securities, which will increase trading activity, liquidity and profits
- Improved protection of shareholders rights resulting from more direct communication from the issuer
- Reduced transaction costs through greater efficiency

## **Disadvantages of Depository System**

- Lack of Control
- Need for greater supervision by SEBI
- Complexity of the system – by-laws

### **Players in the Depository system/ Interacting system**

- Depository – something is deposited for safekeeping
- Depository participant– agent of the depository – N CDSL
- Company/Registrar and share transfer agents
- Investor – beneficial owners
- Stock exchanges and stock brokers – secondary market discovery. Stock brokers are members of S/E.
- Clearing corporation/clearing house and clearing mem

## **Depository**

- Depository is an organisation where the securities of an investor are held in electronic form and carries securities transactions by book entry.
- A depository offers its services to the investors through agents called DP.

### **Functions/Role of Depositories:**

- Enable the surrender and withdrawal of securities in Demat and Remat .
- Maintaining Investors holdings in the electronic form in computers
- Settlement of securities traded in the stock exchange and receipt of bonus or rights shares in electronic form.
- Carrying out settlement of “off market trades”.
- Status updates to the share registrar/ Issuer about the
- Stock lending, borrowing and pledging /hypothecation of Demat securities, freezing/locking an investors account

## **Services of Depository**

- Primary market services- acting as link between issuer and prospective
- Secondary market services-Link between investors and clearing house
- Ancillary services- collecting dividends and interests, crediting bonus,

## **Depositories in India**

### **National Securities Depositories Limited (NSDL)**

### **Central Depository Services Limited (CDSL)**

NSDL is the first Indian Depository established in 1996.

Is a Public Limited Company incorporated under the company's Act 19

## **Functions of NSDL**

- Enables the surrender and withdrawal of securities
- Maintains investors holdings in the electronic form
- Effects settlement of securities traded in the stock exchange
- Carries out settlement of trades not done in the stock exchange
- Transfer of securities
- Pledging/hypothecation of dematerialised securities
- Electronic credit in public offerings of companies
- ~~• Receipt of non-cash corporate benefits like bonus, rights, etc.~~

## **Advantages of NSDL**

- Elimination of Bad Deliveries
- Elimination of all risks associated with physical certificates
- No stamp duty for transfer of any kind of securities
- Immediate transfer and registration of securities
- Faster settlement cycle
- Faster disbursement of Non-cash Corporate benefits
- Reduction in brokerage by many brokers for trading dematerialised securities
- Reduction in handling of huge volume of paper
- Periodic status reports to investors on their holdings
- Elimination of problems related to change of address of investor
- Elimination of problems related to selling securities related to minor
- Ease in portfolio monitoring

## Process of Clearing and settlement

- Main activity of stock market is clearing and settlement of securities
- Depositories like NSDL and CDSL provide basic services in transfer of securities in India
- Clearing and settlement takes place in two situations
  - **Off Market transactions:** When a stock exchange and clearing house are not involved in the trade. E.g large deals between institutions, deals between private parties, deals between a client and a sub broker, large trades in debt instruments
  - **Market transactions:** When a stock exchange is involved in trade. Securities are transferred through stock exchange between two parties.
- **Steps in Off market trade –**
  - Seller gives delivery instructions to his DP to move securities from his account to buyers A/c
  - Buyer automatically receives the credit of the securities on the basis of the delivery instructions or receipt instructions
  - DP needs to be careful about signature of the client
  - Payment is made by buyer to the seller outside NSDL system

## **Central Depository Services Limited (CDSL)**

CDSL was promoted by Bombay Stock Exchange Limited jointly with leading banks such as State Bank India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Union Bank of India and Centurion Bank.

### **Objectives**

- To accelerate the growth of scripless trading
- To make a major thrust in the individual investor's participation in the depository
- To create a competitive environment, this will be responsive to user's interests and demand
- To enhance liquidity

## Function of CDSL

- Dematerialization i.e converting physical certificates into their electronic form
- Rematerialisation i.e converting securities in demat form into physical certificates
- Assisting in repurchase/redemption of mutual funds
- Electronic settlement of trade in stock exchanges
- Pledging or hypothecation of the dematerialized securities against loans
- Electronic credit of securities allotted in public issue
- Services related to change of address
- Effective transmission of securities
- Other facility such as holding debt instrument in demat account or availing stock lending / borrowing facilities

## Advantages

- No bad delivers provided to the investors
- Less paper work done in the depository system
- No risk of loss mutilation or theft of share certificate
- Elimination of all risks associated with physical certificate
- Pay-in and pay-out of securities will take place on T+1 day
- Problem related to change of address of investor, lost transmission etc are eliminated
- No stamp duty for transfer of share
- Low transaction cost for buying and selling dematerialized securities by banks
- Low margin on securities pledged with banks

## Steps in market trade settlement

- Seller gives delivery-out instruction to DP to move the security
- Securities are transferred from brokers A/c to Clearing Corporation
- Securities are moved from CC to buying brokers A/c on the pay-out day
- Buying broker gives instructions and securities move to buyers A/c.

## Rolling settlement

- SEBI introduced T\* 5 rolling settlement in July 2001 onwards.
- T\*3 rolling settlement in April 2002
- T\*2 rolling settlement in April 2003
- In a rolling settlement all trades done on a particular trading day T is settled in terms of payment of money and delivery of securities in T\*X number of days.

## Settlement Process

**Order:** A person places a buy/sell order with a broker who in turn places it on the exchange

**Trade:** S/E converts an order into a trade as soon as matching order is found. S/E sends list of all trades to NSCCL (National Securities Clearing Corporation Limited)

**Obligation:** NSCCL nets off all security obligations and payment obligations of members/brokers.

**Pay-in:** members bring securities and funds to NSCCL. Depositories move securities and clearing banks move funds into NSCCL electronically

- **Pay-out:** NSCCL instructs depositories and clearing bank to pay out securities and funds to members
- Short deliveries are identified and are bought in auction on the day after pay-out day and the clearing member is debited for the difference

**Link for you tube video**

***<https://www.youtube.com/watch?v=MCPCZd4eJzQ>***

## **SEBI Regulations regarding Depository and Depository participant Regulations 1996**

- Registration of depositories
- Certificate of Commencement of Business
- Registration of participants
- Code of conduct for participant
- Rights and obligations of Depositories/Participants/Issuers
- Inspection
- Action in case of default

### **Recent Amendments:**

Amendment 1999 - Change in net worth limit and average value of securities.

Amendment 2003 - Manner of handling share register work and redress investors grievances

Amendment 2004 - Kind of securities dealt with

Amendment 2007 - Activities of Depository

Amendment 2008 - Mechanism for investor protection

Amendment 2011 - Registration of Depository and DP

Amendment 2017 – Regarding Pledge/Hypothecation

## **Custodial Services**

- Custodian is a financial institution that holds and manages clients securities on his/her behalf
- The custodians of securities play a critical role in the secondary market
- According to SEBI regulations custodial services in relation to securities mean:
  - Safe-keeping of the securities of a client who enters into an agreement to avail these securities
  - Providing other services such as – maintaining accounts of the securities of a client, Collecting the benefits accrued to him in respect of securities, keeping him informed of the actions taken by the issuer of the securities, maintaining a record of the services.

## **SEBI Frame work of regulations**

### **1. Registration**

- Application for registration should be made in the prescribed form accompanied by an application fee of Rs. 10,000

#### **•SEBI will consider the following matters:**

- Networth of Rs.50 crores
- Adequate infrastructure
- Employed competent and adequate persons
- Manual is prepared setting out the systems and procedures to be followed
- Is not a person refused registration by SEBI
- Director/Principal Officer is not involved in litigation
- Registration is in the interest of the investor.

#### **•Registration is subject conditions:**

- Capital requirement of Rs. 50 crores
- Abide by the provisions of SEBI Act
- Has to enter into a valid agreement with his clients
- Has to pay annual fee of Rs. 5,00,000

- Responsibilities of custodian
- Inspection and Audit
- Cancellation of Registration