Depositories - e-enabling the market place

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The last decade of the last century set the tone for the shape of things to come in the capital market in the 21st century and that has trans-formed the 130-year old Indian securities industry into a modern, technology enabled market place. The success achieved by the depository system has helped to accelerate introduction of complete paperless trading. Soon, debt instruments and government securities too would follow suit. The issuers, investors and market intermediaries have already reaped a rich harvest of benefits from the introduction of dematerialised system. The biggest gains for investors and market intermediaries have been the elimination of bad deliveries and saving on account of stamp duty, besides the instant transfer of securities. The issuers too have been in for a win-win situation with depositories which have spared them of the torturous process of transfer of securities in physical form and doing away with the maintenance of share transfer set up.

The precursor to the establishment of the depository system, was the ground shift that changed the face of the securities markets in India. It was the introduction of the screen-based trading and a modern and more technologically enabled system of electronic settlements. It still seems like an amazing feat given the fact that the Indian stock markets were run on a traditional basis. Despite not so heart-warming experience of the OTC Exchange, introduction of screen-based trading on main bourses met with instant success. This success was evident from the increasing trading volumes on stock exchanges across the country. The rise in volumes was partly because of the increased trading time from just two hours to over five hours and partly due to the wide network of trading terminals that linked smaller towns to the big boards of the Mumbai Stock Exchange and National Stock Exchange. The second major event that helped transform the archaic Indian securities trading was the march towards a modern and more technologically enabled system of electronic settlements.

Despite these positive developments, there was one major stumbling block in the way to ensure consolidation of the successes achieved so far - the ills of the delivery of paper securities. Introduction of the depository system was a natural progression towards immobilisation or dematerialisation of equity shares. In a bold move, the Government of India decided to directly go in for dematerialisation of securities rather than the immobilisation.

The depositories business did not meet with instant success. The issuers, investing public and market intermediaries had to be cajoled and prodded before they could be made to accept this superior and technologically convenient, dependable and secure way of dealing in securities. The Union Government, in its wisdom, decided to waive off stamp duty applicable on transfer of securities in the demat mode to push ahead the capital market reforms process and kick start the dematerialisation of equity segment. Simultaneously, SEBI mandated that while the right to hold securities in paper or electronic form would remain vested with the investor, settlement of trades in certain securities would have to be made only in demat form. Thoughtfully, the shift from paper to demat form was carried out in tranches. The first set of securities for compulsory settlement in demat mode was announced in January 1999. Three and half years later, today we are close to a total eclipse of the paper certificate regime in the trading of equity despite the fact that it is permissible to settle trades upto 500 shares in physical form. This is - once again thanks to a SEBI directive - because of the mandatory requirement that all traded shares be admitted with both the depositories - National Securities Depository Limited and the Central Depository Services (India) Limited.

Dematerialisation of equity shares has not just been a move to emulate the developed market model. But, it has also been a step towards removing some of the ills that plagued the securities market like bad deliveries, delays in transfer of shares and frauds using duplicate / fake certificates etc. With the dematerialisation of equity shares, investors now find that shares purchased by them are registered in their names within just four days from the trade date, as against anywhere upwards of one month taken earlier. Till such time the shares did not get transferred, investors would have to keep their fingers crossed that the certificates sent by them have reached the company or if reached, were genuine and would not result in bad deliveries. Besides investors, brokers have also been the biggest beneficiaries of demat system as they no longer have to maintain a complement of staff to handle objection and bad delivery cases and are saved from the consequential financial loss.

The success achieved by the depository system is not only because of the regulatory environment or use of technology, but an unyielding commitment to quality, at its broadest and most basic level i.e. the protection of investor interest. The success story of the depository system in India is in itself an ideal case study of what can be achieved when the designated institutions act in concert with the government and the regulator to enforce good practices and introduce new systems to a community that prefers status quo rather than change.

The all round gains that demat has brought is also reflected in the business figures. Some of the statistics are truly revealing.

- Over 4 million demat accounts.
- Over 350 DPs in over 100 towns and cities having electronic connectivity with the depositories.
- Almost 100% of equity trades are now settled in demat form.

Challenges Ahead

The changing regulatory requirements, evolving market practices, continuous and rapid changes in technology coupled with the growth in business volume and proposed shift to Straight Through Processing (STP) and T+1 settlement cycle and above all, the ever increasing investor expectations to get best of the services at a reasonable cost, throws both opportunities and challenges to the depository system in India as also to the issuers, intermediaries and investors, the three main pillars of the system.

Being an Information Technology (IT) based service provider, depository system requires heavy investment of funds in hardware, software, networking and back-up facilities to run the system on 24 / 7 basis. Investment in technology cannot be of a one time process. Besides the need of continuously upgrading their systems and adding user friendly features, depositories have to augment their processing capabilities to ensure that the increasing numbers of accounts and transactions are managed with equal efficiency.

Depository services are made available to investors through Depository Participant (DP), an important link between the depository and the beneficial owner (investor). Depositories conduct regular inspection and audit of DPs to ensure that they adhere to the prescribed operating guidelines and procedures, while servicing investors. Continuous upgradation of systems and skills at DPs' end is a focussed area of depositories activities.

The cost the ultimate investor has to bear would include fees charged by the depository as well as the DP. While each DP is free to fix his tariff, the competitive forces have ensured that DPs charge reasonable fees. While, on one hand, there is a need to keep the charges, the ultimate investor bears, in control, it goes without saying that the depository business is run on commercial lines. The challenge how to keep depositories viable and profitable and at the same time not putting undue financial burden on the retail investor. One of the way to achieve this objective could be to make the issuers pay a part of the cost of the depository services as the advent of depositories has brought about enormous savings for the Issuers.

In June 2002, the Bhave committee on "Reduction of costs for investors relating to their demat operations" too has recommended that, the issuers must be asked to pay a fee. However, even if the payment of such fee is made mandatory for issuers, it is doubtful whether depositories could effectively enforce collection of such fees. When a company fails to pay up its listing fees to the stock exchange, the trading in the company's shares is suspended by stock exchanges. Depositories cannot take recourse to any such course, as once a security is admitted for dematerialisation with the depositories, transfers of that security between beneficial owners is effected automatically and instantaneously without reference to the issuers. It will be necessary to have a proper legal framework before issuers are mandated to bear depository charges.

Initially, issuers were reluctant to join the depository system for the fear of the unknown. Big push to the admission of listed securities came with the SEBI's decision to have settlement of trades in securities compulsorily settled in demat form as also the SEBI's directive to have equity of all the listed companies admitted with both the depositories. By now almost all listed companies whose stocks are traded on stock exchanges have admitted their securities with the depositories. The remaining listed companies, most of which are listed on the regional stock exchange/s, have very small capital base or have small non promoter shareholding or have not witnessed any trading for years. In some other cases, the companies are sick or have been referred to BIFR. Depositories are finding it difficult to admit securities of such companies and, therefore, trade in them have to be settled on trade for trade basis as per the SEBI requirement.

The Reserve Bank of India has made it compulsory that all debt instruments subscribed by regulated entities like banks, mutual funds, etc. should be compulsorily issued and settled in demat form. Similarly, settlement of trades in government securities have to be compulsorily made in demat form. SEBI should now consider to issue directive to issuers of debt securities to have them compulsorily admitted with both the depositories, so that investors having demat account with any one of the depositories can also participate in such investments. This requirement should be for all debt instruments, whether placed privately or otherwise. That will lend depth and liquidity in the debt market.

One of the factors which enabled successful extension of the depository system was to permit issuer companies to establish electronic link with the depositories through a SEBI registered registrar even though the actual work of issue, transfer and other shareholder related matters could continue to be handled by the issuers themselves. That facilitated quick admission of securities with the depositories. This has, however, created division of responsibilities between the issuer and registrar leaving a possibility of some unscrupulous issuer misusing the depository system to manipulate even though the depositories have prescribed an elaborate procedure and documentation before any additional issuance could be uploaded in the system. Depositories have suggested for secretarial audit of issuers to ensure proper compliances. It has also been suggested that the issue and the transfer work are mandated to be handled by the same agency which has electronic connectivity with the depositories. That will facilitate reconciliation and compliance also.

While a majority of the issuers confirm to the demat requests of investors within the stipulated period of 15 days, there are quite a few instances where it has been brought to the notice of depositories that there are undue delays in confirming demat requests. Despite depositories following up the matter with the concerned issuers and publishing their names on the web-sites or giving publicity through monthly press releases, the response is found to be slow. Depositories have no other power to take any action against such issuers even though many investors, who are unaware of the system, tend to believe that the delay in confirmation of demat requests is because of delay at the depository or the DP end. SEBI and the Department of Company Affairs have to come out with some penal measures against errant companies through regulatory or legislative measures, if necessary.

Currently, depositories in India are permitted to undertake only the demat activity. There are moves to introduce to STP and T+1 settlement cycle. Successful transition to STP and T+1 settlement cycle would necessitate that clearing and settlement work is integrated with one organisation viz. with the respective depositories in line with global practice.

Today, securities move much faster than money. While securities received in pay out can get transferred and registered in the new beneficiary's name immediately, transfer of funds to the seller's account does not happen in that way despite RBI having introduced electronic fund transfer facility in metropolitan cities. The system is yet to stabalise. The securities and money could cross over between the buyer and seller simultaneously in a real delivery v/s payment (DvP) system only when clearing function is integrated with the depository system and the depositories are allowed to undertake limited banking facility.

Amongst the more serious challenge ahead for the two depositories is to ensure 100 percent coverage of all investors by the depository system. Out of the estimated 20 million investors, currently only about four million investors have opened demat account. A major nation wide effort has to be made to reach out to all those not covered by the system so far. Today, the depositories electronic network is present in over 100 cities and several collection facility is available across a large number of cities / towns. Besides spreading the network, investor awareness campaign has to be carried out.

By strict enforcement of operating guidelines and bye-laws, undertaking regular inspection and audit of DPs and registrars, continuous updation of technical infrastructure and system upgradation, it has been ensured that the depository system functions without any major aberration. With the expansion of the business and introduction of new instruments, depositories will be required to put additional resources to maintain their excellent record of service at reasonable and affordable cost to the investors.