

Handbook for NSDL Depository Operations Module

Capital Markets and NSDL-Overview



National Securities Depository Limited

PREFACE

Investors have switched over to electronic [demat] settlement and National Securities Depository Limited (NSDL) stands at the centre of this change. In order to provide quality service to the users of depository, NSDL launched a certification programme in depository operations in May 1999. This certification is conducted using NCFM infrastructure created by NSE and is called "NSDL - Depository Operations Module". The programme is aimed at certifying whether an individual has adequate knowledge of depository operations, to be able to service investors. Depository Participants are required to appoint at least one person who has qualified in the certification programme at each of their service centres. This handbook is meant to help the candidates in their preparation for the certification programme.

This handbook has been divided into four volumes for readers' convenience. The first volume gives an overview of the Indian capital market and NSDL depository system. The second volume deals with admission procedure for different business partners of NSDL, their obligations, practices, systems and procedures to be followed by them and benefits and safety of depository system. The third volume helps in acquiring a working level understanding of certain basic services offered by NSDL like account opening, dematerialisation, and transfer of securities and related operations. The last volume deals with special services offered by NSDL like Pledge, Corporate Actions, Warehouse Receipts, and Tax Information Network (TIN).

The procedures explained in the handbook are based on the Depositories Act, Securities and Exchange Board of India (Depositories & Participants) Regulations and Byelaws & Business Rules of NSDL. The book contains illustrations, flow charts and checklists for better understanding of various concepts and procedures.

A sample test paper is given at the end of the fourth volume to help the candidates appearing for NCFM test form an assessment of their preparedness. A thorough understanding of this handbook will form a good base for qualifying the certification test.

Readers may like to visit NSDL website www.nsdl.co.in for updates and to know the new procedures introduced or changes brought about in the existing procedures.

A feedback form is given at the end of the fourth volume. Readers may give their feedback, which will be of great help in enhancing the value of this Handbook in its subsequent editions.

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CHAPTER 1

The Indian Capital Market - An Overview

The function of the financial market is to facilitate the transfer of funds from surplus sectors (lenders) to deficit sectors (borrowers). Normally, households have investible funds or savings, which they lend to borrowers in the corporate and public sectors whose requirement of funds far exceeds their savings. A financial market consists of investors or buyers of securities, borrowers or sellers of securities, intermediaries and regulatory bodies. Financial market does not refer to a physical location. Formal trading rules, relationships and communication networks for originating and trading financial securities link the participants in the market.

Organised money market: Indian financial system consists of money market and capital market. The money market has two components - the organised and the unorganised. The organised market is dominated by commercial banks. The other major participants are the Reserve Bank of India, Life Insurance Corporation, General Insurance Corporation, Unit Trust of India, Securities Trading Corporation of India Ltd., Discount and Finance House of India, other primary dealers, commercial banks and mutual funds. The core of the money market is the inter-bank call money market whereby short-term money borrowing/lending is effected to manage temporary liquidity mismatches. The Reserve Bank of India occupies a strategic position of managing market liquidity through open market operations of government securities, access to its accommodation, cost (interest rates), availability of credit and other monetary management tools. Normally, monetary assets of short-term nature, generally less than one year, are dealt in this market.

Un-organised money market: Despite rapid expansion of the organised money market through a large network of banking institutions that have extended their reach even to the rural areas, there is still an active unorganised market. It consists of indigenous bankers and moneylenders. In the unorganised market, there is no clear demarcation between short-term and long-term finance and even between the purposes of finance. The unorganised sector continues to provide finance for trade as well as personal consumption. The inability of the poor to meet the "creditworthiness" requirements of the banking sector make them take recourse to the institutions that still remain outside the regulatory framework of banking. But this market is shrinking.

The Capital market: The capital market consists of primary and secondary markets. The primary market deals with the issue of new instruments by the corporate sector such as equity shares, preference shares and debt instruments. Central and State governments, various public sector industrial units (PSUs), statutory and other authorities such as state electricity boards and port trusts also issue bonds/debt instruments.

The primary market in which public issue of securities is made through a prospectus is a retail market and there is no physical location. Offer for subscription to securities is made to investing community. The secondary market or stock exchange is a market for trading and settlement of securities that have already been issued. The investors holding securities sell securities through registered brokers/sub-brokers of the stock exchange. Investors who are desirous of buying securities purchase securities through registered broker/sub-broker of the stock exchange. It may have a physical location like a stock exchange or a trading floor. Since 1995, trading in securities is screen-based and Internet-based trading has also made an appearance in India.

The secondary market consists of 22 stock exchanges. The secondary market provides a trading place for the securities already issued, to be bought and sold. It also provides liquidity to the initial buyers in the primary market to re-offer the securities to any interested buyer at any price, if mutually accepted. An active secondary market actually promotes the growth of the primary market and capital formation because investors in the primary market are assured of a continuous market and they can liquidate their investments.

Capital Market Participants: There are several major players in the primary market. These include the merchant bankers, mutual funds, financial institutions, foreign institutional investors (FIIs) and individual investors. In the secondary market, there are the stock exchanges, stock brokers (who are members of the stock exchanges), the mutual funds, financial institutions, foreign institutional investors (FIIs), and individual investors. Registrars and Transfer Agents, Custodians and Depositories are capital market intermediaries that provide important infrastructure services for both primary and secondary markets.

Market Regulation: It is important to ensure smooth working of capital market, as it is the arena for the players associated with the economic growth of the country. Various laws have been passed from time to time to meet this objective.

The financial market in India was highly segmented until the initiation of reforms in 1992-93 on account of a variety of regulations and administered prices including barriers to entry. The reform process was initiated with the establishment of Securities and Exchange Board of India (SEBI).

The legislative framework before SEBI came into being consisted of three major Acts governing the capital markets:

1. The Capital Issues Control Act 1947, which restricted access to the securities market and controlled the pricing of issues.

2. The Companies Act, 1956, which sets out the code of conduct for the corporate sector in relation to issue, allotment and transfer of securities and disclosures to be made in public issues.
3. The Securities Contracts (Regulation) Act, 1956, SC(R)A which regulates transactions in securities through control over stock exchanges. In addition, a number of other Acts, e.g., the Public Debt Act, 1942, the Income Tax Act, 1961, the Banking Regulation Act, 1949, have substantial bearing on the working of the securities market.

Capital Issues (Control) Act, 1947

The Act had its origin during the Second World War in 1943 when the objective of the Government was to pre-empt resources to support the War effort. Companies were required to take the Government's approval for tapping household savings. The Act was retained with some modifications as a means of controlling the raising of capital by companies and to ensure that national resources were channelled into proper lines, i.e., for desirable purposes to serve goals and priorities of the government and to protect the interests of investors. Under the Act, any firm wishing to issue securities had to obtain approval from the Central Government, which also determined the amount, type and price of the issue. This Act was repealed and replaced by SEBI Act in 1992.

Companies Act, 1956

Companies Act, 1956 is a comprehensive legislation covering all aspects of company form of business entity from formation to winding-up. This legislation (amongst other aspects) deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standards of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, substantial acquisitions of shares, payment of interest and dividends, supply of annual report and other information.

This legal and regulatory framework contained many weaknesses. Jurisdiction over the securities market was split among various agencies and the relevant provisions were scattered in a number of statutes. This resulted in confusion, not only in the minds of the regulated but also among regulators. It also created inefficiency in the enforcement of the regulations. It was the Central Government rather than the market that allocated resources from the securities market to competing issuers and determined the terms of allocation. The allocation was not necessarily based on economic criteria, and as a result the market was not allocating the resources to the best possible investments, leading to a sub-optimal use of resources and low allocational

efficiency. Informational efficiency was also low because the provisions of the Companies Act regarding prospectus did not ensure the supply of necessary, adequate and accurate information, sufficient to enable investors to make an informed decision. The many formalities associated with the issue process under various regulations kept the cost of issue quite high. Under the SC(R)A, the secondary market was fragmented regionally, with each stock exchange a self-regulating organisation following its own policy of listing, trading and settlement. The listing agreement did not have the force of law, so issuers could get away with violations. The interests of the brokers, who were market players and dominated the governing boards of stock exchanges, took priority over the interest of investors. The market was narrow and investors did not have an opportunity to have balanced portfolios. The settlement of trades took a long time, because it required physical movement of securities, and the transfer of securities was very cumbersome under the Companies Act and SC(R)A Act, thus depriving the investor of liquidity. Law expressly forbade options and futures. These weaknesses were corrected by passing SEBI Act and giving overall regulatory jurisdiction on capital market to SEBI. SEBI framed regulations and guidelines to improve efficiency of the market, enhance transparency, check unfair trade practices and ensure international standards in market practices necessitated by the large entry of foreign financial institutions.

Securities Contracts (Regulation) Act, 1956

The previously self-regulated stock exchanges were brought under statutory regulation through the passage of the SC(R)A, which provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges. This gives the Central Government regulatory jurisdiction over (a) stock exchanges, through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition of recognition, a stock exchange complies with conditions prescribed by Central Government. Organised trading activity in securities in an area takes place on a specified recognised stock exchange. The stock exchanges determine their own listing regulations which have to conform with the minimum listing criteria set out in the Rules. The regulatory jurisdiction on stock exchanges was passed over to SEBI on enactment of SEBI Act in 1992 from Central Government by amending SC(R)Act.

Securities and Exchange Board of India

With the objectives of improving market efficiency, enhancing transparency, checking unfair trade practices and bringing the Indian market upto international standards, a package of reforms consisting of measures to liberalise, regulate and develop the securities market was introduced during the 1990s. This has changed corporate securities market beyond recognition in this decade. The practice of allocation of resources among different competing entities as well as

its terms by a central authority was discontinued. The secondary market overcame the geographical barriers by moving to screen-based trading. Trades enjoy counterparty guarantee. Physical security certificates have almost disappeared. The settlement period has shortened to two days. The following paragraphs discuss the principal reform measures undertaken since 1992.

A major step in the liberalisation process was the repeal of the Capital Issues (Control) Act, 1947 in May 1992. With this, Government's control over issue of capital, pricing of the issues, fixing of premia and rates of interest on debentures, etc., ceased. The office, which administered the Act, was abolished and the market was allowed to allocate resources to competing uses and users. Indian companies were allowed access to international capital market through issue of American Depository Receipts (ADRs) and Global Depository Receipts (GDRs). However, to ensure effective regulation of the market, SEBI Act, 1992 was enacted to empower SEBI with statutory powers for (a) protecting the interests of investors in securities (b) promoting the development of the securities market and (c) regulating the securities market. Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI can specify the matters to be disclosed and the standards of disclosure required for the protection of investors in respect of issues. It can issue directions to all intermediaries and other persons associated with the securities market in the interest of investors or of orderly development of the securities market; and can conduct inquiries, audits and inspection of all concerned and adjudicate offences under the Act. In short, it has been given necessary autonomy and authority to regulate and develop an orderly securities market.

There were several statutes regulating different aspects of the securities market and jurisdiction over the securities market was split among various agencies, whose roles overlapped and which at times worked at cross-purposes. As a result, there was no coherent policy direction for market participants to follow and no single supervisory agency had an overview of the securities business. Enactment of SEBI Act was the first such attempt towards integrated regulation of the securities market. SEBI was given full authority and jurisdiction over the securities market under the Act, and was given concurrent/delegated powers for various provisions under the Companies Act and the SC(R)A. The Depositories Act, 1996 is also administered by SEBI. A high level committee on capital markets has been set up to ensure co-ordination among the regulatory agencies in financial markets.

In the interest of investors, SEBI issued Disclosure and Investor Protection (DIP) Guidelines. Issuers are now required to comply with these Guidelines before accessing the market. The guidelines contain a substantial body of requirements for issuers/intermediaries. The main

objective is to ensure that all concerned observe high standards of integrity and fair dealing, comply with all the requirements with due skill, diligence and care, and disclose the truth, the whole truth and nothing but the truth. The Guidelines aim to secure fuller disclosure of relevant information about the issuer and the nature of the securities to be issued so that investor can take an informed decision. For example, issuers are required to disclose any material 'risk factors' in their prospectus and the justification for the pricing of the securities has to be given. SEBI has placed a responsibility on the lead managers to give a due diligence certificate, stating that they have examined the prospectus, that they find it in order and that it brings out all the facts and does not contain anything wrong or misleading. Though the requirement of vetting has now been dispensed with, SEBI has raised standards of disclosures in public issues to enhance the level of investor protection.

Improved disclosures by listed companies: The norms for continued disclosure by listed companies have also improved the availability of timely information. The information technology helped in easy dissemination of information about listed companies and market intermediaries. Equity research and analysis and credit rating has improved the quality of information. SEBI has recently started a system for Electronic Data Information Filing and Retrieval System (EDIFAR) to facilitate electronic filing of public domain information by companies.

Introduction of derivatives: To assist market participants to manage risks better through hedging, speculation and arbitrage, SC(R)A was amended in 1995 to lift the ban on options in securities. However, trading in derivatives did not take off, as there was no suitable legal and regulatory framework to govern these trades. Besides, it needed a lot of preparatory work - the underlying cash markets needed to be strengthened with the assistance of the automation of trading and settlement system; the exchanges developed adequate infrastructure and the information systems required to implement trading discipline in derivative instruments. The SC(R)A was amended further in December 1999 to expand the definition of securities to include derivatives so that the whole regulatory framework governing trading of securities could apply to trading of derivatives also. A three-decade old ban on forward trading, which had lost its relevance and was hindering introduction of derivatives trading, was withdrawn. Derivative trading took off in June 2000 on two exchanges. Now different types of derivative contracts i.e. index future, index options, single stock futures and single stock options are available in the market.

The governing bodies of stock exchanges used to be dominated by brokers, leading inevitably to conflicts of interest. To discipline brokers and cure typical stock market ills such as price rigging, it was considered necessary for stock exchanges to have a professionally managed environment. NSE started with the concept of an independent governing body without any broker

representation. It was specified in 1993 that the governing boards of stock exchanges must have 50% non-broker members, and that on committees handling matters of discipline, default, etc., brokers would be in the minority. All stock exchanges were mandated to appoint a non-broker executive director who would be accountable to SEBI for implementing the policy directions of the Central Government/ SEBI. In course of time, the position of the executive director in the management of stock exchange has been strengthened.

Indian securities market is getting increasingly integrated with the rest of the world. FII's have been permitted to invest in all types of securities, including government securities. Indian companies have been permitted to raise resources from abroad through issue of ADRs, GDRs, American Depository Receipts (ADRs), Global Depository Receipts (GDRs), Fully Convertible Corporate Bonds (FCCBs), External Commercial Borrowings (ECBs). Reserve Bank of India has recently allowed the limited two-way fungibility for the subscribers of these instruments. Indian stock exchanges have been permitted to set up trading terminals abroad. The trading platform of Indian exchanges can now be accessed through the Internet from anywhere in the world. In line with the global phenomena, Indian capital markets have also moved to rolling settlements on a T+2 basis where trades are settled on the second day after trading.

National Stock Exchange

The National Stock Exchange commenced its operations in 1994 as a first step in reforming the securities market through improved technology and introduction of best practices in management. It started with the concept of an independent governing body without any broker representation thus ensuring that the operators' interests were not allowed to dominate the governance of the exchange.

Before the NSE was set up, trading on the stock exchanges in India used to take place through open outcry without use of information technology for immediate matching or recording of trades. This was time consuming and inefficient. The practice of physical trading imposed limits on trading volumes as well as, the speed with which new information was incorporated into prices. To obviate this, the NSE introduced screen-based trading system (SBTS) where a member can punch into the computer the quantities of shares and the prices at which he wants to transact. The transaction is executed as soon as the quote punched by a trading member finds a matching sale or buys quote from counterparty. SBTS electronically matches the buyer and seller in an order-driven system or finds the customer the best price available in a quote-driven system, and hence cuts down on time, cost and risk of error as well as on the chances of fraud. SBTS enables distant participants to trade with each other, improving the liquidity of the markets. The high speed with which trades are executed and the large number of participants who can trade

simultaneously allows faster incorporation of price-sensitive information into prevailing prices. This increases the informational efficiency of markets. With SBTS, it becomes possible for market participants to see the full market, which helps to make the market more transparent, leading to increased investor confidence. The NSE started nation-wide SBTS, which have provided a completely transparent trading mechanism. Regional exchanges lost a lot of business to NSE, forcing them to introduce SBTS. Today, India can boast that almost 100% trading takes place through electronic order matching.

Prior to the setting up of NSE, trading on stock exchanges in India took place without the use of information technology for immediate matching or recording of trades. The practice of physical trading imposed limits on trading volumes as well as the speed with which the new information was incorporated into prices. The unscrupulous operators used this information asymmetry to manipulate the market. The information asymmetry helped brokers to perpetrate a manipulative practice known as "gala". Gala is a practice of extracting highest price of the day for "buy" transaction irrespective of the actual price at which the purchase was actually done and give lowest price of the day for "sell" transactions irrespective of the price at which sale was made. The clients did not have any method of verifying the actual price. The electronic and now fully online trading introduced by the NSE has made such manipulation difficult. It has also improved liquidity and made the entire operation more transparent and efficient.

The NSE has set up a clearing corporation to provide legal counterparty guarantee to each trade thereby eliminating counterparty risk. The National Securities Clearing Corporation Ltd. (NSCCL) commenced operations in April 1996. Counterparty risk is guaranteed through fine-tuned risk management systems and an innovative method of on-line position monitoring and automatic disablement. Principle of "novation" is implemented by NSE capital market segment. Under this principle, NSCCL is the counterparty for every transaction and, therefore, default risk is minimised. To support the assured settlement, a "settlement guarantee fund" has been created. A large settlement guarantee fund provides a cushion for any residual risk. As a consequence, despite the fact that the daily traded volumes on the NSE run into thousands of crores of rupees, credit risk no longer poses any problem in the marketplace.

Depository System

The erstwhile settlement system on Indian stock exchanges was also inefficient and increased risk, due to the time that elapsed before trades were settled. The transfer was by physical movement of papers. There had to be a physical delivery of securities -a process fraught with delays and resultant risks. The second aspect of the settlement relates to transfer of shares in favour of the purchaser by the company. The system of transfer of ownership was grossly

inefficient as every transfer involves physical movement of paper securities to the issuer for registration, with the change of ownership being evidenced by an endorsement on the security certificate. In many cases the process of transfer would take much longer than the two months stipulated in the Companies Act, and a significant proportion of transactions would end up as bad delivery due to faulty compliance of paper work. Theft, forgery, mutilation of certificates and other irregularities were rampant. In addition, the issuer has the right to refuse the transfer of a security. All this added to costs and delays in settlement, restricted liquidity and made investor grievance redressal time consuming and, at times, intractable.

To obviate these problems, the Depositories Act, 1996 was passed. It provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. It does 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. In order to streamline both the stages of settlement process, the Act envisages transfer ownership of securities electronically by book entry without making the securities move from person to person. The Act has made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with. Two depositories, viz., NSDL and CDSL, have come up to provide instantaneous electronic transfer of securities.

In any stock exchange, trades or transactions have to be settled by either squaring up the carrying forward positions or settling by payment of net cash or net delivery of securities. This account settlement period, if it is long leads to several price distortions and allows for market manipulation. It increases the chances of speculation resulting in volatility, which hurts the small investors. With the application of IT in the securities market - screen-based trading and trading through the Internet - it has been possible to reduce this settlement period.

Testing and Certification

A critical element of financial sector reforms is the development of a pool of human resources having the skills and expertise to provide quality intermediation services in each segment of the industry. In order to dispense quality intermediation, personnel working in the industry need to (a) follow certain code of conduct usually achieved through regulations and (b) possess requisite skills and knowledge generally acquired through a system of testing and certification. It is necessary that they have a proper understanding of the business and skills to help it remain competitive. Such testing and certification has assumed added significance in India as there is no formal education/training on financial markets, especially in the area of market operations which have undergone a complete transformation in the recent years. Taking into account

international experience and needs of the financial markets, NSE launched NCFM (NSE's Certification in Financial Markets). It tests practical knowledge and skills that are required to operate in financial markets, in a very secure and unbiased manner, and certifies personnel with a view to improve quality of intermediation. This has gained market acceptability, as there is a realisation that the financial markets are soon going to be the turf of certified professionals due to regulatory compulsions and/or initiatives of the industry. By imparting comprehensive knowledge and skill in the chosen field, NCFM enhances career opportunities for NCFM certified persons and allows market participants and intermediaries to build their own staff development strategies tailored to their specific needs.

Capital Market Intermediaries

There are several institutions, which facilitate the smooth functioning of the securities market. They enable the issuers of securities to interact with the investors in the primary as well as the secondary arena.

Merchant Bankers

Among the important financial intermediaries are the merchant bankers. The services of merchant bankers have been identified in India with just issue management. It is quite common to come across reference to merchant banking and financial services as though they are distinct categories. The services provided by merchant banks depend on their inclination and resources - technical and financial. Merchant bankers (Category I) are mandated by SEBI to manage public issues (as lead managers) and open offers in take-overs. These two activities have major implications for the integrity of the market. They affect investors' interest and, therefore, transparency has to be ensured. These are also areas where compliance can be monitored and enforced.

Merchant banks are rendering diverse services and functions. These include organising and extending finance for investment in projects, assistance in financial management, raising Euro-dollar loans and issue of foreign currency bonds. Different merchant bankers specialise in different services. However, since they are one of the major intermediaries between the issuers and the investors, their activities are regulated by:

- (1) SEBI (Merchant Bankers) Regulations, 1992.
- (2) Guidelines of SEBI and Ministry of Finance.
- (3) Companies Act, 1956.
- (4) Securities Contracts (Regulation) Act, 1956.

Merchant banking activities, especially those covering issue and underwriting of shares and debentures, are regulated by the Merchant Bankers Regulations of Securities and Exchange Board of India (SEBI). SEBI has made the quality of manpower as one of the criteria for renewal

of merchant banking registration. These skills should not be concentrated in issue management and underwriting alone. The criteria for authorisation takes into account several parameters. These include: (a) professional qualification in finance, law or business management, (b) infrastructure like adequate office space, equipment and manpower, (c) employment of two persons who have the experience to conduct the business of merchant bankers, (d) capital adequacy and (e) past track record, experience, general reputation and fairness in all their transactions.

SEBI authorises merchant bankers (Category I) for an initial period of three years, if they have a minimum net worth of Rs. 5 crore. An initial authorisation fee, an annual fee and renewal fee is collected by SEBI.

According to SEBI, all issues should be managed by at least one authorised merchant banker functioning as the sole manager or lead manager. The lead manager should not agree to manage any issue unless his responsibilities relating to the issue, mainly disclosures, allotment and refund, are clearly defined. A statement specifying such responsibilities has to be furnished to SEBI. SEBI prescribes the process of due diligence that a merchant banker has to complete before a prospectus is cleared. It also insists on submission of all the documents disclosing the details of account and the clearances obtained from the ROC and other government agencies for tapping peoples' savings. The responsibilities of lead manager, underwriting obligations, capital adequacy, due diligence certification, etc., are laid down in detail by SEBI. The objective is to facilitate the investors to take an informed decision regarding their investments and not expose them to unknown risks.

Credit Rating Agencies

The 1990s saw the emergence of a number of rating agencies in the Indian market. These agencies appraise the performance of issuers of debt instruments like bonds or fixed deposits. The rating of an instrument depends on parameters like business risk, market position, operating efficiency, adequacy of cash flows, financial risk, financial flexibility, and management and industry environment.

The objective and utility of this exercise is two-fold. From the point of view of the issuer, by assigning a particular grade to an instrument, the rating agencies enable the issuer to get the best price. Since all financial markets are based on the principle of risk/reward, the less risky the profile of the issuer of a debt security, the lower the price at which it can be issued. Thus, for the issuer, a favourable rating can reduce the cost of borrowed capital.

From the viewpoint of the investor, the grade assigned by the rating agencies depends on the capacity of the issuer to service the debt. It is based on the past performance as well as an analysis of the expected cash flows of a company, when viewed on the industry parameters and performance of the company. Hence, the investor can judge for himself whether he wants to place his savings in a "safe" instrument and get a lower return or he wants to take a risk and get a higher return.

The 1990s saw an increase in activity in the primary debt market. Under the SEBI guidelines all issuers of debt have to get the instruments rated. They also have to prominently display the ratings in all that marketing literature and advertisements. The rating agencies have thus become an important part of the institutional framework of the Indian securities market.

R&T Agents - Registrars to Issue

R&T Agents form an important link between the investors and issuers in the securities market. A company, whose securities are issued and traded in the market, is known as the Issuer. The R&T Agent is appointed by the Issuer to act on its behalf to service the investors in respect of all corporate actions like sending out notices and other communications to the investors as well as despatch of dividends and other non-cash benefits. R&T Agents perform an equally important role in the depository system as well. These are described in detail in the second section of this Workbook.

Stock Brokers

Stockbrokers are the intermediaries who are allowed to trade in securities on the exchange of which they are members. They buy and sell on their own behalf as well as on behalf of their clients. Traditionally in India, partnership firms with unlimited liabilities and individually owned firms provided brokerage services. There were, therefore, restrictions on the amount of funds they could raise by way of debt. With increasing volumes in trading as well as in the number of small investors, lack of adequate capitalisation of these firms exposed investors to the risks of these firms going bust and the investors would have no recourse to recovering their dues.

With the legal changes being effected in the membership rules of stock exchanges as well as in the capital gains structure for stock-broking firms, a number of brokerage firms have converted themselves into corporate entities. In fact, NSE encouraged the setting up of corporate broking members and has today only 10% of its members who are not corporate entities.

Custodians

In the earliest phase of capital market reforms, to get over the problems associated with paper-based securities, large holding by institutions and banks were sought to be immobilised.

Immobilisation of securities is done by storing or lodging the physical security certificates with an organisation that acts as a custodian - a securities depository. All subsequent transactions in such immobilised securities take place through book entries. The actual owners have the right to withdraw the physical securities from the custodial agent whenever required by them. In the case of IPO, a jumbo certificate is issued in the name of the beneficiary owners based on which the depository gives credit to the account of beneficiary owners. The Stock Holding Corporation of India Limited was set up to act as a custodian for securities of a large number of banks and institutions who were mainly in the public sector. Some of the banks and financial institutions also started providing "Custodial" services to smaller investors for a fee. With the introduction of dematerialisation of securities there has been a shift in the role and business operations of Custodians. But they still remain an important intermediary providing services to the investors who still hold securities in physical form.

Mutual Funds

Mutual funds are financial intermediaries, which collect the savings of small investors and invest them in a diversified portfolio of securities to minimise risk and maximise returns for their participants. Mutual funds have given a major fillip to the capital market - both primary as well as secondary. The units of mutual funds, in turn, are also tradable securities. Their price is determined by their net asset value (NAV) which is declared periodically.

The operations of the private mutual funds are regulated by SEBI with regard to their registration, operations, administration and issue as well as trading.

There are various types of mutual funds, depending on whether they are open ended or close ended and what their end use of funds is. An open-ended fund provides for easy liquidity and is a perennial fund, as its very name suggests. A closed-ended fund has a stipulated maturity period, generally five years. A growth fund has a higher percentage of its corpus invested in equity than in fixed income securities, hence the chances of capital appreciation (growth) are higher. In growth funds, the dividend accrued, if any, is reinvested in the fund for the capital appreciation of investments made by the investor. An Income fund on the other hand invests a larger portion of its corpus in fixed income securities in order to pay out a portion of its earnings to the investor at regular intervals. A balanced fund invests equally in fixed income and equity in order to earn a minimum return to the investors. Some mutual funds are limited to a particular industry; others invest exclusively in certain kinds of short-term instruments like money market or government securities. These are called money market funds or liquid funds. To prevent processes like dividend stripping or to ensure that the funds are available to the managers for a minimum period so that they can be deployed to at least cover the administrative costs of the

asset management company, mutual funds prescribe an entry load or an exit load for the investors. If investors want to withdraw their investments earlier than the stipulated period, an exit load is chargeable. To prevent profligacy, SEBI has prescribed the maximum that can be charged to the investors by the fund managers.

Depositories

The depositories are an important intermediaries in the securities market that is scrip-less or moving towards such a state. In India, the Depositories Act defines a depository to mean "a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (IA) of section 12 of the Securities and Exchange Board of India Act, 1992." The principal function of a depository is to dematerialise securities and enable their transactions in book-entry form.

Dematerialisation of securities occurs when securities issued in physical form are destroyed and an equivalent number of securities are credited into the beneficiary owner's account. In a depository system, the investors stand to gain by way of lower costs and lower risks of theft or forgery, etc. They also benefit in terms of efficiency of the process. But the implementation of the system has to be secure and well governed. All the players have to be conversant with the rules and regulations as well as with the technology for processing. The intermediaries in this system have to play strictly by the rules.

A depository established under the Depositories Act can provide any service connected with recording of allotment of securities or transfer of ownership of securities in the record of a depository. A depository cannot directly open accounts and provide services to clients. Any person willing to avail of the services of the depository can do so by entering into an agreement with the depository through any of its Depository Participants.

The services, functions, rights and obligations of depositories, with special reference to NSDL are provided in the second section of this Workbook.

Depository Participants

A Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act, 1996. In a strictly legal sense, a DP is an entity who is registered as such with SEBI under the provisions of the SEBI Act. As per the provisions of this Act, a DP can offer depository-related services only after obtaining a certificate of registration from SEBI.

SEBI (D&P) Regulations, 1996 prescribe a minimum net worth of Rs. 50 lakh for the applicants who are stockbrokers or non-banking finance companies (NBFCs), for granting a certificate of registration to act as a DP. For R & T Agents a minimum net worth of Rs. 10 crore is prescribed in addition to a grant of certificate of registration by SEBI. If a stockbroker seeks to act as a DP in more than one depository, he should comply with the specified net worth criterion separately for each such depository. If an NBFC seeks to act as a DP on behalf of any other person, it needs to have a network of Rs. 50 cr. in addition to the networth specified by any other authority. No minimum net worth criterion has been prescribed for other categories of DPs. However, depositories can fix a higher net worth criterion for their DPs. NSDL stipulates a minimum net worth of Rs. 300 Lakh to be eligible to become a DP as against Rs. 50 lakh prescribed by SEBI (D&P) Regulations, except for R & T agents and NBFCs, as mentioned above.

The role, functions, responsibilities and business operations of DPs are described in detail in the second section of this book.

Instruments

The changes in the regulatory framework of the capital market and fiscal policies have also resulted in newer kinds of financial instruments (securities) being introduced in the market. Also, a lot of financial innovation by companies who are now permitted to undertake treasury operations, has resulted in newer kinds of instruments - all of which can be traded - being introduced. The variations in all these instruments depend on the tenure, the nature of security, the interest rate, the collateral security offered and the trading features, etc.

Debentures

These are issued by companies and regulated under the SEBI guidelines of June 11, 1992. These are issued under a prospectus, which has to be approved by SEBI like in the case of equity issues. The rights of investors as debenture holders are governed by the Companies Act, which prohibits the issue of debentures with voting rights. There are a large variety of debentures that is available. This includes:

- Participating debentures
- Convertible debentures with options
- Third party convertible debentures
- Debt/equity swaps
- Zero coupon convertible notes
- Secured premium notes
- Zero interest fully convertible debentures

- Fully convertible debentures with interest
- Partly convertible debentures.

Bonds

Indian Development Financial Institutions (DFIs) in India, like IDBI, ICICI and IFCI have been raising capital for their operations by issuing bonds. These too are available in a large variety. These include:

- Income bonds
- Tax-free bonds
- Capital gains bonds
- Deep discount bonds
- Infrastructure bonds
- Retirement bonds

In addition to the interest rates and maturity profiles of these instruments, the issuer institutions have been including a put/call option on especially the very long-dated bonds like deep discount bonds. Since the tenures of some of these instruments spanned some 20 or 25 years during which the interest rate regimes may undergo a complete change, the issuers have kept the flexibility to retire the costly debt. This they do by exercising their option to redeem the securities at pre-determined periods like at the end of five or seven years. This has been witnessed in number of instruments recently much to the chagrin of investors who were looking for secure and hassle-free long-dated instruments.

Preference Shares

As the name suggests, owners of preference shares enjoy a preferential treatment with regard to corporate actions like dividend. They also have a higher right of repayment in case of winding up of a company. Preference shares have different features and are accordingly available as:

- Cumulative and non-cumulative
- Participating
- Cumulative & Redeemable fully convertible to preference shares
- Cumulative & Redeemable fully convertible to equity shares
- Preference shares with warrants
- Preference shares

Equity Shares

As the name indicates, these represent the proportionate ownership of the company. This right is expressed in the form of participation in the profits of the company. There has been some

innovation in the way these instruments are issued. Some hybrid securities like equity shares with detachable warrants are also available.

Government Securities

The Central Government or State Governments issue securities periodically for the purpose of raising loans from the public. There are two types of Government Securities - Dated Securities and Treasury Bills. Dated Securities have a maturity period of more than one year. Treasury Bills have a maturity period of less than or up to one year. The Public Debt Office (PDO) of the Reserve Bank of India performs all functions with regard to the issue management, settlement of trade, distribution of interest and redemption. Although only corporate and institutional investors subscribe to government securities, individual investors are also permitted to subscribe to these securities.

An investor in government securities has the option to have securities issued either in physical form or in book-entry form (commonly known as Subsidiary General Ledger [SGL] form). There are two types of SGL facilities, viz., SGL-1 and SGL-2. In the SGL-1 facility, the account is opened with the RBI directly. There are several restrictions on opening SGL-1 accounts and only entities, which fulfill all the eligibility criteria are permitted to open SGL-1 account. The RBI has permitted banks, registered primary dealers and certain other entities like NSCCL, SHCIL and NSDL to provide SGL facilities to subscribers. A subscriber to government securities who opts for SGL securities may open an SGL account with RBI or any other approved entity. Investments made by such approved entity on its own account are held in SGL-1 account and investments held on account of other clients are held in SGL-2 account.

Ware-house Receipts

NSDL has been approached by multi-commodity exchanges to provide depository facility for warehouse receipts. As legal status of warehouse receipts is different from that of securities, it is necessary for DPs to enter into a separate agreement with persons seeking to open a demat account for the purpose of holding and dealing in electronic warehouse receipts.

Capital Market Processes

There are various processes that Issuers of securities follow or utilise in order to tap the savers for raising resources. Some of the commonly used processes and methods are described below:

Initial Public Offering (IPO)

Companies, new as well as old, can offer their shares to the investors in the primary market. This kind of tapping the savings is called an IPO or Initial Public Offering. SEBI regulates the

way in which companies can make this offering. Companies can make an IPO if they meet SEBI guidelines in this regard. The size of the initial issue, the exchange on which it can be listed, the merchant bankers' responsibilities, the nature and content of the disclosures in the prospectus, procedures for all these are laid down by SEBI and have to be strictly complied with.

Exemption may be granted by SEBI in certain cases for minimum public offer or minimum subscription in the case of certain industry sectors like infrastructure or banking. Several changes have also been introduced in recent years in the manner in which the IPOs can be marketed. For example, they can now take the book building route or they can even be marketed through the secondary market by brokers or DPs. All these changes have been made with the objective of making the process more investor friendly by reducing risk, controlling cost, greater transparency in the pricing mechanism and protecting liquidity in the hands of the investor. Some of the IPOs have been available for subscription online - where the bids are made in real time and the information is made available on an instantaneous basis on the screen. It is possible to subscribe for IPO shares in demat form through DPs.

Private Placement

Many companies choose to raise capital for their operations through various intermediaries by taking what in marketing terms would be known as the wholesale route. This is called in financial markets as private placement. The retail route of approaching the public is expensive as well as time consuming. SEBI has prescribed the eligibility criteria for companies and instruments as well as procedures for private placement. However, liquidity for the initial investors in privately placed securities is ensured as they can be traded in the secondary market. But such securities have different rules for listing as well as for trading.

Preferential Offer/Rights Issue

Companies can expand their capital by offering the new shares to their existing shareholders. Such offers for sale can be made to the existing shareholders by giving them a preferential treatment in allocation or the offer can be on a rights basis, i.e., the existing holders can get by way of their right, allotment of new shares in certain proportion to their earlier holding. All such offers have also to be approved by SEBI which has laid out certain criteria for these routes of tapping the public. These have to be complied with.

Internet Broking

With the Internet becoming ubiquitous, many institutions have set up securities trading agencies that provide online trading facilities to their clients from their homes. This has been possible

since all the players in the securities market, viz., stockbrokers, stock exchanges, clearing corporations, depositories, DPs, clearing banks, etc., are linked electronically. Thus, information flows amongst them on a real time basis.

The trading platform, which was converted from the trading hall to the computer terminals at the brokers' premises, has now shifted to the homes of investors. This has introduced a higher degree of transparency in transactions. The investor knows exactly when and at what rate his order was processed. It also creates an end-to-end audit trail that makes market manipulation difficult. The availability of securities in demat form has given a further fillip to this process.

However, the emergence of what is known as "day-traders" has resulted in the business environment of brokers which has changed. Investors, who can now trade directly, no longer require their intermediation. Service charges have therefore been declining - all of which has been in favour of investors.

Internet Initiatives at NSDL

Securities Position Easy Electronic Dissemination-e (SPEED-e)

In order to extend the benefits of technological progress to investors, NSDL has launched SPEED-e services. SPEED-e is a internet based facility for clients of Depository Participants (DPs) that enables the accountholders to submit instructions to their DPs through SPEED-e website on internet. The clients can submit instructions at a time convenient to them from a place convenient to them using SPEED-e website of NSDL. The accountholders can also view the status of their instructions submitted through SPEED-e on the website itself. SPEED-e is expected to greatly reduce the time and efforts required in processing the instructions.

Submission of Instruction through Mobile Phone Login Easily (SIMPLE)

NSDL launched SIMPLE (Submission of Instruction through Mobile Phone Login Easily), a facility that will enable the password based users of SPEED-e facility to submit instructions on SPEED-e website through their mobile phones.

Salient features of SIMPLE are as follows:

- This facility will be available for password based users (hereinafter referred as Users) of SPEED-e facility.
- Users will be able to submit Client to Clearing Member Pool Account transfer instructions on SPEED-e website through their mobile phones.

- Mobile phones of the Users should be enabled with GPRS facility for accessing SPEED-e website.

Submission of Power of attorney based Instructions for Clients Electronically (SPICE)

NSDL has introduced of a facility for auto pay-in of securities named SPICE (Submission of Power of attorney based Instructions for Clients Electronically) using the infrastructure of SPEED-e and IDeAS. The details of the facility are given below:

This facility is in respect of demat accounts operated on the basis of Power of Attorney (POA). Many investors execute POA in favour of their stock brokers (i.e. Clearing Members). Based on the POA, Clearing Members (CMs) submit instructions (auto pay-in) to the Participants (where Clients maintain demat accounts) to debit the demat accounts of the Clients. SPICE would enable such CMs to submit digitally signed instructions to Participant through the SPEED-e facility thereby eliminating the need to give paper based delivery instructions to the Participants.

Internet-based Demat Account Statement (IDeAS)

NSDL launched its first Internet-based initiative, **SPEED** (Securities Position Easy Electronic Dissemination), in February 2000 now called **IDeAS** (Internet-based Demat Account Statement). This facility is available on SPEED-e website for viewing balances and transactions in demat accounts. It is available to the users of SPEED-e, Clearing Members who have subscribed to IDeAS and to those clients whose Participants are registered for IDeAS. The information (balances and transactions) is updated on an online basis with a delay of maximum 30 minutes.

Securities Trading Information Easy Access and Delivery (STEADY)

Using the infrastructure of **SPEED-e**, NSDL has developed its third Internet-based application, **STEADY** (Securities Trading Information Easy Access and Delivery), which is a means of transmission of trade information electronically across market participants.

STEADY will enable electronic communication between brokers, custodians and fund managers in respect of Custodian trades. In order to use the **STEADY** facility, brokers, custodians and fund managers will have to access **STEADY** website on Internet with smart card, bearing digital signature certificate issued by licensed Certifying Authority (CA), approved by NSDL. Further all batches and uploads from brokers / custodians / fund managers will be digitally signed by the respective users and will be accepted by **STEADY** only after successful verification of digital signature. Also all downloads obtained by brokers / custodians / fund managers will bear the digital signature of **STEADY** site.

CHAPTER 2

Overview of NSDL

Key features of the depository system in India:

Multi-Depository System: The depository model adopted in India provides for a competitive multi-depository system. There can be various entities providing depository services.

Dematerialisation as against immobilisation: The model adopted in India provides only for dematerialisation of securities. This is a significant step in the direction of achieving a completely paper-free securities market. Many of the developed countries have opted either for immobilisation (e.g. Hongkong) or both immobilisation and dematerialisation (e.g. Japan) of securities.

Immobilisation of securities is done by storing or lodging the physical security certificates with an organisation that acts as a custodian - a securities depository. All subsequent transactions in such immobilised securities take place through book entries. The actual owners have the right to withdraw the physical securities from the custodial agent whenever required by them. In the case of IPO, a jumbo certificate is issued in the name of the beneficiary owners based on which the depository gives credit to the account of beneficiary owners.

Dematerialisation of securities occurs when securities issued in physical form are destroyed and an equivalent number of securities are credited into the beneficiary owner's account. India has adopted dematerialisation route to depository. In a depository system, the investors stand to gain by way of efficient settlements, lower costs and lower risks of theft or forgery, etc. But the implementation of the system has to be secure and well governed. All the players have to be conversant with the rules and regulations as well as with the technology for processing. The intermediaries in this system have to play strictly by the rules.

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.

Fungibility - In the depository system, the securities dematerialised are not identified by distinctive numbers or certificate numbers as in the physical environment. Thus all securities in the same class are identical and interchangeable. For example, all equity shares in the class of fully paid up shares are interchangeable.

Registered Owner/ Beneficial Owner - In the depository system, the ownership of securities dematerialised is bifurcated between Registered Owner and Beneficial Owner. For the securities dematerialised, NSDL 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.

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

The Depository System

The Depositories Act, 1996, defines a depository to mean "a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (IA) of section 12 of the Securities and Exchange Board of India Act, 1992.

The principal function of a depository is to dematerialise securities and enable their transactions in book-entry form. The securities are transferred by debiting the transferor's depository account and crediting the transferee's depository account.

A depository is very much like a bank in many of its operations. We can draw an analogy between the two in order to get a better understanding of the depository system. (See Fig.1, 2)

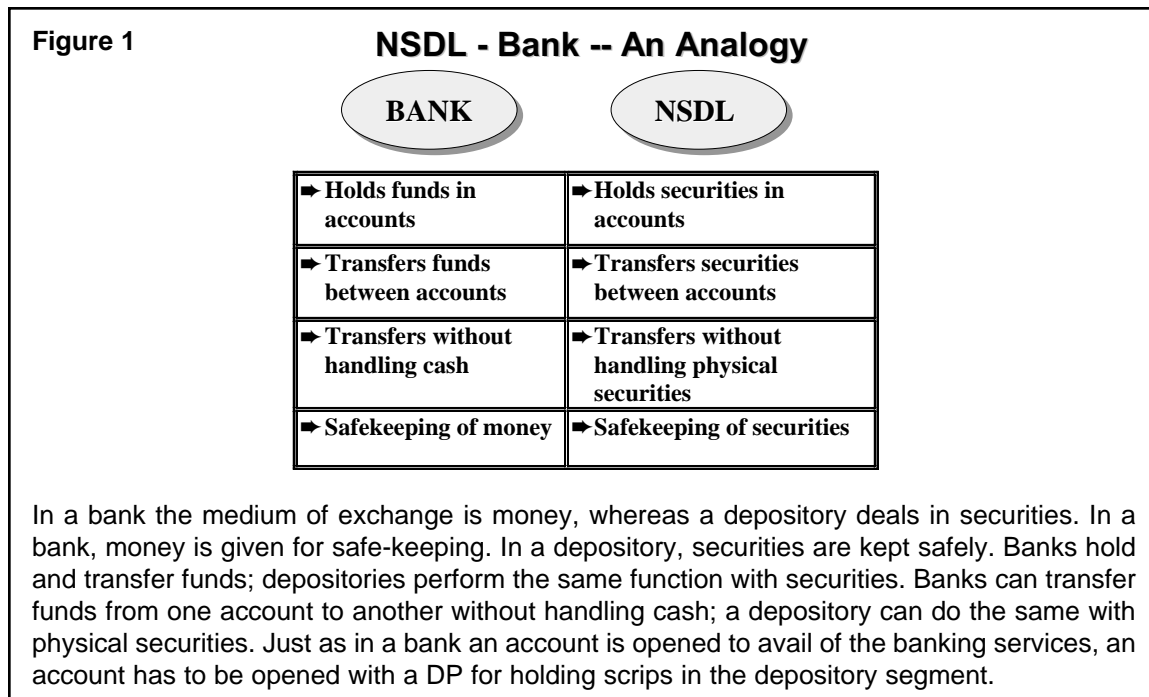


Figure 2

NSDL - Bank -- The Difference

| BANK | NSDL |
|---|--|
| ➤ Either of holders can sign instructions | ➤ All joint holders to sign instructions |
| ➤ Minimum balance to be maintained | ➤ No minimum balance required |
| ➤ Entitled for interest | ➤ Interest can be earned only by participating in Stock Lending Scheme |
| ➤ Uses balances in accounts | ➤ Does not move balances in account without account holder's authorisation |
| ➤ Nomination is kept confidential | ➤ Signature and photograph of nominee to be provided |

In case of transactions in a bank account, any one of the joint holders can sign the instructions (cheques), whereas in the depository, all joint holders are required to sign all the instructions. Minimum funds balance prescribed by the bank has to be maintained in the bank account; no minimum balance of securities is required to be maintained in a depository account. A bank uses the funds held in a bank account for lending purposes. The securities maintained in a depository account by an investor can be moved from the account only on basis of a proper authorisation from the account holder. A depository cannot use the client's security balances. Nomination is kept confidential in case of bank accounts. The photograph and signature of the nominee is required to be affixed on the nomination form for registering the nomination for a depository account.

Legal Framework

The operations of the depositories are primarily governed by the Depositories Act, 1996, Securities and Exchange Board of India (Depositories & Participants) Regulations, 1996, Bye-Laws approved by SEBI, and Business Rules framed in accordance with the Regulations and Bye-Laws.

The Depositories Act passed by Parliament received the President's assent on August 10, 1996. It was notified in a Gazette on August 12 of the same year. The Act enables the setting up of multiple depositories in the country. This was to see that there is competition in the service and there is more than one depository in operation. At present, two depositories are registered with SEBI - The National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL).

Only a company registered under the Companies Act, 1956 and sponsored by the specified category of institutions can set up a depository in India. Before commencing operations, depositories should obtain a certificate of registration and a certificate of commencement of business from SEBI.

The rights and obligations of depositories, depository participants, issuers and beneficial owners are spelt out clearly in the Depositories Act 1996.

As per the Act :

- Section 4: DP is an agent of the Depository: A DP is an agent of the depository, who provides various services of the depository to investors. The DP has to enter into an agreement with the depository to this effect. Any investor who would like to avail the services of a depository has to enter into an agreement with any DP of his choice. The DP will then make the depository services available to the investor.
- Section 7: Free Transferability : The securities held by an investor in the depository are freely transferable from one beneficial owner to another.
- Section 8: Option to hold securities in demat form : In the depository system, every investor subscribing to securities offered by an issuer has an option to receive the same in physical form or dematerialised form. If an investor opts for receiving the securities in dematerialised form, the issuer intimates the depository the details of allotment of security. On receipt of this information, the depository enters the name of the allottee as the beneficial owner of that security in its record.
- Section 9: Securities held in a depository are fungible : All securities held by the depository are in dematerialised and fungible form.
- Section 10: Registered Owner and Beneficial Owner : The depository is deemed to be the registered owner for the purpose of effecting transfer of ownership of security on behalf of a beneficial owner. But as a registered owner, it does not have any voting rights or any other rights in respect of those securities. The beneficial owner is entitled to all rights and benefits as well as subject to all liabilities in respect of his securities held in the depository.
- Section 14: Option to opt out of depository : A beneficial owner may opt out of a depository in respect of any security by requisite intimation to the depository.
- Section 16: Depository to indemnify losses : A depository shall indemnify a beneficial owner, any loss caused due to negligence of the depository or its participant.

Eligibility Criteria for a Depository – Any of the following may promote a depository:

1. A public financial Institution as defined in section 4A of the Companies Act, 1956;
2. A bank included in the Second Schedule to the Reserve Bank of India Act, 1934;
3. A foreign bank operating in India with the approval of the Reserve Bank of India;

4. A recognised stock exchange;
5. An institution engaged in providing financial services where not less than 75% of the equity is held jointly or severally by these institutions;
6. A custodian of securities approved by Government of India, and
7. A foreign financial services institution approved by Government of India.

The promoters of a depository are also known as its sponsors. A depository company must have a minimum net worth of Rs. 100 crore. The sponsor(s) of the depository have to hold at least 51% of the equity capital of the depository company. Participants of that depository, if any, can hold the balance of the equity capital. However, no single participant can hold, at any point of time, more than 5% of the equity capital. No foreign entity, individually or collectively either as a sponsor or as a DP, or as a sponsor and DP together, can hold more than 20% of the equity capital of the depository.

Registration – As per the provisions of the SEBI Act, a depository can deal in securities only after obtaining a certificate of registration from SEBI. The sponsors of the proposed depository should apply to SEBI for a certificate of registration in the prescribed form. On being satisfied with the eligibility parameters of a company to act as a depository, SEBI may grant a certificate of registration subject to certain conditions.

Commencement of Business – A depository that has obtained registration as stated above, can function only if it obtains a certificate of commencement of business from SEBI. A depository must apply for and obtain a certificate of commencement of business from SEBI within one year from the date of receiving the certificate of registration from SEBI.

SEBI grants a certificate of commencement of business if it is satisfied that the depository has adequate systems and safeguards to prevent manipulation of records and transactions. SEBI takes into account all matters relevant to the efficient and orderly functioning of the depository. It particularly examines whether :

1. The depository has a net worth of not less than Rs. 100 crore;
2. The Bye-Laws of the depository have been approved by SEBI;
3. The automatic data processing systems of the depository have been protected against unauthorised access, alteration, destruction, disclosure or dissemination of records and data;
4. The network, through which continuous electronic means of communication are established between the depository, participants, issuers and issuers' agents, is secure against unauthorised entry or access;

5. The depository has established standard transmission and encryption formats for electronic communication of data between the depository, participants, issuers and issuers' agents;
6. The physical or electronic access to the premises, facilities, automatic data processing systems, data storage sites and facilities including back-up sites, and to the electronic data communication network connecting the DPs, issuers and issuers' agents is controlled, monitored and recorded;
7. The depository has a detailed operational manual explaining all aspects of its functioning, including the interface and method of transmission of information between the depository, issuers, issuers' agents, DPs and beneficial owners;
8. The depository has established adequate procedures and facilities to ensure that its records are protected against loss or destruction and arrangements have been made for maintaining back-up facilities at a location different from that of the depository;
9. The depository has made adequate arrangements including insurance for indemnifying the beneficial owners for any loss that may be caused to such beneficial owners by the wrongful act, negligence or default of the depository or its participants or of any employee of the depository or participant; and
10. The granting of certificate of commencement of business is in the interest of investors in securities market.

Agreement between Depository and Issuers – If either the issuer (a company which has issued securities) or the investor opts to hold his securities in a demat form, the issuer enters into an agreement with the depository to enable the investors to dematerialise their securities.

No such agreement is necessary where :

- i. Depository, is the issuer of securities, or;
- ii. The State or Central Government is the issuer of government securities.

Where the issuer has appointed a registrar to the issue or share transfer, the depository enters into a tripartite agreement with the Issuer and Registrar & Transfer (R&T) Agent, as the case may be, for the securities declared eligible for dematerialisation. At present, NSDL is discharging the responsibility of R&T Agent for the securities issued by State and Central Governments.

Rights and Obligations of Depositories – Depositories have the rights and obligations conferred upon them under the Depositories Act, the regulations made under the Depositories Act, Bye-Laws approved by SEBI, and the agreements made with the participants, issuers and their R&T agents.

Every depository must have adequate mechanisms for reviewing, monitoring and evaluating the depository's controls, systems, procedures and safeguards. It should conduct an annual inspection of these procedures and forward a copy of the inspection report to SEBI. The depository is also required to ensure that the integrity of the automatic data processing systems is maintained at all times and take all precautions necessary to ensure that the records are not lost, destroyed or tampered with. In the event of loss or destruction, sufficient back up of records should be available at a different place. Adequate measures should be taken, including insurance, to protect the interests of the beneficial owners against any risks.

Every depository is required to extend all such co-operation to the beneficial owners, issuers, issuers' agents, custodians of securities, other depositories and clearing organisations, as is necessary for the effective, prompt and accurate clearance and settlement of securities transactions and conduct of business.

The depository should indemnify beneficial owners of securities for any loss caused to them due to the negligence of the DP. However, where the loss is caused due to the negligence of a DP, the depository shall have the right to recover it from such DPs.

Bye-Laws – A depository is required to make Bye-Laws governing its operations. The Bye-Laws have to be in conformity with the Depositories Act and the regulations made thereunder, and need to be approved by SEBI before becoming effective.

Records to be maintained by Depository – Every depository is required to maintain the following records and documents. These have to be preserved for a minimum period of five years.

1. Records of securities dematerialised and rematerialised.
2. The names of the transferor, transferee, and the dates of transfer of securities.
3. A register and an index of beneficial owners.
4. Details of the holdings of the securities of beneficial owners as at the end of each day.
5. Records of instructions received from, and sent to, participants, issuers, issuers' agents and beneficial owners.
6. Records of approval, notice, entry and cancellation of pledge or hypothecation.
7. Details of participants.
8. Details of securities declared to be eligible for dematerialisation in the depository.
9. Such other records as may be specified by SEBI for carrying on the activities as a depository.

Services of Depository – A depository established under the Depositories Act can provide any service connected with recording of allotment of securities or transfer of ownership of securities in the record of a depository. Any person willing to avail the services of the depository can do so by entering into an agreement with the depository through any of its participants. A depository can provide depository services only through a DP. A depository cannot directly open accounts and provide services to clients. Every depository in its Bye-Laws must state which securities are eligible for demat holding. Generally, the following securities are eligible for dematerialisation:

- (a) Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate.
- (b) Units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificates of deposit, securitised debt, money market instruments, government securities, and unlisted securities.
- (c) Securities admitted to NSDL depository are notified to all DPs through circulars sent by email. Investors are informed about these securities through NSDL's Website - www.nsdl.co.in and NSDL Update - a monthly newsletter of NSDL.

Functions of Depository

Dematerialisation: One of the primary functions of depository is to eliminate or minimise the movement of physical securities in the market. This is achieved through dematerialisation of securities. Dematerialisation is the process of converting securities held in physical form into holdings in book entry form.

Account Transfer: The depository gives effects to all transfers resulting from the settlement of trades and other transactions between various beneficial owners by recording entries in the accounts of such beneficial owners.

Transfer and Registration: A transfer is the legal change of ownership of a security in the records of the issuer. For effecting a transfer, certain legal steps have to be taken like endorsement, execution of a transfer instrument and payment of stamp duty. The depository accelerates the transfer process by registering the ownership of shares in the name of the depository. Under a depository system, transfer of security occurs merely by passing book entries in the records of the depositories, on the instructions of the beneficial owners.

Corporate Actions: A depository may handle corporate actions in two ways. In the first case, it merely provides information to the issuer about the persons entitled to receive corporate

benefits. In the other case, depository itself takes the responsibility of distribution of corporate benefits.

Pledge and Hypothecation: The securities held with NSDL may be used as collateral to secure loans and other credits by the clients. In a manual environment, borrowers are required to deliver pledged securities in physical form to the lender or its custodian. These securities are verified for authenticity and often need to be transferred in the name of lender. This has a time and money cost by way of transfer fees or stamp duty. If the borrower wants to substitute the pledged securities, these steps have to be repeated. Use of depository services for pledging/hypothecating the securities makes the process very simple and cost effective. The securities pledged/hypothecated are transferred to a segregated or collateral account through book entries in the records of the depository.

Linkages with Clearing System: Whether it is a separate clearing corporation attached to a stock exchange or a clearing house (department) of a stock exchange, the clearing system performs the functions of ascertaining the pay-in (sell) or pay-out (buy) of brokers who have traded on the stock exchange. Actual delivery of securities to the clearing system from the selling brokers and delivery of securities from the clearing system to the buying broker is done by the depository. To achieve this, depositories and the clearing system should be electronically linked.

Having understood the depository system, let us now look at the organisation and functions of National Securities Depository Limited (NSDL).

National Securities Depository Limited

National Securities Depository Limited is the first depository to be set-up in India. It was incorporated on December 12, 1995. The Industrial Development Bank of India (IDBI) - the largest development bank in India, Unit Trust of India (UTI) - the largest Indian mutual fund and the National Stock Exchange (NSE) - the largest stock exchange in India, sponsored the setting up of NSDL and subscribed to the initial capital. NSDL commenced operations on November 8, 1996.

Ownership

NSDL is a public limited company incorporated under the Companies Act, 1956. NSDL had a paid-up equity capital of Rs. 105 crore. The paid up capital has been reduced to Rs. 80 crore since NSDL has bought back its shares of the face value of Rs. 25 crore in the year 2000. However, its net worth is above the Rs. 100 crore, as required by SEBI regulations.

The following organisations are shareholders of NSDL as on December 31, 2009:

1. Industrial Development Bank of India
2. Unit Trust of India
3. National Stock Exchange of India Limited
4. State Bank of India
5. Oriental Bank of Commerce
6. Citibank N.A.
7. Standard Chartered Bank
8. HDFC Bank Limited
9. The Hongkong and Shanghai Banking Corporation Limited
10. Deutsche Bank A.G.
11. Dena Bank
12. Canara Bank
13. Union Bank of India

Management of NSDL

NSDL is a public limited company managed by a professional Board of Directors. The day-to-day operations are conducted by the Managing Director and CEO. To assist the MD and CEO in his functions, the Board appoints an Executive Committee (EC) of not more than 15 members. The eligibility criteria and period of nomination, etc. are governed by the Bye-Laws of NSDL in this regard.

Bye-Laws of NSDL ¹

Bye-Laws of National Securities Depository Limited have been framed under powers conferred under section 26 of the Depositories Act, 1996 and approved by Securities and Exchange Board of India. The Bye-Laws contain fourteen chapters and pertain to the areas listed below :

1. Short title and commencement
2. Definitions
3. Board of Directors
4. Executive Committee
5. Business Rules
6. Participants

¹ The complete text of the bye-laws is available on the NSDL Website - www.nsd.co.in.

7. Safeguards to protect interest of clients and participants
8. Securities
9. Accounts/transactions by book entry
10. Reconciliation, accounts and audit
11. Disciplinary action
12. Appeals
13. Conciliation
14. Arbitration

Amendments to NSDL Bye-Laws require the approval of the Board of Directors of NSDL and SEBI.

Business Rules of NSDL

Amendments to NSDL Business Rules require the approval of NSDL Executive Committee and filing of the same with SEBI at least a day before the effective date for the amendments.

Functions

NSDL performs the following functions through depository participants :

- ❖ Enables the surrender and withdrawal of securities to and from the depository (dematerialisation and rematerialisation).
- ❖ Maintains investor holdings in the electronic form.
- ❖ Effects settlement of securities traded on the exchanges.
- ❖ Carries out settlement of trades not done on the stock exchange (off-market trades).
- ❖ Transfer of securities.
- ❖ Pledging/hypothecation of dematerialised securities.
- ❖ Electronic credit in public offerings of companies or corporate actions.
- ❖ Receipt of non-cash corporate benefits like bonus rights, etc. in electronic form.

Services Offered by NSDL

NSDL offers a host of services to the investors through its network of DPs:

- ❖ Maintenance of beneficiary holdings through DPs
- ❖ Dematerialisation
- ❖ Off-market Trades
- ❖ Settlement in dematerialised securities

- ❖ Receipt of allotment in the dematerialised form
- ❖ Distribution of corporate benefits
- ❖ Rematerialisation
- ❖ Pledging and hypothecation facilities
- ❖ Freezing/locking of investor's account

Fee Structure of NSDL

NSDL charges the DPs and not the investors directly. These charges are fixed. The DPs in turn, are free to charge their clients, i.e., the investors for their services. Thus, there is a two-tier fee structure.

Inspection, Accounting and Internal Audit

NSDL obtains audited financial reports from all its DPs once every year. NSDL also carries out periodic visits to the offices of its constituents - R&T agents, DPs and clearing corporations - to review the operating procedures, systems maintenance and compliance with the Bye-Laws, Business Rules and SEBI Regulations.

Additionally, DPs are required to submit to NSDL, internal audit reports every quarter. Internal audit has to be conducted by a chartered accountant or a company secretary in practice.

The Board of Directors appoints a Disciplinary Action Committee (DAC) to deal with any matter relating to DPs clients, Issuers and R&T agents. The DAC is empowered to suspend or expel a DP, declare a security as ineligible on the NSDL system, freeze a DP account and conduct inspection or call for records and issue notices.

If a DP is aggrieved by the action of the DAC, it has the right to appeal to the EC against the action of the DAC. This has to be done within 30 days of the action by DAC. The EC has to hear the appeal within two months from the date of filing the appeal. The EC has the power to stay the operation of the orders passed by the DAC. The information on all such actions has to be furnished to SEBI.

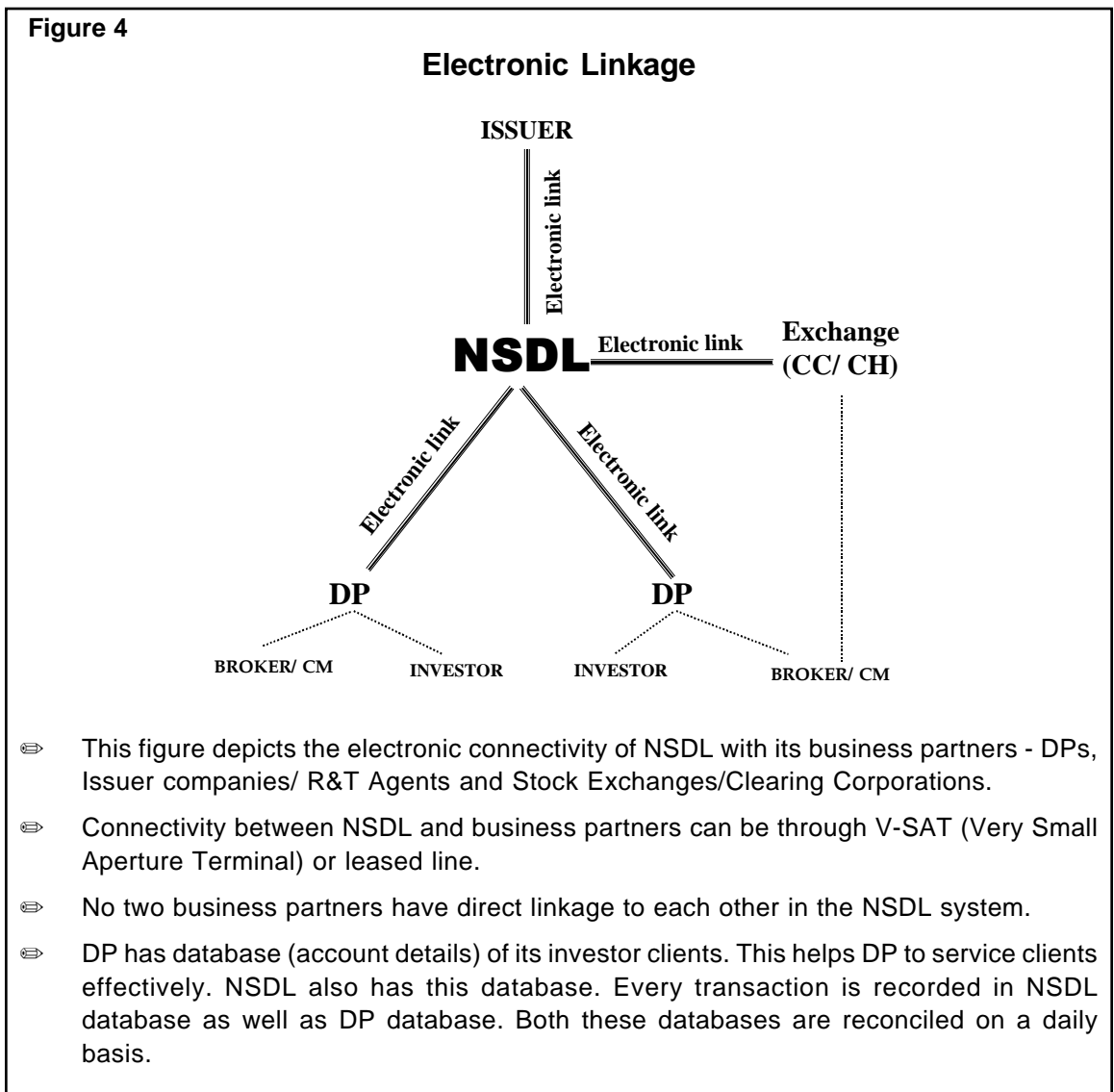
Settlement of Disputes

All disputes, differences and claims arising out of any dealings on the NSDL, irrespective of whether NSDL is a party to it or not, have to be settled under the Arbitration and Conciliation Act 1996.

Technology and Connectivity

System View of NSDL Depository System

Figure 4 depicts a system view of the NSDL depository system.



Account holders (investors) open account with the DPs. The account details, entered in a computer system maintained by Depository Participants called DPM, are electronically conveyed to the central system of NSDL called DM. Companies who have agreed to offer demat facility to

their shareholders use a computer system called DPM (SHR) to connect to the NSDL central system. DPM (SHR) may be installed by the company itself or through its R&T Agent. This system is used to electronically receive demat requests, confirm such requests or to receive beneficial owner data (Benpos) from the depository.

Stock exchanges receive pay-in (receiving securities against sales made by brokers) or to pay-out (giving securities to brokers against their purchases) using a computer system connected to NSDL called DPM (CC).

All the computer systems installed by DPs (DPM-DP), companies (DPM-SHRs), and stock exchanges (DPM-CC) are connected to NSDL central system (DM) through V-SAT (very small aperture terminal) or leased lines. These are collectively called Business Partner Systems. Any transaction conducted by any computer system in the NSDL depository system which is targeted to reach any other computer system first gets recorded in DM and then will reach the target. No two business partners' systems can communicate to each other without passing through the DM.

Maintenance of Accounts at the Central System

The NSDL central system known as DM maintains accounts of all account holders in the depository system. All the transactions entered at any point in the computer system connected to it are first effected in the central system and subsequently at these computers. Thus, the central system of NSDL has the records of all details of every transaction conducted in the depository system.

Distributed Database

Each of the computer systems connected to NSDL system has its own database relating to its clients. This helps in giving prompt and accurate service to the clients. However each of the databases is reconciled with the data at the central system everyday in order to ensure that the data in the distributed database tallies with the central database.

Common Software

NSDL develops software required by depository participants, companies, R&T Agents and clearing corporations for conducting depository operations. Thus, the computer systems used by all the entities will have common software given by NSDL. However, depending on the business potential, branch networks and any other specific features, DPs may develop software

of their own for co-ordination, communication and control and provide service to their clients. Such exclusive software is called "back office software". DPM system given by NSDL gives "export and import" facility to take out the transaction details to be used by back office software and to feed in transaction details generated from the back office software.

Connectivity

The computer system used by DPs, companies, R&T Agents and stock exchanges may be connected to NSDL central system through V-SAT network or leased line network or Multi Protocol Label Switching (MPLS) technology.

V-SAT or leased line or MPLS connections are called primary connectivity. If primary connectivity fails for any reason, BPs must have the ability to connect through other means. Such other means are PSTN lines, ISDN lines, POP lines(normal telephone lines) through which they can dial in to the NSDL system and conduct their transactions.

Figure 3

NSDL KEY MILESTONES

| | | |
|---|----------------|---|
| ⇒ | Sept 1995 | : Drafting of the Depositories Ordinance |
| ⇒ | Dec 1995 | : NSDL Incorporation |
| ⇒ | August 1996 | : Depositories Act |
| ⇒ | Nov 1996 | : NSDL Inauguration |
| ⇒ | Dec 1996 | : Commencement of Demat trading at NSE |
| ⇒ | June 1997 | : Total value of demat securities at NSDL crosses US\$ 1 bn. |
| ⇒ | Dec 1997 | : Commencement of Demat trading at BSE |
| ⇒ | Jan 1998 | : Compulsory demat trading for Institutional investors |
| ⇒ | March 1998 | : Total value of demat securities at NSDL crosses US\$ 5 bn. |
| ⇒ | April 1998 | : Demat delivery in physical segment at NSE and BSE |
| ⇒ | Nov 1998 | : Investor accounts with NSDL crosses 100,000 |
| ⇒ | Dec 1998 | : Introduction of Demat of Government Securities |
| ⇒ | Jan 1999 | : Commencement of compulsory trading for retail investors |
| ⇒ | May 1999 | : NSDL launches NCFM - Depository Operations Module |
| ⇒ | Feb 2000 | : NSDL launches internet based service - SPEED - for CMs |
| ⇒ | May 2000 | : Investor accounts with NSDL crosses 2.5 million |
| ⇒ | June 2000 | : Commencement of Demat of Debt Instruments |
| ⇒ | June 2000 | : 98% settlement in demat form |
| ⇒ | July 2001 | : Introduction of T+5 Rolling Settlement and Uniform Settlement Cycle |
| ⇒ | Sep 2001 | : NSDL launches SPEED-e |
| ⇒ | April 2002 | : Introduction of T+3 Rolling Settlement |
| ⇒ | Nov 2002 | : Launch of STEADY - An STP initiative by NSDL |
| ⇒ | Dec 2002 | : Investor Accounts crosses 5 million |
| ⇒ | April 2003 | : Introduction of T+2 Rolling Settlement |
| ⇒ | Oct 2003 | : Investor Accounts crosses 6 million |
| ⇒ | Oct 2003 | : Demat of NSC / KVP |
| ⇒ | Nov 2003 | : Launch of Market Participants and Investors Database (MAPIN) |
| ⇒ | Nov 2003 | : Introduction of demat of Warehouse Receipts |
| ⇒ | Jan 2004 | : Launch of IDeAS |
| ⇒ | June 2004 | : Launch of Tax Information Network (TIN) |
| ⇒ | September 2007 | : Launch of SMS Alert Facility for Investors |
| ⇒ | August 2009 | : Investor accounts with NSDL crosses 1 Crore |
| ⇒ | October 2009 | : Launch of Submission of Instruction through Mobile Phone Login Easily (SIMPLE) |
| ⇒ | December 2009 | : Launch of Submission of Power of attorney based Instructions for Clients Electronically (SPICE) |

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Salient points of the NSDL-Depository Operations Module

1. The test is of 75 minutes duration.
2. The total marks for the examination are 100.
3. Each participant should secure a minimum of 60% of the marks to be eligible to receive the certificate in NSDL - Depository Operations Module.
4. Thus a participant should secure a minimum of 60 marks out of total 100 to pass the test.
5. A participant should secure a minimum of 80% of the marks to be a certified trainer.
6. Thus a participant should secure a minimum of 80 marks out of total 100 to be certified as a trainer.

LIST OF TEST CENTRES TO APPEAR FOR NCFM EXAMINATION

| Sr. No. | Test Centre | Contact details |
|---------|--|---|
| 1 | National Stock Exchange of India Ltd. United India Building, 2nd Floor Near Kashmir Emporium Opp. Apna Bazaar, Sir Phirozeshah Mehta Road Fort, Mumbai-400001 (Landmark - Above Indian Bank) | National Stock Exchange of India Ltd. Exchange Plaza, Bandra-Kurla Complex Bandra (East), Mumbai 400051 Tel : (022) 26598252 / 8216 Tel : (022) 26598171 / 72 Tel : (022) 26598100 - 114 Fax : (022) 26598393 |
| 2 | National Stock Exchange of India Ltd. 4th Floor, Jeevan Vihar Building Parliament Street, New Delhi-110001 (Landmark - Near Patel Chowk, Metro Station) | Tel : 011-23344313-27 Fax : 011-23366658 Email : ncfm_delhi@nse.co.in |
| 3 | National Stock Exchange of India Ltd. 1st Floor, Park View Apartments 99, Rash Behari Avenue Kolkata – 700 029 (Landmark - Deshpriya Park, Near Priya Cinema, Above GKB Opticals) | Tel : (033) 24631802/40 400 400 Fax : (033) 40400440 Email : ncfm_kolkata@nse.co.in |
| 4 | National Stock Exchange of India Ltd. 2nd Floor, Ispahani Centre, Door No 123-124, Nungambakkam High Road, Nungambakkam, Chennai - 600 034 (Landmark - Next to Income Tax Office / CA Institute) | Tel : (044) 28332500/01 Fax : (044) 28332521 Email : ncfm_chennai@nse.co.in |
| 5 | National Stock Exchange of India Ltd. H No.3-6-322 Mahavir House, IInd Floor Chamber no.203 & 204 Basheerbagh, Hyderabad : 500029 (Landmark - Near Police Commissioner's Office, Basheerbagh Square) | Tel : 040-23227084/5 Fax : 040-23227086 Email : ncfm_hyderabad@nse.co.in |
| 6 | National Stock Exchange of India Ltd. 406 Sakar II, Near Ellis Bridge Ahmedabad – 380 006 (Landmark - Opp. Town Hall, Near Ellisbridge) | Tel : 079-26580212 - 13 Fax : 079-26576123 Email : ncfm_ahmedabad@nse.co.in |
| 7 | Any other centre (depending on demand) | |

Additional information on the NCFM programme can also be obtained at NSE's web-site: www.nse-india.com or by e-mailing at ncfm@nse.co.in.