

Chapter 8 Operations of Depository Participants

Learning Objectives:

After reading this chapter, you should be able:

1. To understand meaning and importance of ISIN
2. To understand the importance of dematerialization of securities and the process involved.
3. To understand the process of transfer of shares.
4. To apply the knowledge in real life situation.

Your guide engine to learning:

1. Introduction – Depository System
2. International Securities Identification Number
 1. Securities that can be dematerialized
3. Dematerialization
 1. Meaning
 2. Process of Dematerialization
 3. Benefits of having a demat account
4. Trading and Settlement of dematted shares:
 1. Meaning of transfer of shares
 2. Settlement of off-market Trades
 3. Settlement of Market Trades
5. Rematerialization

8.1 Introduction – Depository System

The earlier settlement system on Indian stock exchanges was very inefficient as it was unable to take care of the transfer of securities in a quick/speedy manner. Since, the securities were in the form of physical certificates; their quick movement was again difficult. This led to settlement delays, theft, forgery, mutilation and bad deliveries and also to added costs.

To wipeout these problems, the Depositories Act 1996 was passed. It was formed with the purpose of ensuring free transferability of securities with speed, accuracy & security. It has been able to do so by:

- a) Making securities of public limited companies freely transferable, subject to certain exceptions;
- b) Dematerialising the securities in the depository mode; and
- c) Providing for maintenance of ownership records in a book entry form.

For performing the above tasks, two depositories viz, **NSDL & CDSL** have come up.

National Securities Depository Limited (NSDL) does the above tasks for the trades done on NSE. It is a joint venture of:

- IDBI (Industrial Development Bank of India Limited);
- NSE (National Stock Exchange); and
- UTI (Unit Trust of India).

NSDL is the first depository to be set up in India. It was registered by SEBI on June 7, 1996.

The second depository **Central Depository Services Limited (CDSL)** has been promoted by Bombay Stock Exchange and Bank of India. It was formed in February 1999. Both depositories have a network of Depository participants (DPs) which are further electronically connected to their clients. So, DPs act as a link between the depositories and the clients.

The **Depository system** to some extent works like the **banking system**. There is a central bank and the rules and regulations related to the working of all the commercial, foreign, co-operative and other types of banks are framed by the central bank. In order to do the daily transactions, the investors open an account with the associate banks, and not with the central one. Like an investor can have a bank account with more than one bank, similarly one can have more than one Demat Account. We can further bring out the similarities as well as the differences between the two in understanding the depository system. (See Table 8.1)

Table 8.1A: NSDL – BANK: The Similarities	
BANK	NSDL
<ul style="list-style-type: none"> • Holds funds in accounts • Transfers funds between accounts • Transfers without handling cash • Safekeeping of money 	<ul style="list-style-type: none"> • Holds securities in accounts • Transfers securities between accounts • Transfers without handling physical securities • Safekeeping of securities

Table 8.1B: NSDL – BANK: The Differences	
BANK	NSDL
<ul style="list-style-type: none"> • Either of holders can sign instructions • Minimum balance to be maintained • Entitled for interest • Uses balances in accounts • Nomination is kept confidential 	<ul style="list-style-type: none"> • All joint holders to sign instructions • No minimum balance required • Interest can be earned only by participating in Stock Lending Scheme • Does not move balances in account without account holder's authorization • Signature and photograph of nominee to be provided

As a broker represents their investors, and can trade on their behalf either on the stock exchange or off-market. Similarly, a Depository Participant (DP) is the representative (agent) of the investor in the depository system providing the link between the Company and the client through the Depository. The client's Depository Participant will maintain his securities account balances and intimate the status of the holding from time to time. According to SEBI guidelines, Financial Institutions like banks, custodians, stockbrokers etc. can become participants in the depository. A

DP is one with whom a client needs to open an account to deal in electronic form. While the Depository can be compared to a Bank, DP is like a branch of a bank with which one can have an account. Therefore, DPs are authorized to maintain accounts of dematerialized shares. They help in instantaneous electronic transfer of shares held in Demat form through **electronic book entry system**.

Book entry system is a system under which no physical transfer of securities takes place. In case of change of ownership rights, securities do not change hands physically. To facilitate the change of name/ownership rights, merely a book entry is passed. Since, the securities are fungible; transfer becomes easier. **Fungibility** means that all the holdings of a particular security are identical & inter-changeable & they have no unique characteristic such as distinctive number, certificate no., folio no. etc. To have a better understanding of the concept of fungibility, we can take an example of a currency note. Just as an Rs.100 note can be interchangeable with any other note of Rs.100, similarly securities of a company can be interchanged with any other security of the same company, as the distinctive number of the security does not matter.

Whenever securities are bought and sold, transfer of name has to take place. Earlier, when the securities were in the physical form, it used to take a lot of time as it was a cumbersome process. The physical securities were sent to the R&TA (Registrar and Transfer Agents) appointed by the company along with the required form for change of name/transfer of securities. The R&TA (Registrar and Transfer Agents) used to make the due changes as required and send them back. This whole process was time consuming and sometimes the securities never reached its destination, thus creating lot of inconvenience to the investors. To get away with such problems, securities were changed into demat form which helped in quick transfer of securities and also eliminate the fear of theft, mutilation etc. Apart from getting the current holdings changed into demat form, one can also receive their shares in demat form when offered during an initial public issue by giving the appropriate instructions in the application itself. If one is adopting this approach, then he has to also furnish the details of his bank account number, name of the DP, DP ID and client ID to facilitate the transfer of securities.

Registered owner and Beneficiary owner

All the public limited companies are required by the Companies Act 1956 to maintain an index of members, wherein they are required to keep a record of the owners of the company. With the concept of dematerialization of securities and transfer of shares through book entry system coming up, registered owners are NSDL and CDSL only. So, in the index of members of any company, there are only two registered owners, i.e. the two depositories. The depositories keep a track of all the clients through the depository participants. Therefore, **the registered owners are the depositories whereas the beneficiary owners are the people who are holding the securities at any given point of time**. Whenever a company declares a bonus issue, the securities are transferred in the name of the two depositories and they further transfer it to the clients through their participants. Therefore, the depositories are known as the registered owners and the investors are known as the beneficiary owners as they get the benefits of all the corporate actions.

Further, if a company declares a cash dividend, then the details of the holdings by the investors is given by the respective depository participants to the depository so that the details can further be given to the **RTA (Registrar and Transfer Agents)** which **would facilitate them to directly transfer** the amount to the bank account of the investor/holder through the ECS (Electronic Clearing System) system.

For having a security of a **company** in demat form, first a company has to opt for the same. A company can do so by getting itself **registered with at least one of the depositories**. For this, the company has to transfer all its shares to the depository. For differentiating among all the companies, International Securities Identification Number (ISIN) is assigned to them which are unique in nature.

8.2 International Securities Identification Number

Each security issued bears a unique ISIN issued by the International Standards Organisation (ISO). In India, the task of issuing ISIN of various securities has been assigned by SEBI to NSDL. For Government securities, allotment of ISIN is done by Reserve Bank of India. Each member country has a different code according to the ISIN Standard (ISO 6166).

ISIN is a **twelve-character** long identification mark. It has three components – a pre-fix, a basic number and a check digit.

- The **pre-fix** is a two digit country code as stated under ISO 3166 (IN for India).
- The **basic number** is made up of nine alphanumeric characters (digits and/or alphabets).
- The **check digit** at the end of the ISIN is computed to check the validity of the ISIN. It is calculated according to the modulus 10 “Double Add Double Check”.

Distinct ISINs are allotted to securities issued by the same company, issued at different times or carrying different rights of different terms and conditions. Different ISINs are issued to physical and dematerialized securities of the same issue.

To understand it in a better manner, let's take an **example**:

ISIN **INE 475C 01 012** has the following break up:

- IN** - India
- E** - Company
- 475C** - Company serial number
- 01** - Equity (it can be mutual fund units, debt or government securities)
- 01** - Issue number
- 2** - Check digit

The **third character** represents the Issuer Type (E in the above example). It is as follows:

- A - Central government security
- B - State government security

- C - Municipal corporation
- D - Union Territories
- E - Company, Statutory Corporation, Banking Company
- F - Mutual funds including UTI

Maximum issuer types can be 35 (A to Z and 0 to 8.)

The characters **fourth to seventh** represents company identity. The first three characters are numeric and the fourth character is an alpha character.

The **eighth and the ninth** character represent security type for a given issuer. Both the characters are numeric.

<i>Security Type</i>	<i>Code</i>
Equity	01
Non Voting Equity	02
Convertible Preference Shares	03
Non Convertible Preference Shares	04
Mutual Fund Units – Close ended	05
Mutual Fund Units – Open ended	06
Secured Debentures	07
Unsecured Debentures	08
Regular Return Bonds – Promissory Notes	09
Floating Rate Bonds	10
Deep Discount Bonds	11
Step Discount Bonds	12
Warrants	13

The **tenth and the eleventh** characters are serially issued for each security of the issuer entering the system.

The **last number** is double-add-double check digit.

8.2.1 Securities that can be dematerialised

The entire depository system in India is governed by the rules made by the market regulatory SEBI. According to the SEBI (Depositories and Participants) Regulations, 1996, the following securities are eligible for holding in dematerialized form.

1. Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of similar nature of any incorporated company or other body corporate, including underlying shares of ADRs and GDRs.
2. Units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificate of deposit, securitized debt, money market instruments, government securities, national saving certificates, kisan vikas patra and unlisted securities.

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Attention Investors!
PAN Card is now mandatory for Demat Account

With effect from April 1, 2006, SEBI has made PAN Card compulsory for all categories of investors for opening a Demat Account. Existing Demat Account holders would not be able to operate the accounts if they do not produce the PAN card or do not resolve discrepancies, if any, in the PAN details by Dec 31, 2006. Such account would be “Suspended from Debit” until PAN details are verified and updated by the depository participants (DP).

In case of Demat accounts held jointly, all account holder need to provide their PAN cards.

Original PAN Cards need to be produce to be DP for verifying the photocopy.

- Issued by NSDL in the interest of Demat account holders.

8.3 Dematerialisation

8.3.1 Meaning

Dematerialisation is a process by which the physical share certificates of an investor are taken back by the Company and an equivalent number of securities are credited in electronic form at the request of the investor. An investor will have to first open an account with a Depository Participant and then request for the dematerialisation of his share certificates through the Depository Participant so that the dematerialised holdings can be credited into that account. This is very similar to opening a Bank Account.

Dematerialisation of shares is optional and an investor can still hold shares in physical form. However, he/she has to demat the shares if he/she wishes to sell the same through the Stock Exchanges. Similarly, if an investor purchases shares, he/she will get delivery of the shares in demat form.

8.3.2 Process of Dematerialisation

The following steps may be followed for getting physical securities converted into Demat form. The following diagram will make the understanding of the steps even better.

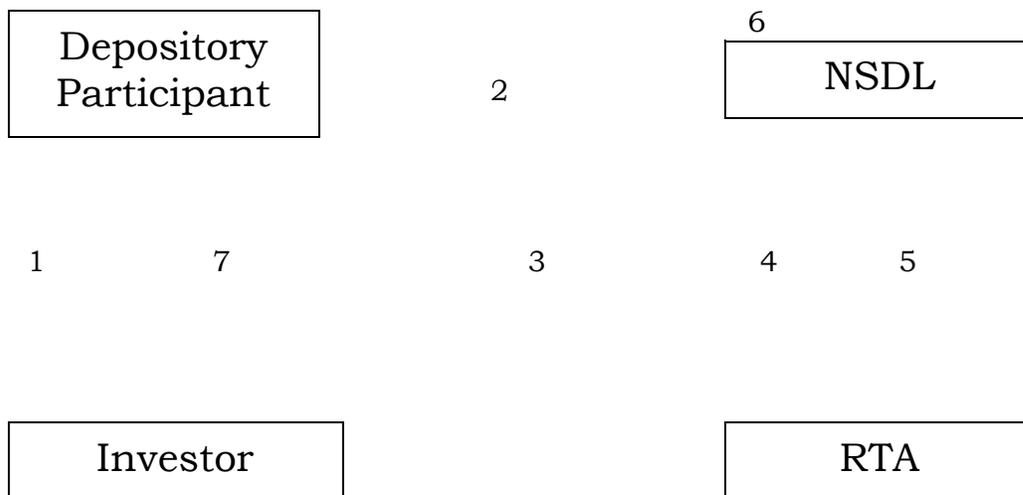
- Step: 1** Client/Investor submits the DRF (Demat Request Form) and physical certificates (to be dematted) to the DP. DP checks whether the securities are available for demat. Client defaces the certificate by stamping **‘Surrendered for Dematerialisation’**. DP punches two holes on the name of the company and draws two parallel lines across the face of the certificate. This ensures that your shares are not lost in transit or misused till credit is received by you in your demat account. The DP upon receipt of the shares and the DRF, will issue the client an acknowledgement and will send an electronic request to the Company.
- Step: 2** DP enters the demat request in his system to be sent to NSDL.
- Step: 3** DP dispatches the physical certificates along with the DRF to the R&T Agent.

Step: 4 NSDL records the details of the electronic request in the system and forwards the request to the R&T Agent.

Step: 5 R&T Agent, on receiving the physical documents and the electronic request, verify and check them. Once the R&T Agent is satisfied, dematerialization of the concerned securities is electronically confirmed to NSDL.

Step: 7 NSDL credits the dematerialised securities to the beneficiary account of the investor and intimates the DP electronically.

Step: 8 The DP issues a statement of transaction to the client.



Annexure D of NSDL Business Rules

Participant's Name Address & DP id
(Pre-printed)

DEMATERIALISATION REQUEST FORM

D R N
(to be filled-in by the DP)
Date:

Serial No. (Pre Printed)

I/We request you to dematerialise the enclosed certificates into my/our account as per the details given below:

Client Id							
Sole/First Holder Name							

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Second Holder Name				
Third Holder Name				
Company Name				
Type of Security	<i>Equity/Others (please specify)</i>			
Quantity to be Dematerialised (in figures)				
(in words)				
(in words)				
Face Value				
ISIN (To be filled in by the DP)	I	N		

Details of Securities :					
Free Securities			Locked-in Securities		
Folio No.	Certificate Nos.		Distinctive Nos.		Quantity
	From	To	From	To	
			1		
			■		

Total No of Certificates: _____

Details of Locked-in Securities:

Lock in reason	
Lock in release date	

(In case the space is found to be insufficient, an annexure containing the certificate details in the same format may be attached. Please use separate form for free securities and locked-in securities)

Declaration

I/we hereby declare that the above mentioned securities are registered in my/our name. The original certificates are hereby surrendered by me/us for dematerialisation. I/We also hereby declare that the securities surrendered by me/us for dematerialisation are free from any lien or charge or encumbrance and represents the bonafide securities of the company to the best of my/our knowledge and belief.

Holder(s)	Signature(s)
Sole/First Holder	
Second Holder	
Third Holder	

Participant Authorisation

We have received the above-mentioned securities for dematerialisation. The application form is verified with the certificates surrendered for dematerialisation and we certify that the application form is in accordance with the details mentioned in the enclosed certificates. It is

also certified that the holders of the securities have beneficiary account with us in the same name(s).

Name of the Executive:

Signature:

Participant's Stamp & Date

Acknowledgement

Serial No. (Pre-printed)

We hereby acknowledge the receipt of _____ shares/units/bonds/debentures of _____ surrendered for dematerialisation by Mr/Ms/M/s _____ having Client id _____.

Date:

Participant's Stamp & Signature

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Dematerialisation:	
Month/year	Demat Quantity (cr)
Aug-05	14,708
Aug-06	19,040
Aug-07	22,014
As on August 31, 2007, 22,014 cr. securities having a value of	

Table 8.2

Month/year	Demat Quantity (cr)	Demat Value (Rs cr)
Aug-05	14,708	17,71,445
Aug-06	19,040	25,79,119
Aug-07	22,014	38,66,690

8.3.3 Benefits of having a demat account

- I. Trading in the shares of the Company is now under the compulsory demat segment. With SEBI making demat mandatory on most of the traded scrips, electronic transaction will be the only way everyone will trade.
- II. No stamp duty for transfer of securities in the electronic form. In case of transfer of physical shares, stamp duty is payable on the market value of shares being transferred.
- III. All risks associated with physical certificates such as delays, loss, in transit, theft, mutilation, bad deliveries, etc. eliminated. The shares can be kept in the "Frozen Mode" by your Depository Participant under the specific instructions of the client.
- IV. The concept of an "odd lot" in respect of dematerialized shares stands abolished, i.e. in the demat mode, market lot becomes one share.
- V. Dematerialised securities are most preferred by banks and other financiers for providing credit facility against securities. Generally, demat securities attract lower margin and lower rates of interest compared to physical securities.
- VI. Even in the electronic mode of trading, the payment mechanism (usually

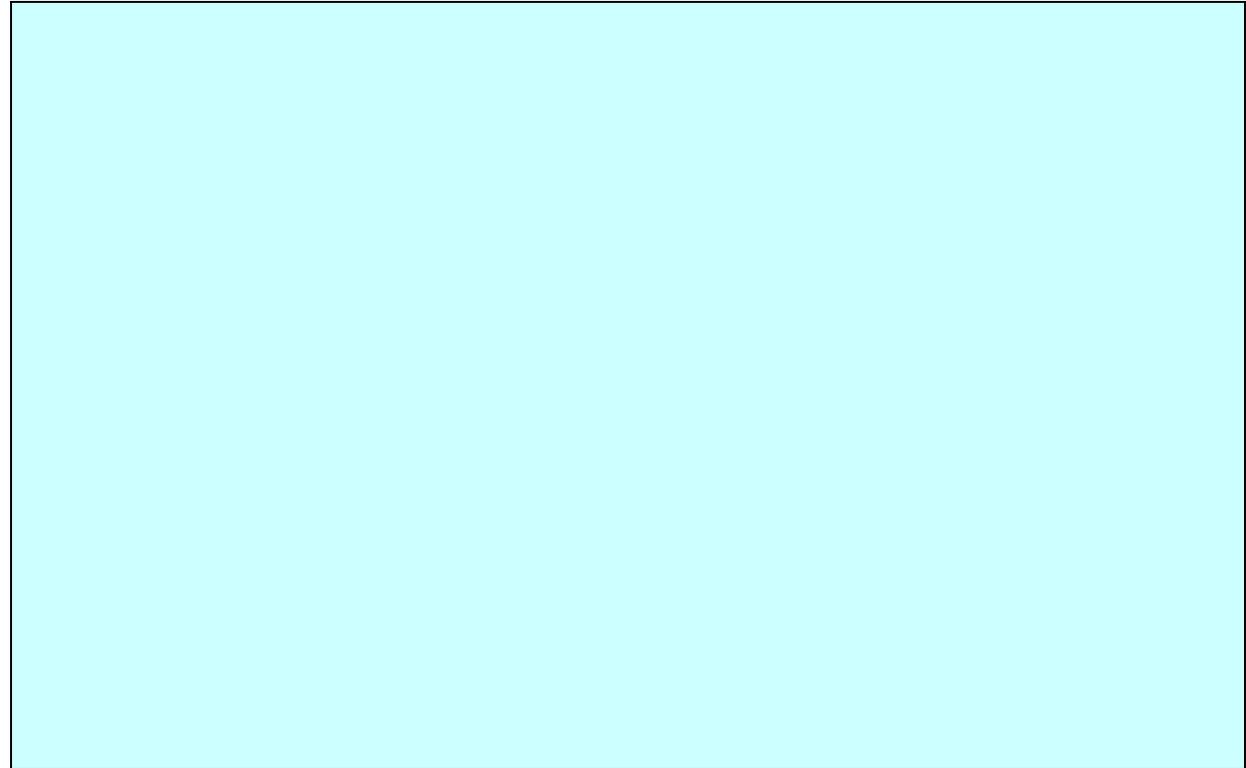
through a broker) between the buyer and seller continues to be as before. Also the usual brokerage charges would have to be incurred. However, after the settlement, pay in and pay out are on the same day for scripless trading which means you get your securities as well as cash immediately.

- VII. Shares bought or sold are transferred in your name on the very next day of pay out. In case of physical shares, transfer of ownership takes 30 days or sometimes even more.
- VIII. No courier/postal charges for sending share certificates/transfer deeds.
- IX. Facility for freezing/locking of investor accounts, which enables you to make your account non-operational, for instance if you are abroad.
- X. Facility to pledge and hypothecate your securities available.
- XI. As the Depository System becomes popular, brokers will be increasingly reluctant to deal with physical shares.
- XII. Investors prefer to buy shares which are already in dematerialised form.

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Investors:		
		Table 8.4
Month Year	Client Accounts	
	No. of Accounts (Lakh)	
Aug-05		68.05
Aug-06		78.33
Aug-07		79.16

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SMS Alert facility for NSDL demat account holders

NSDL has launched SMS Alert facility for demat account holders whereby investors can receive alerts for debits (transfers) to their demat accounts and for credits in respect of corporate

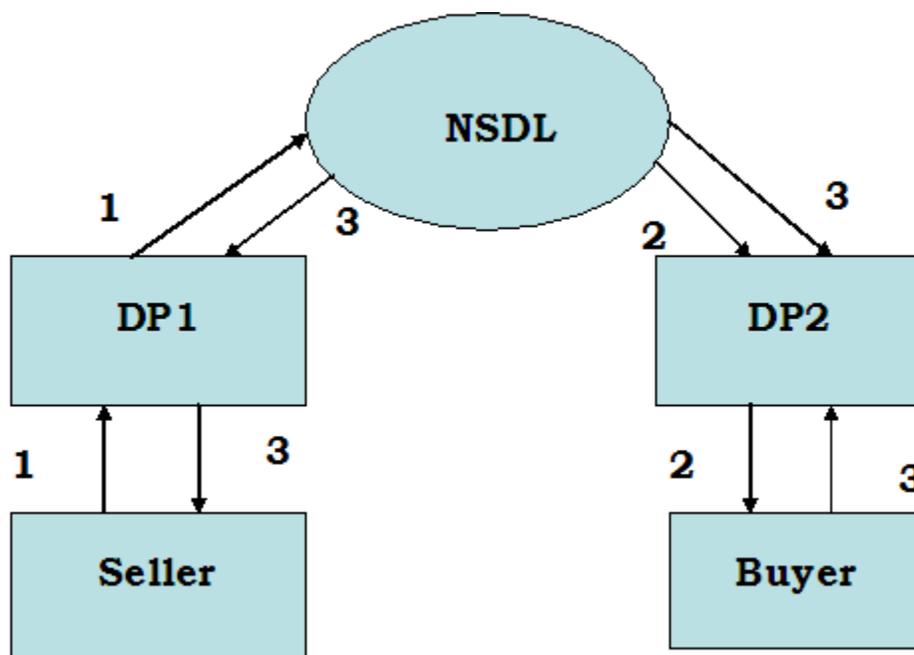
8.4 Trading and Settlement of dematted shares

8.4.1 Meaning of transfer of shares

One of the most important functions of the depositories is to provide the facility of transfer of shares. It basically means transfer of ownership from the seller to the buyer at the instruction of the account holder. Both the buyer (transferee) and the seller (transferor) have to give instructions to their respective depository participants regarding the transfer of ownership. A transferee is allowed to give Standing Instructions (SI) to the DP regarding the credit. But a beneficiary account can be debited only if the beneficiary owner has given the Delivery Instructions (DI) in the prescribed form.

Transfers can arise out of Off-market Trades or Market Trades. Any trade carried out without the participation of the clearing corporation is called **off-market trade**, i.e. trades cleared and settled without the intervention of NSCCL. Generally, bulk deals between institutions; trades between private parties, transfer of securities between a client and a sub-broker are off-market trades. On the other hand, a **market trade** is one which is settled through the clearing corporation. All the trades done in a regular manner on the exchange are a part of market trade. Even the negotiated trades done with the intervention of the clearing corporation are a part and parcel of market trades.

8.4.2 Settlement of Off-market Trades

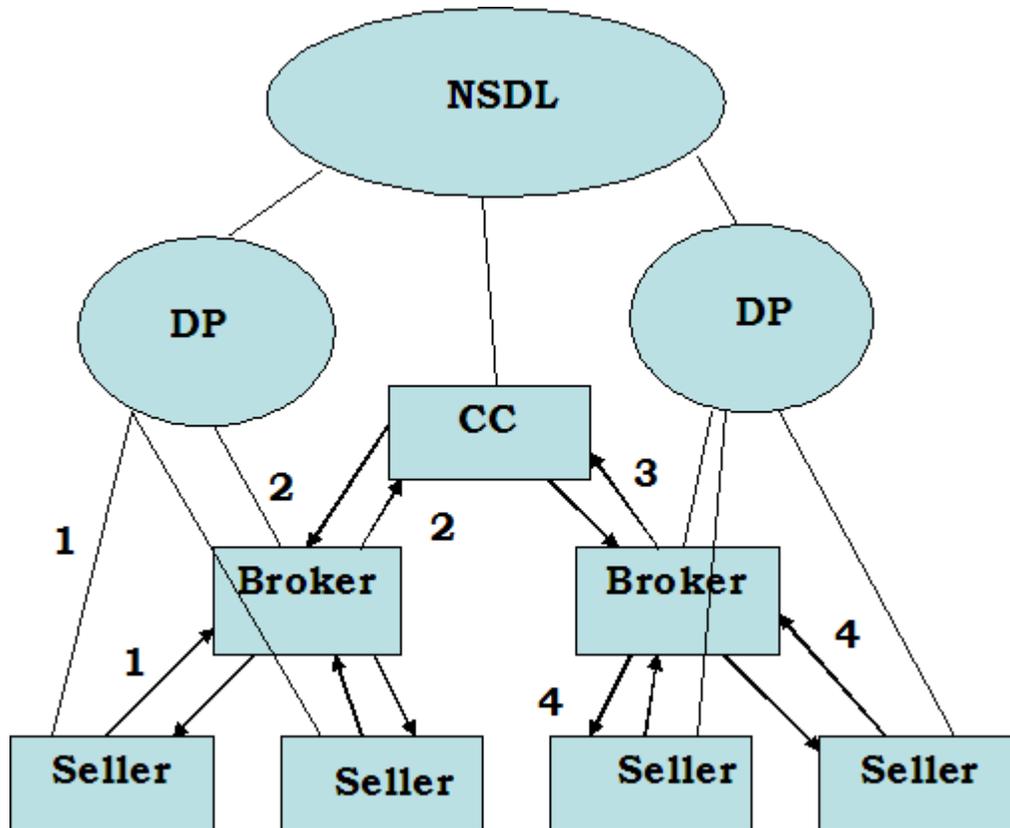


- Step: 1** Seller gives delivery instructions to his DP to move securities from his account to the buyer's account.
- Step: 2** Buyer automatically receives the credit of the securities into his account on the basis of standing instruction for credits.
- Step: 3** Buyer receives credit of securities into his account only if he gives receipt instructions, if standing instructions have not been given.
- Step: 4** DP needs to be extra careful in verifying the signature of the client if large quantities of securities are being debited to the account.
- Step: 5** Funds move from buyer to seller outside the NSDL system.

In case of Off-market trades, all the funds related settlements are made outside the system of NSDL and NSCCL. Only the transfer of securities is done through the NSDL channel. Therefore, NSCCL is not responsible for the timely payment of funds.

8.4.3 Settlement of Market Trades

Market trades include all the trades done through the NSE system. Even the trades done through negotiation, wherein the buyers and sellers fix a deal on their own but want that the securities should move through the NSDL system, and the clearing and settlement through the NSCCL will also be a part of market trades.



Step: 1 Seller gives delivery out instructions to his DP to move securities from his account to his broker's account.

Step: 2 Securities are transferred from broker's account to CC on the basis of a delivery out instruction.

Step: 3 On the pay-out day securities are moved from CC to buying broker's account.

Step: 4 Buying broker gives instructions and securities move to the buyer's account.

<ul style="list-style-type: none"> • International Securities Identification Number 	<ul style="list-style-type: none"> • Dematerialisation
<ul style="list-style-type: none"> • Rematerialisation 	<ul style="list-style-type: none"> • Book entry system
<ul style="list-style-type: none"> • Fungibility 	<ul style="list-style-type: none"> • Beneficiary owner
<ul style="list-style-type: none"> • Registered owner 	<ul style="list-style-type: none"> • Market Trades
<ul style="list-style-type: none"> • Off market trades 	<ul style="list-style-type: none"> • NSCCL

Multiple Choice Questions—Time your efforts

- Q.1 ISIN fro all securities, except government ones, is allotted by:
a) NSE b) NSDL c) SEBI d) BSE
- Q.2 How many characters are there in ISIN?
a) 14 b) 12 c) 11 d) 10
- Q.3 In ISIN, what does Code 08 signify?
a) Non voting equities
b) Unsecured Debentures
c) Warrants
d) Step Discount Bonds
- Q.4 When was CDSL formed?
a) September'99
b) August'00
c) February'99
d) January'00
- Q.5 Which organization provides for maintenance of ownership records in a book entry form?
a) BSE
b) NSCCL
c) Depositories
d) NSE
- Q.6 Who has permitted NSDL to allot an ISIN for demat shares?
a) NSCCL
b) CRISIL
c) ICICI
d) SEBI
- Q.7 Which character in ISIN alphabetic by nature?
a) 6 b) 1 c) 4 d) 2
- Q.8 What is the code allotted as security type for “Unsecured Debentures”?
a) 05
b) 13
c) 01
d) 08
- Q.9 Which act in 1996 was passed to provide free transferability of securities with speed and accuracy?
a) Depositories Act
b) SEBI Act

- c) SCRA
- d) Companies Act

- Q.10 What is the name of the company set up by NSE in order to promote dematerialization of securities?
- a) BSE
 - b) NSCCL
 - c) CDSL
 - d) NSDL

Answers:

- | | | | | | |
|---------|---------|---------|----------|---------|---------|
| Q.1 (b) | Q.2 (b) | Q.3 (b) | Q.4 (c) | Q.5 (c) | Q.6 (d) |
| Q.7 (c) | Q.8 (d) | Q.9 (a) | Q.10 (d) | | |

Very short answer type:

- Q.1 What is a Depository?
- Q.2 Who is a Depository Participant?
- Q.3 What is Rematerialisation?
- Q.4 Who is a beneficiary owner?
- Q.5 What do you mean by fungibility?
- Q.6 What is the need to have ISIN?

Short answer type:

- Q.1 Why should investors prefer to buy shares in the depository mode?
- Q.2 What is book entry system?
- Q.3 What is the difference between market and off market trades?

Long answer type:

- Q.1 How does the Depository System operate?
- Q.2 What are the benefits of having a demat account?
- Q.3 Explain the process of dematerialization.
- Q.4 Write the steps to be followed in settlement of market trades.