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# The Depositories' Bit Part in Investor Protection

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## ABSTRACT

*"The Regulatory framework as well as operational procedures prescribed for depositories and participants, provide for a number of measures aimed at protecting investors' interest within the Depository System."[2]*

*A depository is an entity/ body which help an investor to sell or buy securities such as bonds and stocks in a paper-less manner. Securities in depository accounts are held and transacted in electronic mode. Here came the concept of dematerialization, where physical certificates are converted in electronic records. These are registered, operated and regulated under the supervision of SEBI (The Securities and Exchange Board of India).*

*Two depositories which are registered under SEBI are- National Securities Depositories Limited NSDL and Central Depository Service Limited (CDSL). The safety provided to the investor's are 3 fold, Firstly, the technical safety of data is ensured. All transactions are absolutely safe as several built- in safety measures are taken up by the depositories to ensure complete security of the investor's holdings. Secondly, security is provided in processing operation or regular transaction where a system of check and follow up is maintained in order to avoid any false/ fraudulent act against investors. Lastly, the investor's own vigilance and awareness is appreciated and maintained. These precautions are generally suggested by NSDL for the benefits of account holder's towards managing their Demat accounts.*

## I. INTRODUCTION

Investors are the backbone of the securities market. They not only determine the level of activity in the securities market but also the level of activity in the economy. The growth in the numbers of investors in India is encouraging. The trends reveal that in addition to FIIs and Institutional Investors, small investors were also gradually beginning to regain the confidence in the capital markets that had been shaken consequent to the stock market scams

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[2] Vijay K. Gaba, Taxmann's Depository Participants Law and Practice

 

during the past decade. It is imperative for the healthy growth of the corporate sector that this confidence is maintained. However, many investors may not possess adequate expertise/knowledge to take informed investment decisions. Some of them may not be aware of the complete risk-return profile of the different investment options. Some investors may not be fully aware of the precautions they should take while dealing with market intermediaries and dealing in different securities. They may not be familiar with the market mechanism and the practices as well as their rights and obligations.

The corporate systems and processes need to be credible and transparent, so that the interests of the investors may be safeguarded in a manner that enables them to exercise their choice in an informed manner while making investment decisions, and also providing them with a fair exit option. The Securities and Exchange Board of India (SEBI) has been mandated to protect the interests of investors in securities and to promote the development and regulate the securities market so as to establish a dynamic and efficient Securities Market contributing to Indian Economy.

## II. WHO IS AN INVESTOR?

An investor is a person who is an individual or a corporate legal entity investing his capital in another venture or business but does not do the business himself or itself. The investor has no role to play in the day-to-day management of the business or its control except as permitted by the law. Investor carries on business when they buy and sell assets, arranges for other to buy and sell assets, manages assets belonging to others, or operates collective investment schemes. An investor engages these activities, but they are not having any control over the day-to-day activities of any corporate. Normally, an investor is a blind person; they do not know any activities made by the company. Investor cannot guide the fate or destiny of the money invested. An investor to that extent is quite fragile and is exposed to certain risks because the utiliser of his money can commit mistakes. Normally they are contributing the funds for productive purpose of the company, and they are exposing him to the business decisions that the company has taken or will be taking. There are no doubt laws some of which are adequate but some are not. An investor obviously needs some protection.

Investor protection is a very popular phrase which everyone concerned with regulation of the capital markets uses these days, be they the Securities and Exchange Board of India, Stock Exchanges, Investors associations or for that matter of fact the companies themselves. The term Investor Protection is a wide term encompassing various measures designed to protect the investors from malpractices of companies, merchant bankers, depository participants and other intermediaries. Investor Beware should be the watchword of all programmes for mobilization of savings for investment. As all investment has some risk element, this risk factor should be borne in mind by the investors and they should take all precautions to protect their interest in the first place. If caution is thrown to the winds and they invest in any venture without a prior assessment of the risk, they have only to blame themselves. Investors are a heterogeneous group, they are large or small, rich or poor, expert or lay and not all investors need equal degree of protection for their invested amount from the corporate securities.

As an investor has three objectives while investing his surplus money, namely safety of invested money, liquidity position of invested money, and return on investment in selected securities. Normally, an investor desires to have safety of his invested funds, liquidity of his investments and a good return with minimum risk. An investor can be classified as individual or professional who manages the funds on behalf of others. First there are inexperienced investor who needs to be properly advised about the intricacies of investment avenues and opportunities in corporate securities. Secondly, there are the experienced investors who understand the risks involved in the selected investment avenues and who need no advices from others, his response / order just to be executed without much time. Thirdly, there are occasional investors who seek advice and assistance once in a while with no desire to create a long- term perspective.

During 1990s, there was a bearish trend in the Indian capital market. During 2000s, there is an unexpected bullish trend in the capital market. There is every uncertainty in terms of market price and rate of return. The uncertainty acts as barriers for many investors to enter into the stock market operations. The investors fear that there is no protection for their investments and immediate return as dividend. The disclosure of information relating to the issue of securities, market operations, grievance redressal mechanism etc, is there but there is no regulator to give assurance relating to the return on investment and capital appreciation.

In spite of these legislative measures, there are fraudulent companies, which are cheating the investors. For example, in India around 9600 listed companies are available for trade in Bombay Stock Exchange and National Stock Exchange of India Ltd., but only 2500 company shares are traded in Bombay Stock Exchange and nearly 800 company shares are actively traded in National Stock Exchange, most of companies are traded only in the penny stock level. The remaining companies are enjoying benefit from the legal provisions of corporate veil from the Companies Act 1956. Recently the Central Government has identified nearly 229 companies which were vanished. The Government also was unable to trace some companies managerial persons, proper communication addresses, etc, and the Department of

Company affairs filed a prosecution against 75 companies through the Registrar of Companies. Most of the vanished companies tapped capital from the market and collected funds from the public through issue of shares / debentures at the time of Capital Market boom period during early 1990s. Some of the companies took advantage of the market conditions but later defaulted in their commitments made to the public while mobilizing funds. Some of these companies are not even traceable; the public has thus been cheated of their hard earned money.

At present there is no ceiling on the quantum of issue of securities by the issuing companies and instead any number of securities can be issued for raising funds subject to the guidelines of SEBI for issue of securities.

Besides fresh issue of securities can be made either at free pricing or as a process of book building price. But dividend will be paid only on the par value, under this circumstance the investors will be benefited only when there is capital appreciation over and above free pricing or book building process pricing. Whether the liberalized capital market followed by free pricing or book building process will protect the investors in terms of capital gain and return on investment or not?

## III. WHERE DOES A DEPOSITORY COME INTO THE PICTURE?

Shares and bonds are being issued by companies for quite some time. Twelve years back, all these were issued in the form of physical certificates that the investor had to keep safe and then forward to the buyer once sold. This process was highly time consuming and gave rise to issues like fake securities and bad deliveries. All these reasons and the improvement in technology gave rise to depositories and the electronic mode of holding securities. A depository resembles a bank; however in case of a depository the deposits are securities, such as shares, debentures, bonds and government securities, in electronic form. A depository functions as a bank- both are common houses that hold assets of the participating members and provide services to clients. In India there is Depository System for securities trading in which book entry is done electronically and no paper work is involved. The physical form of securities is extinguished and shares or securities are held in an electronic form. Before the introduction of the depository system through the Depository Act, 1996, the process of sale, purchase and transfer of securities was a huge problem, and there was no safety at all.

**DEMATERIALISATION OF SECURITIES**: Dematerialization is relatively a new concept introduced in the securities market. It is basically a process by which the physical certificates of an investor are taken/surrendered-by/to the company/registrar and actually destroyed and an equivalent number of securities are credited in the depository account of the 129 investor on request of the investor. To overcome the problems associated with settlement of physical share certificates and to provide electronic depository facilities for securities traded in the equity and the debt markets, the process of dematerialization of shares was evolved.

## IV. Key Features of the Depository System in India

1. **Multi-Depository System**: The depository model adopted in India provides for a competitive multi-depository system. There can be various entities providing depository services. A depository should be a company formed under 4 the Company Act, 1956 and should have been granted a certificate of registration under the Securities and Exchange Board of India Act, 1992. Presently, there are two depositories registered with SEBI, namely: National Securities Depository Limited (NSDL), and Central Depository Service Limited (CDSL)

2. **Depository services through depository participants**: The depositories can provide their services to investors through their agents called depository participants. These agents are appointed subject to the conditions prescribed under Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 and other applicable conditions.

3. **Dematerialization**: The model adopted in India provides for dematerialization of securities. This is a significant step in the direction of achieving a completely paper-free securities market. Dematerialization is a process by which physical certificates of an investor are converted into electronic form and credited to the account of the depository participant.

4. **Fungibility:** The securities held in dematerialized form do not bear any notable feature like distinctive number, folio number or certificate number. Once shares get dematerialized, they lose their identity in terms of share certificate distinctive numbers and folio numbers. Thus all securities in the same class are 130 identical and interchangeable. For example, all equity shares in the class of fully paid up shares are interchangeable.

5. **Registered Owner/ Beneficial Owner**: In the depository system, the ownership of securities dematerialized is bifurcated between Registered Owner and Beneficial Owner. According to the Depositories Act, 'Registered Owner' means a depository whose name is entered as such in the register of the issuer. A 'Beneficial Owner' means a person whose name is recorded as such with the depository. Though the securities are registered in the name of the depository actually holding them, the rights, benefits and liabilities in respect of the securities held by the depository remain with the beneficial owner. For the securities

dematerialized, NSDL/CDSL is the Registered Owner in the books of the issuer; but ownership rights and liabilities rest with Beneficial Owner. All the rights, duties and liabilities underlying the security are on the beneficial owner of the security.

6. **Free Transferability of shares**: Transfer of shares held in dematerialized form takes place freely through electronic book-entry system.

There are various advantages and disadvantages to the system mentioned above.

**Advantages are as follows-**

1. Share certificates, on dematerialization, are cancelled and the same will not be sent back to the investor. The shares, represented by dematerialized share certificates are fungible and, therefore, certificate numbers and distinctive numbers are cancelled and become non-operative.
2. It enables processing of share trading and transfers electronically without involving share certificates and transfer deeds, thus eliminating the paper work involved in scrip-based trading and share transfer system.
3. Transfer of dematerialized securities is immediate and unlike in the case of physical transfer where the change of ownership has to be informed to the company in order to be registered as such, in case of transfer in dematerialized form, beneficial ownership will be transferred as soon as the shares are transferred from one account to another.
4. The investor is also relieved of problems like bad delivery, fake certificates, shares under litigation, signature difference of transferor and the like.
5. There is no need to fill a transfer form for transfer of shares and affix share transfer stamps.
6. There is saving in time and cost on account of elimination of posting of certificates.
7. The threat of loss of certificates or fraudulent interception of certificates in transit that causes anxiety to the investors, are eliminated.

**Disadvantages/Problems of the Depository System are as follows-**

1. **Lack of control** - Trading in securities may become uncontrolled in case of dematerialized securities.
2. **Need for greater supervision** - It is incumbent upon the capital market regulator to keep a close watch on the trading in dematerialized securities and see to it that trading does not act as a detriment to investors. The role of key market players in case of

dematerialized securities, such as stock brokers, needs to be supervised as they have the capability of manipulating the market.

3. **Complexity of the system** - Multiple regulatory frameworks have to be confirmed to, including the Depositories Act, Regulations and the various Bye Laws of various depositories. Additionally, agreements are entered at various levels in the process of dematerialization. These may cause anxiety to the investor desirous of simplicity in terms of transactions in dematerialized securities.
4. Current regulations prohibit multiple bids or applications by a single person. But investors open multiple demat accounts and make multiple applications to subscribe to IPOs in the hope of getting allotment of shares.
5. Some listed companies had obtained duplicate shares after the originals were pledged with banks and then sold the duplicates in the secondary market to make a profit.
6. Promoters of some companies dematerialized shares in excess of the company's issued capital.
7. Certain investors pledged shares with banks and got the same shares reissued as duplicates.
8. There is an undue delay in the settlement of complaints by investors against depository participants. This is because there is no single body that is in charge ofensuring full compliance by these companies.

Some disadvantages were about the depository system were known beforehand. But since the advantages outweighed the shortcomings of dematerialization, the depository system was given the go-ahead.

## V. ROLE OF NSDL AND CDSL IN INDIAN CAPITAL MARKET

**NSDL**

NSDL carries out its activities through service providers such as depository participants (DPs), issuing companies and their registrars and share transfer agents and clearing corporations/ clearing houses of stock exchanges. These entities are NSDL's business partners and are integrated in to the NSDL depository system to provide various services to investors and clearing members. The investor can get depository services through NSDL's depository participants.

NSDL was registered by the SEBI on June 7, 1996 as India's first depository to facilitate trading and settlement of securities in the dematerialized form. The NSDL is promoted by IDBI, UTI and NSE to provide electronic depository facilities for securities traded in the equity and debt markets in the country. NSDL has been set up to cater to the demanding needs of the Indian capital markets. In the first phase of operations, NSDL will dematerialize scripts and replace them with electronic entries. This depository promoted by institutions of national stature responsible for economic development of the country has since established a national infrastructure of international standard that handles most of the trading and settlement in dematerialized form in Indian capital market. The Depositories Act also provides for multiple depository system. Using innovative and flexible technology systems, NSDL works to support the investors and brokers in the capital market of the country.

NSDL provides numerous direct and indirect benefits like:

• Elimination of bad deliveries

• Elimination of all risks associated with physical certificates

• No stamp duty • Immediate transfer and registration of securities

• Faster settlement cycle

• Faster disbursement of non cash corporate benefits like rights, bonus, etc.

• Reduction in brokerage by many brokers for trading in dematerialized securities

• Reduction in handling of huge volumes of paper

• Periodic status reports

• Elimination of problems related to change of address of investor

• Elimination of problems related to transmission of demat shares

• Elimination of problems related to selling securities on behalf of a minor

• Ease in portfolio monitoring

**CDSL**

CDSL was promoted by BSE Ltd. jointly with leading banks such as State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank and Union Bank of India.

CDSL was set up with the objective of providing convenient, dependable and secure depository services at affordable cost to all market participants.

The balances in the investors account recorded and maintained with CDSL can be obtained through the DP. The DP is required to provide the investor, at regular intervals, a statement of account which gives the details of the securities holdings and transactions. The depository system has effectively eliminated paper-based certificates which were prone to be fake, forged, counterfeit resulting in bad deliveries. CDSL offers an efficient and instantaneous transfer of securities.

CDSL was promoted by BSE Ltd. in association with Bank of India, Bank of Baroda, State Bank of India and HDFC Bank. BSE Ltd. has been involved with this venture right from the inception and has contributed overwhelmingly to the fruition of the project. The initial capital of the company is 104.50 crores (INR). The list of shareholders with effect from 5th July, 2010 is as under.

<u>Role of CDSL in Indian Depository System are as follows:</u>

• Maintenance of individual investors' beneficial holdings in an electronic form

• Dematerialization and re-materialization of securities

• Account transfer for settlement of trades in electronic shares

•Allotments in the electronic form in case of initial public offerings

• Distribution of non-cash corporate actions

• Facility for freezing/locking of investor accounts

• Facility for pledge and hypothecation of securities

## VI. REGULATORY PROTECTION TO INVESTORS

Following are the important measures for investors' protection provided in the regulatory framework of Depository Act, SEBI (D&P) Regulations and NSDL Bye-laws:

1. Registration of Participants Before granting a certificate of registration to any DP, SEBI considers whether grant of such certificate is in the interest of investors in the securities market. Even after giving the certificate of registration, SEBI can ban any DP if it finds its involvement in any of the scams against interest of common investors. In exercise of its power, **SEBI has banned 12 DPs (including Karvy, Pratik and India Bulls)** from opening fresh accounts for their involvement in IPO scams[3]

2. Indemnity against loss The Depository is liable to indemnify the beneficial owners for any loss caused to them due to the negligence of the depository or its DPs.

[3] Reference from articles 'SEBI Cracks the Whip,' 'Karvy, Pratik Banned from being DPs', 'Ban to tame a fiery bull', ' Non-interest imcome hit- HDFC Babk, Centurion, IDBI Bank & ING Vysya barred from being opening demat accounts', 'Indiabulls Checkmated', published in The Economic Times, 28.4.06, page 1

3. Transfer without consideration The Depository shall register the transfer of a security in the name of the transferee only after it is satisfied that payment for such transfer has been made.

4. Settlement of Disputes As per Bye-law of NSDL, all claims, differences and disputes between participants and clients are referred in accordance with and subject to the provisions of the Arbitration and Conciliation Act, 1996.

5. Inspection As per Depository Act, 1996, SEBI can call upon any issuer, Depository, DP or beneficial owner to furnish in writing such information relating to the securities held in a depository as it may require, in the public interest or in the interest of investors.

This authority was used in the following cases: -

***IPO ALLOTMENT SCAM***

In the case of Yes Bank IPO (June 2005), Roopalben received 9.47 lakh shares from 6315 demat accounts and Sugandh received 1.97 lakh shares from 1315 demat accounts. Hence both of them received a total of 11.44 lakh shares out of 1.75 crore shares reserved for the retail investors which comes around 6.54% of retail category of shares. Similarly in the case of IDFC IPO (August 2005), the retail investors were offered 14.13 crore shares, out of which Roopalben received 72.04 lakh shares from 27064 demat accounts and Sugandh received 27.09 lakh shares from 10181 demat accounts. Two other persons named Purshottam Budhwani received 12.63 lakh shares from 4748 accounts while Manojdev Seksaria received 5.29 lakh shares from 1989 demat accounts. Thus four persons received a total of 1.17 crore shares from 43982 demat accounts and managed to corner over 8.28% IDFC shares from the retail category.[4]

In Yes Bank and IDFC IPO scams, DPs played dubious role by opening thousands offictitious/ benami demat accounts with active involvement of financiers, banks and RTAs. The scamsters opened fictitious or bogus demat accounts and applied for the IPO shares through these accounts in the retail category. Although there has been no ‘real loss on anybody’s part’ except retail investors suffered an opportunity loss (their chances of allotment were reduced by the fact that certain individuals have multiple applications), SEBI tightened the depositories to strictly enforce the ‘Know Your Client’ norms. After the scam, SEBI made it mandatory to present proof of Permanent Account Number (PAN) while opening any demat account.

[4] Details extracted from article ‘IPO Scam - will it impact the primary market Sentiments?’ published in Dalai Street, Feb 6-19,2006, pp. (78-84)

6. Protection under NSDL Bye-laws The Depository can order an inspection of participants to investigate into the affairs of the participant in the interest of the investors.

This authority was exercised by NSDL in the following case:

***THE INDIA BULLS CASE***

This case was detected by NSDL in November 2005. In this case Indiabulls Securities (DP) used to ask for a comprehensive Power of Attorney (PoA) in the account-opening process by investors. The DP made the PoA mandatory and took away all rights of investors to operate their demat accounts. When NSDL noticed this anomaly, it issued a notice to its DPs instructing them not to force clients to sign the PoA and asked them to desist from (i) restraining the investor from operating his demat account (ii) denying delivery instruction slip books (iii) merging shares kept under various client accounts (iv) having a lien on client accounts' shares.[5] NSDL even started probe into 559 demat accounts of Indiabulls clients from May 1, 2006.[6]

## VII. Steps taken to make the system more secured in the interest of the investors

Depository is a self-regulatory organization (SRO) and it is not a requirement of SEBI Regulations, 2004 that systemic deficiencies be detected 'in advance' by SRO. Also as per Depository act, NSDL is not concerned in any manner with IPO process as all applications of investors to an IPO are forwarded to the RTA who scrutinize these applications under the overall supervision of SEBI. On the basis of these grounds, NSDL got itself free from the responsibility of bogus accounts opened by its DPs[7].

The following steps have been taken by the SEBI to make the system more secured in the interest of investors:

1) PAN proof has been made mandatory while opening a demat account.

2) Person has to be physically present while opening a demat account

3) DPs have been instructed to strictly enforce the 'Know Your Client' norms before opening

[5] Gajra R in article 'Very one sided-Head I win; tails you lose: that seems to be the idea behind most Client-broker/DP agreements. Why?,' published in Outlook Money 15th February, 2006 pp. (38-39)
[6] Rajawat Yatish K., Final verdict on all Companies not before June - Jail up to 5 years under Depositories Act, The Economic Times, 1st May 2006, p. 13
[7] Patil P., IPO Scam- Willi it impact the primary market Sentiments? Dalal Street, Feb. 6-19, pp 78-84 D

any demat account.

## VIII. Suggestions and conclusion

The securities market operations promote the economic growth of the country. More efficient is the securities market; the greater is the promotion effect on economic growth. It is, therefore, necessary to ensure that securities market operations are more efficient, transparent and safe. The investors need protection from the various malpractices and unfair practices made by the corporate and intermediaries. As the individual investor's community and the investment avenues are on the rise, it is interesting to know how the investors shall be protected through various legislations. Securities market in general are to be regulated to improve the market operations in fair dealings and easy to access the market by corporate and investors. The present positive attitude of investors is heartening though investor sentiments have been shaken by the various scandals. Even though, there are various opportunities available for investment, investors are scared of investing in corporate. In this situation, the individual investor's protection becomes necessary to sustain the economic development of all countries.

To achieve the desired level of economic growth is dependent upon investor's protection availability of the concerned country.

Globally, there is increased evidence to suggest that investor protection has assumed an important role in the economic development of a country. Integrity of the financial markets and economic well being of the country depend on corporate accountability and investor confidence. The global concern to make capital markets safer, transparent, strengthening financial system and managing the crisis cannot be quickly fixed. But they add up to a stronger system. Globally, many countries have undergone investor's confidence crisis in different aspects. The global evidence suggests that every time there is stock market crisis, money pours into bank deposits. SEBI, if not 100%, than for sure it has been near to 100% success as far as the protections of the investors are concerned. As we have seen that via different guidelines it had made it sure that no stone remains unturned in the path of the mission of protecting the investors.

Again with economic recovery in the country, the funds are diverted to the markets. Investors panic when markets slide. It is important for investors to realize that returns on equities are cyclical in nature and also, market moves up and down with time. Understanding market and being patient while market is going down is important while investing in equities. The revival of investor's protection in the corporate securities market is necessary to make market more

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efficient by means of converting savings to investment. If the investors have not been protected properly by means of rate of return and capital, the corporate will not be able to collect the funds from the market with cheap rate and effectively in future days. For gaining the confidence of investors in the securities market there is a need to provide an adequate rate of return and fair operating efficiency of corporate in the securities market, then the investors lure back to market. This can be done by a series of systematic measures, which would build their confidence in the systems and processes and protect the interest of investors.

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