

A quiet revolution in depository architecture

TRANSFORMATIVE. Three structural shifts elevate depositories, but recasting its participants complicates investor protection



GETTY IMAGES/ISTOCKPHOTO



MS SAHOO
SUMIT AGRAWAL

Buried within the dense statutory language of the Securities Markets Code, 2025 (SMC), lies a shift that is easy to miss but difficult to overstate. A depository, long treated as an intermediary under the Depositories Act, 1996, is now recognised as a market infrastructure institution (MII). At the same time, the depository participant (DP), earlier an agent of the depository, is recast as its member. These changes reflect a deeper reconfiguration of the depository's role in India's market architecture. Three structural changes make the elevation of depositories to MIIs both logical and, perhaps, inevitable.

First, the expansion of function: Under the 1996 framework, depositories were essentially record-keeping utilities, responsible for the allotment and transfer of securities. The SMC significantly broadens this mandate. Depository services now include the distribution of monetary and securities-based benefits, facilitation of electronic voting, the exercise of interests and rights attached to securities, and such other services. Depositories are no longer passive ledgers. They are the institutional interface through which investors receive entitlements and participate in corporate governance. An entity that distributes dividends, enables voting, and administers rights issues is integral to market functioning in a way that far exceeds the role of an intermediary.

Second, the expansion of scope: The earlier regime largely confined depository services to securities within the securities market. The SMC expands this to 'other regulated instruments,' defined broadly to include instruments governed by any regulatory authority. This opens the door to the

dematerialisation of a much wider class of assets, beyond traditional financial instruments, including small savings products, insurance policies, pension credits, loan contracts, warehouse receipts, carbon credit certificates, land records, and even testamentary instruments such as living wills. As the universe of dematerialised assets expands, so does the systemic importance of the depository. It moves from being a market utility to a foundational layer of the financial and potentially administrative architecture.

Third, the elimination of choice: The 1996 Act allowed investors to choose between physical and dematerialised holdings and opt in and opt out of the demat system. The SMC largely removes this choice, subject to limited grandfathering. Securities must now be issued and held in dematerialised form. The depository is no longer an efficiency-enhancing option; it is a compulsory gateway to the market. Once participation becomes mandatory, the institution's design, governance, and accountability assume far greater significance.

Taken together, these three structural changes transform the scale and centrality of depositories. The volume and diversity of transactions they handle are set to increase exponentially. Mandatory dematerialisation of mutual fund units, given the scale of folios and transaction frequency, would by itself multiply the system's footprint. When other regulated instruments follow, the growth would compound further. And once the depository layer extends across all services associated with the dematerialised universe, the effect

Depository participants are no longer agents; they are members of the depository. The architecture shifts from a principal-agent model to one of membership and institutional governance

would shift to an entirely different order of magnitude. In such a landscape, the emergence of multiple, possibly specialised, depositories is not inconceivable. The law, in recognising depositories as MIIs, appears to be catching up with this operational reality.

FROM AGENTS TO MEMBERS

But does this transformation warrant a corresponding shift in the role of DPs? Under the earlier framework, DPs functioned as agents of the depository. This had substantive consequences for investor protection. Liability was centralised; risk was absorbed at the top. If an investor suffered a loss due to the negligence of either the depository or the DP, the depository was required to indemnify the investor upfront, with a right of recovery against the errant participant. This structure ensured that the investor dealt, in effect, with a single, well-capitalised institution that stood behind the system.

The SMC alters this conceptual foundation, even as it retains the indemnification outcome. DPs are no longer agents; they are members of the depository. The architecture shifts from a principal-agent model to one of membership and institutional governance. Depositories are recast along MII lines: they set eligibility norms, regulate admission and expulsion, and exercise disciplinary powers through their bye-laws, while members may hold limited ownership and governance rights. The result is a carefully constructed hybrid, membership in form, but with elements of centralised liability preserved. Over time, this architecture could also allow depositories to engage more directly with investors, potentially through their own service channels, reducing the degree of intermediation that has traditionally defined the DP's role.

The shift is historically resonant. Before the 1992 reforms, Indian securities markets were organised around membership-based institutions, in which ownership, trading rights, and governance were closely intertwined. Those reforms dismantled this structure, separating ownership from

trading membership, and recasting members as regulated actors within institutional frameworks. The SMC does not revive the earlier model, but it does align depositories conceptually with the MII architecture, much like stock exchanges.

In the securities market, membership operates on a different logic from agency. Membership implies regulation and discipline within an institutional framework; it does not automatically attribute the conduct of members to the institution. Agency, by contrast, carries with it an element of attribution and responsibility. This creates a subtle but important tension. Is the SMC merely relabelling what remains, in substance, an agency relationship? Or does it mark the beginning of a gradual shift towards a model where depositories resemble exchanges, whose members are regulated but whose conduct is not attributable to the institution?

The question is not merely semantic. While the indemnification framework preserves investor outcomes, it shifts the underlying logic of the system. Over time, as the regulatory framework evolves and the system matures, this distinction may acquire practical significance. It goes to the heart of where trust is located: whether it remains concentrated in the institution or becomes more diffusely distributed across its participants.

In this sense, the SMC does more than modernise depository law. It redefines the institution. It expands its role, broadens its reach, embeds it within the core market infrastructure, and positions it at the centre of an increasingly digitised financial system.

The elevation of depositories to MIIs is easy to justify. Whether the parallel recasting of DPs strengthens or subtly dilutes the architecture of investor protection is less certain.

For now, the law attempts to hold both ideas together. Whether this balance endures will be the defining question this quiet reform leaves behind.

The writers are legal practitioners and former officials of SEBI