

Chapter 35 Depository System

The process of physical transfer of certificates has many demerits. In absence of a depository system:

1. Every share transfer is required to be accomplished by physical movement of share certificates and registration with, the company concerned.
2. The process often involves long delays in settlements and a significant portion of transactions end up as 'bad delivery' due to faulty completion of paperwork.
3. Theft, forgery, mutilation of certificates and other irregularities.
4. The issuer has the right to refuse the transfer of a security. All this adds to costs and delays in settlement, restricted liquidity and made investor grievance redressal time consuming and, at times, intractable. Thus the limitations of having shares in physical form are:
5. High cost involved by way of postal charges, stamp duty, cost on paper work etc.
6. Depository system is a system wherein the securities of investors are held in the electronic form with the depository at the request of the investors and transfer of securities takes place by means of book entries on the ledger of the depository. The system is also referred as the 'scripless trading system' as the system dispenses with the securities and its movement in the physical form.

Features of the Depository System

1. **Securities in Dematerialized Form** – Depository system provides for maintenance of ownership record of the securities of the investor in a book entry form. The system immobilizes physical securities so that there is no physical certificate in existence.
2. **Fungibility** - 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.
3. **Parties Involved** - In a depository system, the parties involved are:
 - I. The depository
 - II. The depository participant (DP)
 - III. The beneficial owner

IV. The issuer. The depository renders service connected with the recording of allotment of securities or transfer of ownership of securities in its record. A depository functions through depository participants who are the agent of the depository through whom the investors avail of the depository service. In the depository system, the ownership of securities dematerialized is bifurcated between Registered Owner and Beneficial Owner. For the securities dematerialized, depository is the Registered Owner in the books of the issuer (i.e. company)

4. **Free Transferability of Shares:** Transfer of shares held in dematerialized form takes place freely through electronic book-entry system. The system dispenses with the transfer deed and other procedural requirements with respect to transfer of securities.
5. **No Stamp Duty:** No stamp duty for transfer of securities in the electronic form is payable. In case of transfer of physical shares, stamp duty of 0.5 percent is payable on the market value of shares transferred.
6. **No Risk:** All risks associated with physical certificates such as delays, loss in transit, theft, bad deliveries, etc. eliminated in the depository system. Depositories curb the irregularities in the capital market and protect the interests of the investors and pave a way for an orderly conduct of the financial markets through the free transferability of securities with speed, accuracy, transparency etc.

Functioning of Depository System

The depository system functions as under:

1. The system envisages setting up of one or more depositories to hold securities of investors in the electronic form.
2. The depository functions through its agents, who are called Depository Participants (DP).
3. The investor, who wants to avail the services of the Depository, has to open a beneficiary account with the Depository through a DP. The account known as the “Demat” account can be opened with more than one DP.
4. After opening the demat account, the investor is required to dematerialize the securities held by him in the physical form. To dematerialize the securities, the investor has to fill the Dematerialization Request Form (DRF) and submit the same to the DP along with the security certificate. The DP through the Depository will intimate the company/issuer and surrender the security certificate. The process known as ‘dematerialization takes about 30 days.

5. The issuer/company on receipt of the intimation shall cancel the security certificate and substitute the name of the Depository as the registered owner of the security.
6. The Depository on being intimated by the company/issuer, enters the name of the investor in its record as the beneficial owner of the security.
7. Whenever any rights, bonus or dividend is announced by a company for its particular security, the Depository would furnish all details of the investors having electronic holdings of that security on the record date. The disbursement of the rights, dividends etc. will be done by the company based the information provided.
8. In case of sale of the security under this mode, the investor/transferor (the client) has to intimate the DP through issuing a Delivery Instruction Slip (DIS) duly signed and containing the details of the security transaction. In case of purchase, the client will send the intimation to the DP giving details of the security purchased. The Depository on receiving the information through the DP will register the transfer of securities in the name of the transferee in its record.
9. DP will also make book entries in the account of the investor to record sale/purchase of securities.
10. DP is required to send statement of accounts to the clients at regular intervals, and update the account after each transaction.
11. The client/investor has to pay charges to the Depository and the DP for availing the services.

Benefits of Depository System

The following are the benefits for the investors:

1. Bad deliveries are almost eliminated.
2. The risks associated with physical certificates such as loss, theft, mutilation of certificate etc. are eliminated.
3. It eliminates handling of huge volumes of paper work.

4. There is immediate transfer and registration of the securities (at the end of every settlement cycle, which is 4 working days i.e. T+3) and you need not have to suffer delays on account of processing time.
5. It leads to faster settlement cycle and faster realization of sale proceeds so the fund of the investor is not tied up unnecessarily.
6. The system facilitates a faster disbursement of security holding benefits like rights shares, bonus shares etc.
7. The stamp duty on transfer of securities, which is 0.25% of the consideration on transfer of shares in physical form is not applicable.
8. Availability of periodical status report to investors on their holding and transactions is disseminated by the depository.

The Depositories Act 1996

The Depositories Act, 1996, which came into force from 20th September 1995, provides a legal framework for establishment of depositories to facilitate holding of securities including shares in the demat form (electronic form) and to effect transfer of shares through book entry in accounts maintained by the depository.

Rights and Obligations

1. **Agreement between depository and participant.** A depository shall enter into an agreement with one or more participants as its agent in the prescribed form. (Section 4).
2. **Services of depository.** Any person, through a participant, may enter into an agreement, in such form as may be specified by the bye-laws, with any depository for availing its services. (Section 5).
3. **Surrender of certificate of security.** (a) Any person who has entered into an agreement with the depository will have to surrender the certificate of security, for which he seeks to avail the services of a depository, to the issuer; (b) The issuer, on receipt of certificate of security shall cancel the certificate of security and substitute in its records the name of the depository as a registered owner in respect of that security and inform the depository accordingly;

and (c) the depository, thereafter will enter the name of the person referred to in sub-section (1) in its records, as the beneficial owner. (Section 6).

- 4. Registration of transfer of securities with depository.** Every depository shall, on receipt of intimation from a participant, register the transfer of security in the name of the transferee. Further, if a beneficial owner or a transferee of any security seeks to have custody of such security the depository shall inform the issuer accordingly. (Section 7).
- 5. Options to receive security certificate or hold securities with depository.** Every person subscribing to securities offered by an issuer shall have the option either to receive the security certificates or hold securities with a depository. (Section 8).
- 6. Securities in depositories to be in fungible form.** All securities held by a depository shall be dematerialized and shall be in a fungible form. (Section 9).
- 7. Rights of depositories and beneficial owner.** A depository shall be deemed to be the registered owner for the purposes of effecting transfer of ownership of security on behalf of a beneficial owner. The depository as a registered owner shall not have any voting rights or any other rights in respect of securities held by it. The beneficial owner shall be entitled to all the rights and benefits and be subjected to all the liabilities in respect of his securities held by a depository. (Section 10).
- 8. Register of beneficial owner.** Every depository shall maintain a register and an index of beneficial owners in the manner provided in Section 150, Section 151 and Section 152 of the Companies Act, 1956. (Section 11).
- 9. Pledge or hypothecation of securities held in a depository.** A beneficial owner may with the previous approval of the depository create a pledge or hypothecation in respect of a security owned by him through a depository. Every beneficial owner shall give intimation of such pledge or hypothecation to the depository and such depository shall thereupon make entries in its records accordingly. (Section 12).
- 10. Furnishing of information and records by depository and issuer.** Every depository is required to furnish to the issuer information about the transfer of securities in the name of beneficial owners at such intervals and in such manner as may be specified by the bye-laws. Every issuer also has to make available to the depository copies of the relevant records in respect of securities held by such depository. (Section 13).
- 11. Option to opt out in respect of any security.** If a beneficial owner seeks to opt out of a depository in respect of any security he shall inform the depository accordingly who will make appropriate entries in its records and shall inform the issuer. (Section 14).
- 12. Depositories to indemnify loss in certain cases.** The depository shall have to indemnify any loss caused to the beneficial owner due to its negligence or the participant. Where the loss due to the

negligence of the participant is indemnified by the depository, the depository shall have the right to recover the same from such participant.

13. Systems and procedures. Every depository shall have systems and procedures which will enable it to co-ordinate with the issuer or its agent, and the participants, to reconcile the records of ownership of securities with the issuer or its agent, as the case may be, and with participants, on a daily basis. (Regulation 30 of SEBI Regulations).

14. Internal monitoring, review and evaluation of systems and controls. Every depository shall have adequate mechanisms for the purposes of reviewing, monitoring and evaluating the depository's controls, systems, procedures and safeguards.

Summary

1. Shares of a public company are freely transferrable whereas a private company is required to restrict the right of the members to transfer the shares.
2. A company shall register a transfer of shares when a proper instrument of transfer; duly stamped, dated and executed by or on behalf of the transferor and transferee is delivered to the company by either party within a period of sixty days from date of execution, along with the certificate of security or the letter of allotment of securities.
3. Blank transfer means a transfer form signed by the transferor of shares and completed in all respect except the name and signatures of the transferee.
4. Transfer of shares on account of operation of law is termed transmission of shares.
5. Depository system is a system wherein the securities of investors are held in the electronic form with the depository at the request of the investors and transfer of securities takes place by means of book entries on the ledger of the depository.
6. The Depositories Act, 1996, which came into force from 20th September 1995, provides a legal framework for establishment of depositories to facilitate holding of securities including shares in the demat form (electronic form) and to effect transfer of shares through book entry.