

The Depositories Ordinance, 1995 Explained

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THE present system of transfer of ownership of securities is grossly inefficient as every transfer is required to be accomplished by the physical movement of paper securities to the issuer for registration and the ownership is evidenced by the endorsement on the security certificate. The process of transfer in many cases takes much longer time than two months stipulated in section 113 of the Companies Act, 1956 or section 22A of the Securities Contracts (Regulations) Act (SCRA), 1956. A significant proportion of transactions ends up as 'bad delivery' due to faulty compliance of paper work, mismatch of signatures on transfer deeds with the specimen record of the issuer or for other procedural reasons. Theft, forgery, mutilation of certificates and other irregularities have also become rampant. The inherent right of the issuer to refuse the transfer of a security also adds to the misery of the investors. The cumbersome paraphernalia associated with the transfer of a securities under section 108 of the Companies Act, 1956, alongwith huge paper work, printing of stationary, safe custody of securities, transportation and despatch add to the cost of servicing paper securities, delay in settlement and restrict liquidity in securities and make investor grievance redressal time consuming and at times intractable. All these problems have not surfaced overnight but these have been compounded by burgeoning trade volumes in secondary market and increasing dependence on capital market for financing trade and industry. About 75,000 trades take place everyday on Bombay Stock Exchange only. The average daily turnover of Bombay Stock Exchange was Rs. 292 crores during 1994-95. About 1500 companies accessed the capital market during 1994-95. All these underscore the need for streamlining the transfer of ownership of securities which has been sought to be accomplished by the Depositories Ordinance, 1995, promulgated by the President on 20.9.95. The Ordinance provides a legal basis for establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by—(a) making the securities of public limited companies freely transferable; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form.

THREE MAIN PLANKS

Legal Basis

The Depositories Ordinance, 1995, read with section 12 of the Securities Exchange Board of India (SEBI) Act, 1992, provides a legal basis for establishment of multiple depositories and entrusts

them with the responsibility of maintaining ownership records of securities and effecting transfer of securities through book entry only. The depositories will render, through participant, any service connected with recording of:

- (a) allotment of securities; and
- (b) transfer of ownership of securities.

By fiction of law under section 10 of the Depositories Ordinance, the depository is deemed to be registered owner of security with the limited purpose of effecting transfer of ownership of security. In respect of securities held in a depository, the name of the depository will appear in the records of the issuer as registered owner of securities. The depository will have right to effect the transfer of securities and shall not have any other right associated with them. The owners of the securities will become beneficial owners on the records of the depository in respect of the securities held in a depository. The beneficial owner will have all the rights and liabilities associated with the securities. The depositories holding the securities shall maintain ownership records in the name of the each participant. Each such participant, as an agent of the depository, shall in turn, maintain ownership records of every beneficial owner in book entry form. The relationship between depository and participant will be that of a principal and agent and their relations will be governed by the bye-laws of the depository and the agreement between them.

Both the depository and participant need to be registered with Securities and Exchange Board of India (SEBI) under section 12 of the SEBI Act, 1992, and would be regulated by SEBI. only a company formed and registered under the Companies Act, 1956, can be registered as a depository by SEBI. However, before commencing business, the depository registered with SEBI has to obtain a certificate of commencement of business from SEBI. Such certificate will be

* The explanations provided here is of the author and not necessarily of the Government.

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issued by SEBI on being fully satisfied that the depository has adequate systems and safeguards to ensure against manipulation of records and transactions. SEBI has also been given powers to suspend or cancel the certificate of registration of a depository as well as of the participants after giving a reasonable opportunity of being heard.

The ownership records of securities maintained by depositories/participants, whether maintained in the form of books or machine readable form, shall be accepted as *prima facie* evidence in legal proceedings. The depository will be treated as if it were a bank under the Bankers' Books of Evidence Act, 1891.

The depository services shall be available in respect of the securities as may be specified by SEBI. The type of securities and the eligibility criteria for admission to the depository mode shall be determined by SEBI regulations. This provides the flexibility to SEBI, for example, to admit certain instruments like units of mutual funds and prohibit admission of certain securities like shares of Private Ltd. companies from depository mode.

Free Transferability of Securities

The securities of all public companies have been made freely transferable. The Ordinance has taken away the companies' right to use discretion in effecting transfer of securities by deleting section 22A from SCRA, 1956 and by inserting section 111A in the Companies Act, 1956. These provisions, read with section 7 of the Depositories Ordinance, 1995, make the transfer of securities in any company, whether listed or not, other than a private company and a deemed public company, free and automatic. That is, once the agreed consideration is paid and the purchase transaction is settled, the buyer is automatically entitled to all the rights associated with the security. As soon as the intimation regarding delivery of security against the payment of cash (*delivery v. payment*) is received, the transfer will be effected by the depository or company and the transferee will enjoy all the rights and obligations associated with the security immediately. If the securities are in the depository mode, depository would effect the transfer on the basis of intimation (contract notes or some other suitable evidence) from the participants. If the securities are outside the depository mode, the company would effect the transfer on receipt of the transfer deed. For the securities in the depository mode, no transfer deed is required and other procedural requirements under section 108 of the Companies Act have been dispensed with. The transferee in both the modes would be entitled to all the rights including voting rights and obligations associated with security.

However, if it is felt that the transfer of a security is in contravention of any of the provisions of the SEBI Act, 1992 or Regulation made thereunder or Sick Industrial Companies (Special Provisions) Act (SICA), 1985, the company, depository, participant, investor or SEBI can make an application to the Company Law Board (CLB) to determine if the alleged contravention has taken place. After enquiry, if the CLB is satisfied of the contravention, it can direct the company/depository to make rectification in ownership records. In other words, transfer has to be effected immediately even if the

transfer is contravention of SEBI Act, 1992 or SICA, 1985, subject to subsequent rectification by the direction of CLB. Pending the completion of enquiry, CLB can suspend voting rights in respect of securities so transferred. The transferee will continue to enjoy economic rights (bonus, dividend, rights etc.) which can not be suspended under any circumstances. During the pendency of the application with CLB, the transferee can transfer the securities and such further transfer will entitle the transferee to the voting rights also unless the voting rights in respect of transferee has also been suspended.

Partial Dematerialisation of Securities

Section 9 of the Depositories Ordinance provides that the securities held by a depository shall be dematerialised and be fungible. The Ordinance envisages dematerialisation of securities in the depository mode as against immobilisation of securities. The later refers to a situation when the depositories hold securities in physical form side by side with ownership records. In such a case the transfer are not accompanied by physical movement of securities but securities are in existence in the custody of the depository. What the Ordinance envisages is that ownership of securities shall be reflected through book entry system and this will not require existence of securities certificates. However, the securities outside the depository would be represented by physical security certificates as at present. Hence, the depository mode envisaged is one of the partial dematerialisation, that is, a portion of securities is dematerialised and the other portion remains in physical form.

The securities have been made fungible by deleting section 83 of the Companies Act, 1956, which required that each share in a company shall be distinguished by an appropriate number. Now the certificates will not carry a distinct number and will form a part of a "fungible mass". All certificates of the same security will become interchangeable in the sense that the owner of the security will lose the right to obtain the exact certificate. It is like withdrawing money from the bank without bothering about the number and denomination of the currencies.

MECHANISM

The investor has been given the option between holding physical securities as at present or opting for a depository based ownership records. At the time of fresh issue, the issuer is under obligation to give the option to the investors either to seek physical scrips under the existing paper based system (non-depository mode) or opt for book entry system of recording ownership (depository mode). The decision on whether or not to hold securities within the depository mode, if in depository mode, which depository or participant, would be entirely with the investor. Such freedom can be exercised either at the time of the initial offer of the security by indicating his choice in the application form or at any subsequent time. He will also have the freedom to switch from depository mode to non-depository mode and vice versa.

At the time of initial offer, if the investor opts to hold a security in the depository mode, the issuer shall be intimated concerned depository the details of allotment of a security and record the depository as registered owner of the securities. On

receipt of such information, the depository shall enter in its records the names of allottees as the beneficial owners.

An investor who holds physical securities and seeks to avail the services of a depository will surrender the certificates to the issuer. The issuer on receipt of certificates shall cancel them and substitute in its records the name of the depository as a registered owner in respect of that security and inform the depository accordingly. The depository shall thereafter enter the name of the investor in its records as beneficial owner.

If a beneficial owner or a transferee of a securities seeks to opt out of a depository in respect of any security, he shall inform the depository of his intention. The depository in turn shall make appropriate entries in its records and shall inform the issuer. The issuer shall make arrangements for the issue of certificate of securities to the investor.

The depository shall record all transfers made within the depository mode on receipt of intimation from a participant. The type of intimation would be specified by SEBI regulations.

An investor, before availing the services of a depository, shall enter into an agreement with a depository through a participant. The participant is also required to enter into an agreement with the depository to act as the latter's agent. There will also be an agreement between the depository and the issuer of securities. The rights and obligations of depositories, participants, issuers and investors would be governed by the agreement among them, the bye-laws of the depository and the regulations of SEBI.

The investor will have a right to be indemnified by the depository for any loss caused to him due to the negligence of depository and/or participant. The depository, in turn, may raise consequential claims on the concerned participants.

REGULATORY FRAMEWORK

SEBI has been given powers to regulate depositories, participants, and their relationship with the beneficial owners and to regulate companies in respect of their rights and obligations towards depositories. SEBI has also been given powers to monitor, inspect, issue of direction, call for information, summon and enforce attendance of witnesses and production of documents, conduct enquiries and audits of depositories, participants, beneficial owners and issuers of securities. SEBI has been authorised to make regulations to provide, *inter-alia*, for :

- the form in which record is to be maintained by the Depository;
- the form in which the certificate of commencement of business shall be issued to the Depository;
- the manner in which the certificate of security shall be surrendered to the issuer;
- the manner of creating a pledge or hypothecation in respect of security owned by a beneficial owner;

- the conditions and the fee payable with respect to the issue of certificate of securities while coming out of depository;
- the rights and obligations of the depositories, participants and the issuers; and
- the eligibility criteria for admission of securities into the depository.

A depository is required to make bye-laws with the previous approval of the SEBI. The bye-laws will provide, *inter alia*, for :

- the eligibility criteria for admission and removal of securities in the depository;
- the conditions subject to which the securities shall be dealt within a depository;
- the eligibility criteria for admission of any person as a participant;
- the manner and procedure for dematerialisation of securities;
- the procedure for transactions within the depository;
- the manner in which securities shall be dealt with or withdrawn from a depository;
- the procedure for ensuring safeguards to protect the interests of participants and beneficial owners;
- the conditions of admission into and withdrawal from a participant by a beneficial owner;
- the procedure for conveying information to the participants and beneficial owners on dividend declaration, shareholder meetings and other matters of interest to the beneficial owners;
- the manner of distribution of dividends, interest and monetary benefits received from the company among beneficial owners;
- the manner of creating pledge or hypothecation in respect of securities held with a depository;
- inter-se* rights and obligations among the depository, issuer, participants and beneficial owners;
- the manner and the periodicity of furnishing information to the Board, issuer and other persons;
- the procedure for resolving disputes involving depository, issuer, company or a beneficial owner;
- the procedure for proceeding against the participant committing breach of the regulations and provisions for suspension and expulsion of participants from the depository and cancellation of agreements entered with the depository; and
- the internal control standards including procedure for auditing, reviewing and monitoring.

AMENDMENTS IN OTHER ACTS

To provide for the smooth operation of the depositories, the Depositories Ordinance has also amended the following Acts:

- (a) The Indian Stamps Act, 1989;
- (b) The Companies Act, 1956;
- (c) The Securities Contracts (Regulation) Act, 1956;
- (d) The Income-tax Act, 1961;
- (e) The Benami Transactions (Prohibition) Act, 1988; and
- (f) The Securities and Exchange Board of India Act, 1992.

The major amendments have been effected in the Acts mentioned at (a), (b) and (d) above. These have been discussed in the following paragraphs:

Amendment to Indian Stamps Act

Section 8A has been inserted in the Indian Stamps Act to provide for the following :

- (i) At the time of issue of securities, shares or otherwise, the issuer shall pay the Stamp Duty on the total amount of the security issued by it, whether through a depository or direct to investors, even though there will be no physical securities (instrument) which can be stamped (executed).
- (ii) Entry into depository involves change of registered ownership as the investor becomes the beneficial owner and the depository becomes the registered owner in respect of the security. As it involves change in registered ownership, it attracts stamp duty under the existing provisions. The new section 8A, however, exempts such change of registered ownership of shares from an investor to a depository from the stamp duty.
- (iii) All transactions of securities involving change in registered ownership and/or beneficial ownership of shares within the depository mode shall not attract any stamp duty.
- (iv) If an investor opts to exit from the depository and seeks the issue of physical certificate of securities from the issuer, the issue of such certificates shall attract stamp duty as is payable on the issue of duplicate certificates.
- (v) All transactions outside the depository mode shall attract stamp duty as at present.
- (vi) The securities other than shares will attract stamp duty at the time of entry into depository and at the time of transfer within the depository mode by implication.

Amendments to the Income-tax Act

Sub-section 2A has been inserted in section 45 to provide that the depositories as well as the participants will not be liable to pay any capital gains tax in respect of profits or gains arising from transfer securities held in depositories and transacted

from time to time since these securities are held on behalf of the beneficial owners. In other words, *inter-se* transfer of securities between the participants in the books of a depository as well as between the depositories in the records of an issuer shall not be treated as transfer unless it involves change in beneficial ownership. If it involves any change in the beneficial ownership, only the beneficial owner shall be chargeable to capital gains tax, not the registered owner.

Due to fungible characteristic of the securities, while calculating capital gains tax, the cost of acquisition of securities shall not be determined with reference to cost of acquisition of specific identifiable securities, but be ascertained on the principle of first in first out. That is, the securities acquired first by the beneficial owner would be deemed to have been transferred first irrespective of the intention of the investor. This principle is applicable only in respect of securities held in a depository.

Amendment to the Companies Act

Section 83 of the Companies Act has been deleted. This does away with the mandatory requirement of each company limited by shares to distinguish them by distinguishing numbers, in order to introduce the concept of fungibility. The abolition of section 83, however, does not prohibit a company from having distinct numbers, although there is no mandatory requirement to that effect.

Section 108 has been amended to provide that the provisions of section 108 shall apply to transfer of securities effected outside the depository mode. The provisions of section 108 shall not apply to transfers of securities effected within the depository mode.

Section 111 has been amended to provide that the provisions of section 111 shall apply to a private company and a deemed public company. The new Section 111A has been inserted to govern the transfer of securities of a public limited company. The shares or debentures and any interest therein of a company has been made freely transferable and all the rights and obligations associated with them immediately accrue to the transferee. However, if the transfer violates any of the provisions of the SEBI Act, 1992 or SICA, 1985, the depository, company, participant, investor or SEBI can make an application to the CLB. The CLB, pending completion of enquiry may make an interim order to suspend the voting rights in respect of those securities, and on-completion of the enquiry, may direct the company or depository to rectify the register or records if transfer is in violation of the aforesaid provisions. During the pendency of the application with CLB, the economic rights accrue to the transferee and the transferee has a right to transfer the securities further and such further transferee shall be entitled to voting rights also.

NEXT STEP

The Ordinance has paved the way for rendering of depository services. Its operationalisation, however, requires framing of Regulations by SEBI under SEBI Act, 1992 to register the depositories and participants. For operational details to the functioning of depositories, let us wait for SEBI Regulations. □