

Depositories and Custodians

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

- 1 *The meaning of the depository system*
- 2 *The need for setting up a depository system in India*
- 3 *The difference between a demat share and a physical share*
- 4 *The benefits of a depository system*
- 5 *The move on the depository System in India*
- 6 *The depository process*
- 7 *Depositories such as the National Securities Depository Limited and the Central Depository Services (India) Limited*
- 8 *The meaning of custodians*
- 9 *The stock holding Corporation of India Limited*

- A depository is an organization which holds securities of an investor in an electronic form through a registered depository participant.

THE DEPOSITORY SYSTEM

Technology has changed the face of the Indian stock markets in the post-liberalization era. Competition amongst the stock exchanges, increase in the number of players, and changes in the trading system have led to a tremendous increase in the volume of activity. The traditional settlement and clearing system have proved to be inadequate due to operational inefficiencies. Hence, there has emerged a need to replace this traditional system with a new system called the 'depository system'.

Depository, in very simple terms, means a place where something is deposited for safekeeping. A depository is an organization which holds securities of a shareholder in an electronic form and facilitates the transfer of ownership of securities on the settlement dates. According to Section 2(e) of the Depositories Act, 1996, 'Depository means a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under Section 12(1 A) of the Securities and Exchange Board of India Act, 1992.'

The depository system revolves around the concept of paperless or scripless trading because the shares in a depository are held in the form of electronic accounts, that is, in dematerialized form. This system is similar to the opening of an account in a bank wherein a bank will hold money on behalf of the investor and the investor has to open an account with the bank to utilize its services. Cash deposits and withdrawals are made in a bank, in lieu of which a receipt and bank passbook are given, while in depositories, scrips are debited and credited and an account statement is issued to the investor from time to time. An investor in a bank deals directly with the bank while an investor deals through a depository participant in a depository. A depository also acts as a securities bank, where dematerialized physical securities are held in custody.

An effective and fully developed depository system is essential for maintaining and enhancing market efficiency, which is one of the core characteristics of a mature capital market.

Need for Setting-up a Depository in India

This need was realized in the 1990s due to various reasons as outlined below:

- Large-scale irregularities in the securities scam of 1992 exposed the limitations of the prevailing settlement system.
- A lot of time was consumed in the process of allotment and transfer of shares, impeding the healthy growth of the capital market.
- With the opening up of the Indian economy, there was a widespread equity cult which resulted in an increased volume of transactions.
- Mounting fiscal deficit made the government realize that foreign investment was essential for the growth of the economy and that was being restricted due to non-availability of depositories.
- There were various problems associated with dealing in physical shares, such as:
 - problems of theft, fake and/or forged transfers,
 - share transfer delays particularly due to signature mismatches; and
 - paper work involved in buying, selling, and transfer leading to costs of handling, storage, transportation, and other back office costs.

To overcome these problems, the Government of India, in 1996, enacted the Depositories Act, 1996 to start depository services in India.

Depository can be in two forms—dematerialized or immobilized. In dematerialization, paper certificates are totally eliminated after verification by the custodians. In immobilization, initial paper certificates are preserved in safe vaults by custodians and further movement of papers are frozen.

The depository system provides a wide range of services.

- Primary market services by acting as a link between the issuers and the prospective shareholders.
- Secondary market services, by acting as a link between the investors and the clearing house of the exchange to facilitate the settlement of security transactions through book-keeping entries.
- Ancillary services, by providing services such as collecting dividends and interests, reporting corporate information, and crediting bonus, rights, shares.

These services lead to a reduction in both time and cost which ultimately benefits the investors, issuers, intermediaries, and the nation as a whole.

Difference Between a Demat Share and a Physical Share

A demat share is held by the depository on behalf of the investor whereas a physical share is held by the investor himself. The holding and handling of a demat share is done electronically, whereas a physical share is in the form of a paper. The demat share can be converted into a physical share on request. This is referred to as the rematerialization of the share. The interface between the depository and the investor is provided by a market intermediary called the depository participant (DP) with whom an investor has to open an account and give all instructions. The demat share does not have a folio number, distinctive number, or certificate number like a physical share. Demat shares are fungible, that is, all the holdings of a particular security will be identical and interchangeable. Though there is no stamp duty on the transfer of demat shares from one account to another, the depository participant charges a transaction fee and levies asset holding charges.

There is, however, no difference between demat shares and physical shares as far as the beneficial interests of ownership of securities are concerned. The owner is entitled to exactly the same benefits of ownership of a security no matter in what form it is maintained.

Benefits of a Depository System

Benefits of a Depository System

- Immediate allotment, transfer and registration of securities.
- No stamp duty on transfer of securities
- Elimination of risks associated with physical certificates.
- Reduction in paperwork and transaction costs.
- Decrease in settlement risks and frauds.
- Loan against the pledged demat shares at low cost.

A depository system enables immediate allotment, transfer, and registration of securities, thereby increasing the liquidity of stocks. It eliminates all problems related with the holding of shares in physical form, thereby increasing investor confidence. An investor saves in terms of costs like stamp duty, postage, and brokerage charges (Table 18.1). Pledging of shares and portfolio shuffling become convenient for an investor. This system enables trading of even a single share, thereby eliminating the problem of odd-lot shares. Shares get credited into the demat holder's account in a couple of days, unlike the physical mode where it took an average of a month to transfer the shares.

Further, loans against the pledged demat shares come at interest rates that are lower by 0.25 per cent to 1.5 per cent in comparison to pledged physical shares. The limit of loan against dematerialized security as collateral is double (at ₹20 lakh) of that against collateralized physical security (₹10 lakh). The Reserve Bank of India has also reduced the minimum margin to 25 per cent for loans against dematerialized securities as against 50 per cent for loan against physical securities. Many brokerage firms have brought down their brokerage to the extent of 0.5 per cent as the risk associated with bad delivery has reduced.

This system has facilitated the introduction of the rolling settlement system which, in turn, has led to shorter settlement cycles and a decrease in settlement risks and frauds. Lastly, this system helps in integrating the domestic capital market with international capital markets.

Cost Comparison for Trading in Physical and Demat Segments

A comparison of cost for a long term-investor who buys and trades shares worth ₹10,000.

An investor saves 35–100 basis points in case of demat shares without transacting and saves a higher amount, that is, 140–445 basis points when transacting 10 times a year in case of demat shares.

TABLE 18.1 (Figures in Basis Points)

	Without Transacting			With Transacting 10 Times/Year		
	Physical Shares	Demat Shares	Savings	Physical Shares	Demat Shares	Savings
Brokerage	75–100	50–75	25–50	750–1000	500–750	250–500
Stamp Duty	50	–	50	–	–	–
Postal Charges	10–30	–	10–30	–	–	–
Company Objection (Notarization, etc.)	10–30	–	10–30	–	–	–
Settlement Charges	–	5–10	–(5–10)	–	50–100	–(50–100)
Custody (5 Years)	–	25–50	–(25–50)	–	5–10	–(5–10)
Total	–	–	35–100	–	–	140–445

Source: *An Investor's Guide to Depositories*, NSDL.

The Move on to a Depository System in India

The move on to a depository system in India was initiated by the Stock Holding Corporation of India Limited (SHCIL) in July 1992 when it prepared a concept paper on 'National Clearance and Depository System' in collaboration with Price Waterhouse under a programme sponsored by the US Agency for International Development. Thereafter, the government of India constituted a technical group under the chairmanship of R. Chandrasekaran, Managing Director, SHCIL, which submitted its report in 1993.

Subsequently, the Securities and Exchange Board of India (SEBI) constituted a seven-member squad to discuss the various structural and operational parameters of the depository system. The Government of India promulgated the Depositories Ordinance in September 1995, thus paving the way for setting up of depositories in the country.

Some features of the Depositories Ordinance are as follows:

- The depository is a registered owner of the share while the shareholder is the beneficial owner retaining all the economic and voting rights arising out of share ownership.
- Shares in the depository will be fungible.
- Transfers pertaining to sale and purchase will be effected automatically.
- Any loss or damage caused to the participant will be indemnified by the depository.
- If trades are routed through depository, there is no need to pay stamp duty.

The Depositories Act was passed by the Parliament in August 1996. It lays down the legislative framework for facilitating dematerialization and book entry transfer of securities in a depository. The act provides that a depository is required to be a company under the Companies Act, 1956 and depository participants (DPs) need to be registered with the SEBI. The investors have the option to hold securities in physical or dematerialized form or to rematerialize securities previously held in dematerialized form.

The SEBI issued a consultative paper No. X on the draft regulations for depositories and participants in October 1995 for wide consultation and notified the regulations in May 1996. The SEBI has allowed multiple depositories to ensure competition and transparency.

The Depositories Related Laws (Amendment) Ordinance, 1997, issued in January of that year enabled units of mutual funds and UTI, securities of statutory corporations and public corporations to be dealt through depositories. The Dhanuka Panel in its draft Depository Act (Amendment) Bill, 1998 recommended empowering the SEBI to make trading in demat shares mandatory. The SEBI laid down an elaborate time schedule envisaging that beginning January 4, 1999, till March 26, 2001, 3,145 listed scrips or 40 per cent of the total listed securities would be traded compulsorily in the demat form. Besides equity, new debt issues will also be in demat form. The minimum networth stipulated by the SEBI for a depository is ₹100 crore.

It is mandatory for all listed companies to have their securities admitted for dematerialization with both the depositories, viz, NSDL and CDSL. Securities include shares, debentures, bonds, commercial paper, certificate of deposits, pass through certificates, government securities and mutual fund units.

SEBI (Depositories and Participants) (Amendment) Regulations 2008 were notified on March 17, 2008, which provided for the shareholding such as

1. sponsor should at all times hold at least 51 per cent shares in the depository;
2. no person, either singly or together with persons acting in concert, can hold more than 5 per cent of the equity share capital in the depository;

3. the combined holding of all persons resident outside India in the equity share capital of the depository will not exceed, at any time, 49 per cent of its total equity share capital, subject further to the following:
 - a. the combined holdings of such persons acquired through the foreign direct investment route are not more than 26 per cent of the total equity share capital, at any time;
 - b. the combined holdings of foreign institutional investors are not more than 23 per cent of the total equity share capital, at any time;
 - c. no foreign institutional investor acquires shares of the depository otherwise than through the secondary market.

The Depository Process

Eligibility to Join as a DP

- Public Financial Institution.
- Bank included in the second schedule to the RBI Act, 1934.
- Foreign bank operating in India.
- State Financial Corporation
- Custodian of Securities.
- Clearing corporation or a clearing house of a stock exchange.
- Stock Broker
- Non-banking finance company.
- Registrar to an issue or share transfer agent.

There are four parties in a demat transaction: the customer, the depository participant (DP), the depository, and the share registrar and transfer agent (R&T).

Opening an Account An investor who wants to avail of the services will have to open an account with the depository through a DP, who could either be a custodian, a bank, a broker, or individual with a minimum net worth of ₹1 crore. The investor has to enter into an agreement with the DP after which he is issued a client account number or client ID number. PAN Card is now mandatory to operate a demat account. The holder of a demat account is called 'beneficial owner' (BO). He can open more than one account with the same or multiple DPs.

Dematerialization To convert his physical holdings of securities into the dematerialized form, the investor makes an application to the DP in a dematerialization request form (DRF). Within seven days, the DP forwards the form, along with the security certificates, to the issuer or its registrar and transfer agent after electronically registering the request with the depository.

The depository electronically forwards the demat request to the respective issuer or its registrar and transfer agent, who verifies the validity of the security certificates as well as the fact that the DRF has been made by a person recorded as a member in its register of members.

After verification, the issuer or its registrar and transfer agent authorises an electronic credit for the security in favour of the client. Thereafter, the depository causes the credit entries to be made in the account of the client.

Rematerialization To withdraw his security balance with the depository, the investor makes an application to the depository through its DP. He requests for the withdrawal of balance in his account in a rematerialization request form (RRF). On receipt of the RRF, the participant checks whether sufficient free relevant security balance is available in the client's account. If there is, the participant accepts the RRF and blocks the balance of the client to the extent of the rematerialization quantity and electronically forwards the request to the depository.

On receipt of the request, the depository blocks the balance of the participant to the extent of the rematerialization quantity in the depository system. The depository electronically forwards the accepted rematerialization application to the issuer or its registrar agent, which is done on a daily basis.

The registrar and transfer agent confirm electronically to the depository that the RRF has been accepted. Thereafter, the issuer or registrar and transfer agent despatches the share certificates arising out of the rematerialization request within 30 days.

Distributing Dividend A company (issuer) or its registrar and transfer agent shall make known the depository of the corporate actions such as dates for book closures, redemption or maturity of security, conversion of warrants, and call money from time to time. The depository will then electronically provide a list of the holdings of the clients as on the cut-off date. The company can then distribute dividend, interest, and other monetary benefits directly to the client on the basis of the list. If the benefits are in the form of securities, the company or its registrar and transfer agent may distribute these, provided the newly created security is an eligible security and the client has consented to receive the benefits through depository.

Closing an Account A client wanting to close an account shall make an application in the format specified to that effect to the participant. The client may close his account if no balances

- **Dematerialization** is conversion of physical certificates to electronic form.

- **Rematerialization** is conversion of securities in demat form into physical certificates.

are outstanding to his credit in the account. If any balance exists, the account may be closed in the following manner: (i) By rematerialization of all its existing balances in his account and/or (ii) By transferring his security balances to his other account held either with the same participant or with a different participant.

The participant shall ensure that all pending transactions have been adjusted before closing such an account. After ensuring that there are no balances in the client's account, the participant shall execute the request for closure of the client's account.

Trading/Settlement of Demat Securities

The procedure for buying and selling dematerialized securities is similar to the one for physical securities. In case of purchase of securities, the broker will receive his securities in his account on the pay-out day and give instruction to its DP to debit his account and credit investor's account. Investor can either give receipt instruction or standing instruction to DP for receiving credit by filling appropriate form. In case of sale of securities, the investor will give delivery instruction to DP to debit his account and credit the broker's account. Such instruction should reach the DP's office at least 24 hours before the pay-in.

THE NATIONAL SECURITIES DEPOSITORY LIMITED

The Indian capital market took a major step in its rapid modernization when the National Securities Depository Limited (NSDL) was set up as the first depository in India. The NSDL, promoted by the Industrial Development Bank of India, the Unit Trust of India (UTI), the National Stock Exchange of India Limited (NSE), and the State Bank of India (SBI) was registered on June 7, 1996, with the SEBI and commenced operations in November 1996. The NSDL is a public limited company formed under the Companies Act, 1956 with a paid-up capital of ₹105 crore.

The NSDL interacts with investors and clearing members through market intermediaries called depository participants (DPs). The NSDL performs a wide range of securities-related functions through the DPs. These services are as follows:

1. **Core services**
 - a. Maintenance of individual investors' beneficial holdings in an electronic form.
 - b. Trade settlement.
2. **Special services**
 - a. Automatic delivery of securities to the clearing corporation.
 - b. Dematerialization and rematerialization of securities.
 - c. Account transfer for settlement of trades in electronic shares.
 - d. Allotments in the electronic form in case of initial public offerings.
 - e. Distribution of non-cash corporate actions (bonus, rights, etc.).
 - f. Facility for freezing/locking of investor accounts.
 - g. Facility for pledge and hypothecation of securities.
 - h. Demat of National Savings Certificates (NSC)/Kisan Vikas Patra (KVP).
 - i. Internet based services such as SPEED-e and IDeAS.

Business Partners of the NSDL

An important link between the NSDL and an investor is a DP. A DP could be a public financial institution, a bank, a custodian, or a stock broker. Corporate entities are not allowed to become DPs nor can they set up depositories. A DP acts as an agent of the NSDL and functions like a securities bank as an investor has to open an account with the DP. The SHCIL was the first depository participant registered with the SEBI. The number of DPs operational as on March end 2010 stood at 287 as against 24 in the end of March 1997 including all custodians providing services to local and foreign institutions.

At present, the competition among DPs has increased and, in a bid to attract and retain customers, DPs are exploring new avenues including latest technology for increasing their efficiency. For instance, many DPs have launched interactive voice response (IVR) units. They have also slashed their service charges and many of them are rendering free-market and off-market buy services to their corporate clients.

Besides DPs, other business partners of the NSDL include issuing companies/their share transfer agents, clearing corporations/houses, and clearing members. The NSDL facilitates the settlement of trades carried

- A depository participant is an agent of the depository through which it interfaces with the investor. A DP can offer depository services only after it gets registered with the SEBI.

Box 18.1 The NSDL at a Glance

<i>The NSDL at a Glance (June 30, 2017)</i>		<i>Demat Custody</i>	<i>Instruments</i>
Investor Accounts	1,57,84,891	Shares	18,190
		Debt/Bonds	15,097
		CP	2,591
Depository Participants			
DPs	268		
DP Service Centres	27,395		
Companies Joined	18,190		
Demat Custody Quantity (cr. securities)	1,34,982		

Source: www.nsdl.co.in

out in the book entry segment of stock exchanges. The actual settlement function is performed by the clearing corporation/houses of the stock exchanges. The NSDL has its by-laws regarding the powers and functions of board of directors, executive committee, rules of business, participants, nomination of persons of eminence, safeguards for clients, participants, and accounts by book entry. Trading in dematerialized securities commenced on December 26, 1996, in the NSE.

The NSDL has achieved paperless trading in perhaps the shortest time in the world—a little over three years. Today, 99.9 per cent of all equity is traded in demat form. The NSDL has more than 1.58 crore (Box 18.1) investor accounts and 268 DPs, making it the second largest depository in the world.

The NSDL's computer system handles around eight to nine million messages (to debit and credit individual investor accounts) per day on an online basis. It links three types of data bases—a central NSDL one, those of 281 DPs as well as those of 8,338 companies. Moreover, it has the ability to monitor everything that is happening in the computers of its DPs.

The NSDL has undertaken a pilot project to dematerialize securities like National Savings Certificates and Kisan Vikas Patra at select post offices. In addition, it also manages a countrywide tax information network for the ministry of finance. It has also been appointed as central Record keeping agency for the New Pension System of the Government of India.

The NSDL has created three pioneering systems : SPEED-e, STeADY, and IDeAS. SPEED-e allows users to execute delivery instructions using the Internet. STeADY (Securities Trading—Information Easy Access and Delivery) was launched by the NSDL on November 30, 2002 and it constitutes an internet-based infrastructure for facilitating straight-through processing. It is a means of transmitting digitally signed trade information with encryption across market participants electronically, through the Internet. This facility enables brokers to deliver contract notes to custodians and/or fund managers electronically. 'IDeAS' (Internet-based Demat Account Statement) enables its account-holders including clearing members to view their account balances and transactions of the last five days. These systems reflect the continual process of sophistication of depository services being undertaken by the NSDL.

THE CENTRAL DEPOSITORY SERVICES (INDIA) LIMITED

The CDSL is the second depository set up by the Bombay Stock Exchange (BSE) and co-sponsored by the State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Union Bank of India, and Centurion Bank. The BSE has a 54 per cent stake in the CDSL while the banks have a 46 per cent stake. The CDSL commenced operations on March 22, 1999. The same year, five stock exchanges established connectivity with the CDSL for offering trade in demat securities and 765 companies signed up with the CDSL to get their securities admitted for dematerialization. The CDSL has 590 DPs in 105 cities across 296 locations. (Box 18.2) With a net worth of ₹104 crore, CDSL plans to offer facilities like inter-depository transfer and linking of accounts through cell phones.

Box 18.2 CDSL at a Glance**Securities available for demat (July 31, 2017)**

Equity	9,353
Debt instruments including debentures, bonds, government securities, certificates of deposits, commercial paper and pass through certificates	14,774
Mutual fund units	16,647

Depository participants

Number of depository participants	590
Number of branches with LIVE connectivity	208
Number of cities/ towns with LIVE connectivity	105
Number of locations with LIVE connectivity	296

Demat custody

Number of securities in million	2,56,221
Value (₹ in million)	1,76,63,615

Demat settlement (July 2013)

Investor accounts (excluding closed accounts)	1,27,50,757
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Source: www.cdslindia.com

All leading stock exchanges have established connectivity with the CDSL.

The CDSL has been the preferred platform by the Government of India for carrying out actual share transactions. PSU disinvestments have been done through the CDSL system. CDSL was the first Depository to come up with an IPO in June 2017.

Every transaction at the CDSL is done at one e-space. The centralized system of the CDSL keeps a watch on every transaction.

The CDSL has also attained membership of the Asia-Pacific Central Securities Depository Group (ACG). The ACG is an organization that facilitates exchange of information and promotes mutual assistance among member depositories and clearing organizations of the Asia-Pacific region. It has 22 member organizations including depositories from Japan, Hong Kong, Singapore, Malaysia, Australia's clearing organization, and the Reserve Bank of New Zealand. Membership of the organization is expected to help the CDSL in enhancing its knowledge base and contributing to the development of other member organizations in the best international practices, settlement risk management, cross-border linkages, and technological development. This, in turn, would help the CDSL to secure foreign institutional investors' business through their custodians.

COMPARISON OF CHARGES AT THE NSDL AND THE CDSL AND GROWTH OF DEMAT ACCOUNTS

With effect from January 1, 2004, the NSDL has moved from an ad-valorem variable charge structure to fixed charges which is in trend with the international practice, whereas the CDSL still follows the variable rate structure. The amount payable by the DPs to the NSDL for debit instruction has been reduced from ₹10 to ₹8 effective from January 1, 2004 (Table 18.2).

Despite a reduction in rates, the demat charges are still high. To hold shares in demat form, an investor has to pay DPs an account opening fee of ₹50 to ₹100 and an annual fee of ₹100 to ₹150. At present, investor pays an annual maintenance charge ranging from ₹300–500, irrespective of whether or not there are any transactions during the year. Besides, for each scrip the investor demats, he pays ₹2 to ₹3 per share. Transaction charges are 0.05 per cent of the value or ₹20, whichever is higher. Depositories need to make their rates more affordable to investors. The SEBI constituted a panel to recommend a demat fee structure of depositories. The committee recommended that small investors be charged fees on the basis of deal value in demat transactions, no account maintenance charges to be levied on investors, companies pay a

- Of 1.74 crore demat accounts, only 24% are active.

TABLE 18.2 Comparison of Charges at the NSDL and the CDSL

Charges	NSDL	CDSL
Custody Fee	₹0.50/Month ₹6 per Annum	Nil Nil
Purchase	Nil	Nil
Sale	₹10/Transaction (₹8 Effective from January 1, 2004)	₹6 per Transaction
Pledge Creation	₹25	₹12
Annual Fee	Nil	Nil
Rematerialization	₹10/Certificate	₹10/Certificate
Rate Structure	Fixed	Ad-valorem

Source: *The Economic Times*.

one-time fee to depositories at 0.1 per cent of market capitalization or number of post-issue shares, new companies to pay fees on post-issue paid-up capital or number of post-issue shares, no account closure charges to be levied on investors, if they shift from one DP to another and a need to rationalize depository participant fees.

The SEBI has asked both the depositories to offer 'no-frills' demat accounts to retail investors who do not trade regularly.

Growth in Demat Accounts

As seen from Box 18.1, an impressive progress was achieved with regard to the dematerialization process. There was an expansion in the coverage of number of companies, number of DPs, number of beneficial owners, and turnover. The number of client accounts registered with the NSDL increased from 25.3 lakh in May 2000 to 1 crore in August 2009. This increase indicates a continuing inclination for paperless trading.

The SEBI gradually added more number of scrips in the list for compulsory trading in the demat form. The SEBI increased the number of scrips from 12 in January 1999 to 2,335 in June 2001. In order to expedite the process of dematerialization, the SEBI made the settlement of trade in certain scrips mandatory in demat form. Moreover all public issues, rights issues, and offer for sale shall be in the demat form. Delivery of underlying shares of Global Depository Receipt (GDR)/American Depository Receipt (ADR) shall compulsorily be in demat form.

The Union Budget for the year 1999–2000 did away with stamp duty on transfer of debt instruments within the depository mode to encourage the dematerialization process further.

Investors can use their demat accounts with the NSDL and the CDSL for buying and selling mutual funds. An increasing trend in dematerialization was witnessed in instruments such as commercial papers and bonds since 2005–06.

The spurt in demat business can be largely attributed to the fact that it is now mandatory to trade in demat shares. Almost 95 per cent of the issued capital in the market is converted into electronic form. Moreover, the revival of the primary market after the Maruti Udyog Limited's IPO led to a rise in depository accounts of retail investors.

A large number of shares were cornered through multiple share applications and opening of benami dematerialized accounts by a few scamsters during the IPO scam that took place in April 2006. Depositories and DPs were blamed for the IPO scam. SEBI levied on depositories—both NSDL and CDSL—₹116 crore as part of its disgorgement order. Disgorgement is the practice of recovering money from perpetrators of financial funds and compensating investors who have been impacted.

Since the introduction of the depository system, dematerialization has progressed at a fast pace and has gained acceptance amongst the market participants. All actively traded scrips are held, traded and settled in the demat form. As the network of depositories expands and the proportion of securities dematerialized increases, the benefits of faster settlement of trades, short settlement cycles, reduced transaction costs, and greater protection will increase liquidity in the stock markets. The ratio of dematerialization to floating stock in the market is around 100 per cent. The shareholders who have not participated in the demat process are passive shareholders such as government, multinational corporations and some Indian promoters. The government has not dematerialized holdings in public sector enterprises

- Both NSDL and CDSL have 1.74 crore investor accounts. NSDL is the market leader with 1.07 crore investor accounts.

such as SBI, ONGC and BHEL, while foreign parent firms such as Unilever, Colgate, Palmolive, Procter and Gamble, and Pfizer have not dematerialized their holdings in their Indian subsidiaries as they have no intention of selling shares. The demat process has turned out to be the fastest of all programmes undertaken. At the beginning of 1997, not more than 100 stocks were available in the electronic form. By June 2002, the number rose to 4,252. The demat quantity (number of securities) increased from 16.39 billion in 2000 to 440 billion in 2010, an almost thirty-fold increase in first ten years. The Indian market has achieved this level of dematerialization in just four years while the US market could achieve it in 20 years. Dematerialization had a tremendous impact on liquidity and trading volumes in the equity segment.

CUSTODIANS

Custodians provide custodial services which are quite different from depositories. A custodian is an intermediary which keeps the scrips of the clients in custody or is the keeper of the accounts of its clients. According to Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996 custodian of securities means any person who carries on or proposes to carry on the business of providing custodial services.

Custodial services in relation to securities of a client or gold or gold related instruments held by a mutual fund or title deeds of real estate assets held by a real estate mutual fund scheme in accordance with the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 means, safekeeping of such securities or gold or gold related instruments or title deeds of real estate assets and providing services incidental thereto, and includes—

- (i) maintaining accounts of securities or gold or gold related instruments or title deeds of real estate assets of a client; (a) undertaking activities as a domestic depository in terms of the companies (Issue of Indian Depository Receipts) Rules, 2004;
- (ii) collecting the benefits or rights accruing to the client in respect of securities or gold or gold related instruments or title deeds of real estate assets;
- (iii) keeping the client informed of the actions taken or to be taken by the issuer of securities, having a bearing on the benefits or rights accruing to the client; and
- (iv) maintaining and reconciling records of the services.

A custodian shall have minimum net worth (the paid-up capital and the free reserves as on the date of the application) of rupees fifty crores.

A custodian is not only a safekeeper of share certificates and a trustee of the same but also provides ancillary services such as physical transfers of share certificates, collecting dividends and interest warrants, and conforming to transfer regulations. Besides these, it updates clients on their investment status. To claim benefits on behalf of its clients, a custodian keeps track of book closures, record dates, bonus and rights shares. For rendering these services, custodians charge a fee of 1 per cent of the total volume of transactions. Scope of custodial services has been enlarged to include safekeeping of gold or gold related instruments, consequent to introduction of gold and gold related instruments by the Indian mutual funds.

Even though depositories have been set up, there is a need for custodians as they act as complements to depositories. The volume of transactions by fund managers is so large that custodial services are imminent. With depositories in existence, their volume of paper work has not only reduced but most of them also act as depository participants. Custodians provide the infrastructure facilities which ease the post-issue, post-trade and settlement work.

Custodians are clearing members but not trading members. They are involved in the process of clearing. They settle trades on behalf of other trading members. A trading member may assign a particular trade to a custodian for settlement. If the custodian confirms to settle that trade, then the clearing corporation assigns that particular obligation to the custodian who is then required to settle it on the settlement day.

In India, the SHCIL and the SBI Share Holding Corporation are the most prominent custodians catering to the requirements of the UTI and financial institutions. The SHCIL is the leading custodian with a 75 per cent market share. Other banks like Canara Bank and Indian Bank have promoted Canbank Computer Services and India Clearing and Depository Services Limited (ICDS). These custodians usually provide services to institutional investors.

After liberalization, foreign institutional investors (FIIs) were allowed to invest in the Indian capital market. Most of the FIIs' business is routed through foreign banks' custodians. According to the laws governing US funds, no US fund is allowed to use a custodian that does not have a capital adequacy of USD 200 million. No Indian custodian, including the SHCIL, meets this requirements; hence, only

- A custodian is an intermediary which helps register and safeguard the securities and gold or gold related instruments of its clients.

foreign banks operate as custodians for US-based FIIs, pension funds, and corporates. Hong Kong Bank, Deutsche Bank, Citibank, and Standard Chartered Bank are some prominent foreign banks which operate as custodians. At present, there are 9 registered foreign custodians in India.

A custodian must be registered with the SEBI. SEBI regulations provide the eligibility criteria and code of conduct to be followed by a custodian. A custodian is required to participate in the clearing and settlement process through the clearing house/clearing corporation. As on July 31, 2017, the number of custodians registered with the SEBI stood at nineteen.

KEY TERMS

Custodial Services

Custodians

Dematerialization

Demat Share

Depository

Rematerialization

SUMMARY

1. A depository is an organisation which holds securities of a shareholder in an electronic form and facilitates the transfer of ownership of securities on the settlement dates.
2. An effective and fully developed depository system is essential for maintaining and enhancing market efficiency.
3. The depository system provides a wide range of services such as primary market services by acting as a link between the issuers and the prospective shareholders; secondary market services by acting as a link between the investors and the clearing house of the exchange to facilitate the settlement of security transactions through book-keeping entries, and ancillary services by providing services such as collecting dividends and interests, reporting corporate information, and crediting bonus, rights, and shares.
4. A demat share is held by the depository on behalf of the investor whereas a physical share is held by the investor himself. The holding and handling of a demat share is done electronically, whereas a physical share is in the form of a paper. The demat share can be converted into a physical share on request.
5. A depository system enables immediate allotment, transfer, and registration of securities, thereby increasing the liquidity of stocks. An investor saves in terms of costs like stamp duty, postage, and brokerage charges. Pledging of shares and portfolio shuffling become convenient for an investor.
6. There are four parties in a demat transaction: the customer, depository participant, depository, and share registrar and transfer agent (R&T).
7. The Indian capital market took a major step in its rapid modernisation when the National Securities Depository Limited (NSDL) was set up as the first depository in India.
8. An important link between a depository and an investor is a depository participant. A depository participant could be a public financial institution, bank, custodian, or a stock broker.
9. The NSDL has created three pioneering systems: SPEED-e, STeADY and IDEAS. SPEED-e allows users to execute delivery instructions using the Internet. The NSDL has achieved paperless trading in perhaps the shortest time in the world, a little over three years.
10. The CDSL is the second depository set up by the Bombay Stock Exchange (BSE) and co-sponsored by the State Bank of India, Bank of India, Bank of Baroda, and HDFC Bank.
11. With effect from January 1, 2004, the NSDL has moved from an ad-valorem variable charge structure to fixed charges which is in trend with the international practice, whereas the CDSL still follows the variable rate structure.
12. A custodian is an intermediary who keeps the scrips of the clients in custody or is the keeper of the accounts of its clients. It also provides ancillary services such as physical transfers of share certificates, collecting dividends and interest warrants, and conforming to transfer regulations.
13. Even though depositories have been set up, there is a need for custodians as they act as complements to depositories. Custodians are clearing members but not trading members.
14. In India, the Stock Holding Corporation of India Limited (SHCIL) and SBI Share Holding Corporation are the prominent custodians catering to the requirements of the UTI and financial institutions. The SHCIL is the leading custodian with a 75 per cent market share.

REVIEW QUESTIONS

1. Explain the term 'depositories'. What type of services do depositories provide? What are the benefits of a depository system?
2. Are custodians required today when the depository system is functioning successfully?
3. Explain the functioning of the NSDL and the SHCIL.
4. Explain the depository process.
5. Answer the following in brief:
 - a. Compare depository with a bank.
 - b. What was the need for setting up a depository in India?
 - c. State the difference between a demat share and a physical share?
 - d. What is rematerialization?
 - e. Who are the business partners of NSDL?
 - f. What kind of services do custodians provide?

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