

SECURITIES LAWS AND COMPLIANCES

PART A — SECURITIES LAWS

STUDY XIII - DEPOSITORIES

LEARNING OBJECTIVES

The study will enable the students to understand

- The Concept and Overview of Depository System
- Legal framework for depository system in India
- Provisions of Depositories Act, 1996
- Overview of SEBI(Depositories and Participants) Regulations, 1996
- Internal Audit of Depository Participants
- Audit by a Practising Company Secretary under SEBI(Depositories and Participants) Regulations, 1996

INTRODUCTION

The advent of online automated trading in India brought with it several associated benefits such as transparency in trading and equal opportunity for market players all over the country but the problems related to settlement of trades such as high instances of bad deliveries and long settlement cycles continued. As an answer to these settlement problems and in order to provide a safe and efficient system of trading and settlement, Depositories Act, 1996 was enacted. SEBI notified Regulations in order to provide the regulatory framework for the depositories. Depositories gave a new dimension and a new scope for conducting transactions in capital market-primary as well as secondary, in a more efficient and effective manner, in a paperless form on an electronic book entry basis. It provided electronic solution to the aforementioned problems of bad deliveries and long settlement cycles.

I. DEPOSITORY

A Depository is an organisation like a Central Bank where the securities of a shareholder are held in the electronic form at the request of the shareholder through the medium of a Depository Participant. To utilise the services offered by a Depository, the investor has to open an account with the Depository through a Depository Participant. According to Section 2(e) of the Depositories Act, 1996,

“Depository means a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under Section 12(1A) of the Securities and Exchange Board of India Act, 1992”.

As per Section 2(10) of the Companies Act, 1956, a company means a company as defined in Section 3 of the Act. According to Section 3 company means a company formed and registered under the Companies Act, 1956. A depository cannot act as a depository unless it obtains a certificate of commencement of business from SEBI.

There are two Depositories functioning in India, namely the National Securities Depository Limited (NSDL) and the Central Depository Services (India) Limited (CDS). Under the provisions of the Depositories Act, these Depositories provide various services to investors and other Participants in

the capital market, such as, clearing members, stock exchanges, investment institutions, banks and issuing corporates. These include basic facilities like account opening, dematerialisation, rematerialisation, settlement of trades and advanced facilities like pledging, distribution of non-cash corporate actions, distribution of securities to allottees in case of public issues, etc. All the securities held by a depository shall be dematerialized and shall be in a fungible form. To utilize the services offered by a depository, the investor has to open an account with the depository through a participant, similar to the opening of an account with any of the bank branches to utilize services of that bank. Registration of the depository is required under SEBI (Depositories and Participants) Regulations, 1996 and is a precondition to the functioning of the depository. Depository and depository participant both are regulated by Securities and Exchange Board of India.

Difference between depository and custodian

Both depository and custodial services are responsible for safe keeping of securities but they are different in the sense that the Depository can legally transfer beneficial ownership, which a custodian cannot. The main objective of a Depository is to minimize the paper work involved with the ownership, trading and transfer of securities.

Benefits of depository system

In the depository system, the ownership and transfer of securities takes place by means of electronic book entries. At the outset, this system rids the capital market of the dangers related to handling of paper. The system provides numerous direct and indirect benefits, like:

Elimination of bad deliveries - In the depository environment, once holdings of an investor are dematerialised, the question of bad delivery does not arise i.e. they cannot be held "under objection". In the physical environment, buyer of shares was required to take the risk of transfer and face uncertainty of the quality of assets purchased. In a depository environment good money certainly begets good quality of assets

Elimination of all risks associated with physical certificates - Dealing in physical securities have associated security risks of theft of stocks, mutilation of certificates, loss of certificates during movements through and from the registrars, thus exposing the investor to the cost of obtaining duplicate certificates and advertisements, etc. This problem does not arise in the depository environment.

Immediate transfer and registration of securities - In the depository environment, once the securities are credited to the investors account on pay out, he becomes the legal owner of the securities. There is no further need to send it to the company's registrar for registration. Having purchased securities in the physical environment, the investor has to send it to the company's registrar so that the change of ownership can be registered. This process usually takes around three to four months and is rarely completed within the statutory framework of two months thus exposing the investor to opportunity cost of delay in transfer and to risk of loss in transit. To overcome this, the normally accepted practice is to hold the securities in street names i.e. not to register the change of ownership. However, if the investors miss a book closure the securities are not good for delivery and the investor would

also stand to lose his corporate entitlements.

Faster disbursement of non cash corporate benefits like rights, bonus, etc. – Depository system provides for direct credit of non cash corporate entitlements to an investor's account, thereby ensuring faster disbursement and avoiding risk of loss of certificates in transit.

Reduction in brokerage by many brokers for trading in dematerialised securities - Brokers provide this benefit to investors as dealing in dematerialised securities reduces their back office cost of handling paper and also eliminates the risk of being the introducing broker.

Reduction in handling of huge volumes of paper and periodic status reports to investors on their holdings and transactions, leading to better controls.

Elimination of problems related to change of address of investor, transmission, etc. - In case of change of address or transmission of demat shares, investors are saved from undergoing the entire change procedure with each company or registrar. Investors have to only inform their DP with all relevant documents and the required changes are effected in the database of all the companies, where the investor is a registered holder of securities.

Elimination of problems related to selling securities on behalf of a minor - A natural guardian is not required to take court approval for selling demat securities on behalf of a minor.

II. DEPOSITORY SYSTEM - AN OVERVIEW

The Depository System functions very much like the banking system. A bank holds funds in accounts whereas a Depository holds securities in accounts for its clients. A Bank transfers funds between accounts whereas a Depository transfers securities between accounts. In both systems, the transfer of funds or securities happens without the actual handling of funds or securities. Both the Banks and the Depository are accountable for the safe keeping of funds and securities respectively.

In the depository system, share certificates belonging to the investors are to be dematerialised and their names are required to be entered in the records of depository as beneficial owners. Consequent to these changes, the investors' names in the companies' register are replaced by the name of depository as the registered owner of the securities. The depository, however, does not have any voting rights or other economic rights in respect of the shares as a registered owner. The beneficial owner continues to enjoy all the rights and benefits and is subject to all the liabilities in respect of the securities held by a depository. Shares in the depository mode are fungible and cease to have distinctive numbers. The transfer of ownership changes in the depository is done automatically on the basis of delivery v. payment. In the Depository mode, corporate actions such as IPOs, rights, conversions, bonus, mergers/amalgamations, subdivisions & consolidations are carried out without the movement of papers, saving both cost & time. Information of beneficiary owners is readily available. The issuer gets information on changes in shareholding pattern on a regular basis, which enables the issuer to efficiently monitor the changes in shareholdings.

The Depository system links the issuing corporates, Depository Participants (DPs), the Depositories and clearing corporation/ clearing house of stock

exchanges. This network facilitates holding of securities in the soft form and effects transfers by means of account transfers.

Following presentation about depositories reveal all about depositories, its concepts and trading, i.e. models of depositories, Depository functions, Legal linkage, depository participant, Registrars and issuers, dematerialisation, rematerialisation, electronic credit in new issues, trading system, corporate action—

Models of Depository

— *Immobilisation* – Where physical share certificates are kept in vaults with the depository for safe custody. All subsequent transactions in these securities take place in book entry form. The actual owner has the right to withdraw his physical securities as and when desired. The immobilization of fresh issue may be achieved by issuing a jumbo certificate representing the entire issue in the name of depository, as nominee of the beneficial owners.

— *Dematerialisation* – No Physical scrip in existence, only electronic records maintained by depository. This type of system is cost effective and simple and has been adopted in India.

Dematerialisation

Dematerialisation is a process by which the physical share certificates of an investor are taken back by the Company and an equivalent number of securities are credited his account in electronic form at the request of the investor. An investor will have to first open an account with a Depository Participant and then request for the dematerialisation of his share certificates through the Depository Participant so that the dematerialised holdings can be credited into that account. This is very similar to opening a Bank Account. Dematerialisation of shares is optional and an investor can still hold shares in physical form. However, he/she has to demat the shares if he/she wishes to sell the same through the Stock Exchanges. Similarly, if an investor purchases shares from the Stock Exchange, he/she will get delivery of the shares in demat form.

Depository Functions

- Account opening
- Dematerialisation
- Rematerialisation
- Settlement
- Initial Public Offers (IPO's) corporate benefits
- Pledging

Legal linkage

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Depository Participant

Just as a brokers act an agent of the investor at the Stock Exchange; a Depository Participant (DP) is the representative (agent) of the investor in the depository system providing the link between the Company and investor through the Depository. The Depository Participant maintains securities account balances and intimate the status of holding to the account holder from time to time. According to SEBI guidelines, Financial Institutions like banks, custodians, stockbrokers etc. can become participants in the

depository. A DP is one with whom an investor needs to open an account to deal in shares in electronic form. While the Depository can be compared to a Bank, DP is like a branch of that bank with which an account can be opened. The main characteristics of a depository participant are as under:

- Acts as an Agent of Depository
- Customer interface of Depository
- Functions like Securities Bank
- Account opening
- Facilitates dematerialisation
- Instant transfer on pay-out
- Credits to investor in IPO, rights, bonus
- Settles trades in electronic segment

Registrar/Issuer

- Dematerialisation
- Confirmation of Beneficiary Holdings
- Corporate Actions – Rights, Bonus, etc.
- Reconciliation of Depository Holdings
- Rematerialisation

Dematerialisation

- Investor opens account with DP
- Fills Dematerialisation Request Form (DRF) for registered shares
- Investor lodges DRF and certificates with DP
- DP intimates the Depository
- Depository intimates Registrar/Issuer
- DP sends certificates and DRF to Registrar/Issuer
- Registrar/Issuer confirms demat to Depository
- Depository credits investor a/c

Rematerialisation

- Client submits Rematerialisation Request Form (RRF) to DP
- DP intimates Depository
- Depository intimates the Registrar/Issuer
- DP sends RRF to the Registrar/Issuer
- Registrar/Issuer prints certificates and sends to Investor
- Registrar/Issuer confirms remat to Depository
- Investor's account with DP debited

Electronic Credit in New Issues

- Investor opens account with DP
- Submits application with option to hold securities in depository giving DP-Id and Client-Id
- Registrar uploads list of allottees to Depository
- Depository credits allottee's account with DP
- Refunds sent by Registrar as usual

Trading System

- Separate quotes in Book Entry
- Trading Member to have Clearing Account with DP
- Settlement as per Settlement Calendar of Stock Exchange
- Trading can be introduced in any Stock exchange if settlement is guaranteed

Corporate Actions

- Dividends/cash benefits – these benefits are directly forwarded to the investors by the company or its registrar and transfer agent.
- Non-cash benefits, viz. Bonus, Rights Issue, etc. – these benefits are electronically credited to the beneficial owner's account through Depository.

III. LEGAL FRAMEWORK

The legal framework for a depository system has been laid down by the Depositories Act, 1996 and is regulated by SEBI. The depository business in India is regulated by –

- The Depositories Act, 1996
- The SEBI (Depositories and Participants) Regulations, 1996
- Bye-laws of Depository
- Business Rules of Depository.

Apart from the above, Depositories are also governed by certain provisions of:

- The Companies Act, 1956
- The Indian Stamp Act, 1899
- Securities and Exchange Board of India Act, 1992
- Securities Contracts (Regulation) Act, 1956
- Benami Transaction (Prohibition) Act, 1988
- Income Tax Act, 1961
- Bankers' Books Evidence Act, 1891

The legal framework for depository system as envisaged in the Depositories Act, 1996 provides for the establishment of single or multiple depositories. Any body to be eligible for providing depository services must be formed and registered as a company under the Companies Act, 1956 and seek registration with SEBI and obtain a Certificate of Commencement of Business from SEBI on fulfillment of the prescribed conditions. The investors opting to join depository mode are required to enter into an agreement with depository through a participant who acts as an agent of depository. The agencies such as custodians, banks, financial institutions, large corporate brokerage firms, non-banking financial companies etc. act as participants of depositories. The companies issuing securities are also required to enter into an agreement with the Depository.

IV. THE DEPOSITORIES ACT, 1996

Objectives

The depositories legislation as per the Statement of Objects and Reasons appended to the Depositories Act, 1996 aims at providing for:

- A legal basis for establishment of depositories to conduct the task of maintenance of ownership records of securities and effect changes in ownership records through book entry;
- Dematerialisation of securities in the depositories mode as well as giving option to an investor to choose between holding securities in physical mode and holding securities in a dematerialized form in a depository;
- Making the securities fungible;
- Making the shares, debentures and any interest thereon of a public limited company freely transferable; and

— Exempting all transfers of shares within a depository from stamp duty.

Eligibility Condition for Depository Services

Any company or other institution to be eligible to provide depository services must:

- be formed and registered as a company under the Companies Act, 1956.
- be registered with SEBI as a depository under SEBI Act, 1992.
- has framed bye-laws with the previous approval of SEBI.
- has one or more participants to render depository services on its behalf.
- has adequate systems and safeguards to prevent manipulation of records and transactions to the satisfaction of SEBI.
- complies with Depositories Act, 1996 and SEBI (Depositories and Participants) Regulations, 1996.
- meets eligibility criteria in terms of constitution, network, etc.

Eligible Securities Required to be in the Depository mode

Section 8 of the Depositories Act gives the option to the investors to receive securities in physical form or in depository mode.

It is not necessary that all eligible securities must be in the depository mode. In the scheme of the Depositories legislation, the investor has been given supremacy. The investor has the choice of holding physical securities or opt for a depository based ownership record.

However in case of fresh issue of securities all securities issued have to be in dematerialised form. However after that investor will also have the freedom to switch from depository mode to non-depository mode and vice versa. The decision as to whether or not to hold securities within the depository mode and if in depository mode, which depository or participant, would be entirely with the investor.

Fungibility

Section 9 states that securities in depositories shall be in fungible form.

The Act envisages that all securities held in depository shall be fungible i.e. all certificates of the same security shall become interchangeable in the sense that investor loses the right to obtain the exact certificate he surrenders at the time of entry into depository. It is like withdrawing money from the bank without bothering about the distinctive numbers of the currencies.

Immobilisation of securities in a depository mode refers to a situation where the depository holds securities in the form of physical paper side by side with electronic evidence of ownership. In such a case the transfers are not accompanied by physical movement of securities but securities are in existence in the custody of the depository. However, the Depositories Act, envisages dematerialisation in the depository mode. In such a case the securities held in a depository shall be dematerialized and the ownership of the securities shall be reflected through book entry only. The securities outside the depository shall be represented by physical scrips. Hence, the depository legislation envisages partial dematerialisation, i.e. a portion of the securities in dematerialized form and the other portion in physical form.

Sections 153, 153A, 153B, 187B, 187C and 372 (now 372A) of Companies Act, 1956 shall not apply to a depository in respect of shares held on behalf of beneficial owners in depositories.

Rights of depositories and beneficial owner

A depository should be deemed to be the registered owner for the purposes of effecting transfer of ownership of security on behalf of a beneficial owner. The depository as a registered owner should not have any voting rights or any other rights in respect of securities held by it. The beneficial owner is entitled to all the rights and benefits and be subjected to all the liabilities in respect of his securities held by a depository.

Register of beneficial owner

Every depository is required to maintain a register and an index of beneficial owners in the manner provided in the Companies Act.

Pledge or hypothecation of securities held in a depository

A beneficial owner may with the previous approval of the depository create a pledge or hypothecation in respect of a security owned by him through a depository. Every beneficial owner should give intimation of such pledge or hypothecation to the depository participant and such depository is required to make entries in its records accordingly. Any entry in the records of a depository should be evidence of a pledge or hypothecation.

Option to opt out in respect of any security

Section 14 of the Act provides that if a beneficial owner seeks to opt out of a depository in respect of any security he should inform the depository accordingly. After the receipt of intimation the depository should make appropriate entries in its records and also inform the issuer. Every issuer may, within thirty days of the receipt of intimation from the depository and on fulfilment of such conditions and on payment of such fees as may be specified by the regulations, issue the certificate of securities to the beneficial owner or the transferee, as the case may be.

Depositories to indemnify loss in certain cases

Any loss caused to the beneficial owner due to the negligence of the depository or the participant, would be indemnified by the depository to such beneficial owner. Where the loss due to the negligence of the participant is indemnified by the depository, the depository has the right to recover the same from such participant.

Power of SEBI

Section 18 of the Act provides that SEBI in the public interest or in the interest of investors may by order in writing to call upon any issuer, depository, participant or beneficial owner to furnish in writing such information relating to the securities held in a depository as it may require; or authorise any person to make an enquiry or inspection in relation to the affairs of the issuer, beneficial owner, depository or participant, who shall submit a report of such enquiry or inspection to it within such period as may be specified in the order. Sub-section (2) to Section 18 provides that every director, manager, partner, secretary, officer or employee of the depository or issuer or the participant or beneficial owner shall on demand produce before the person making the enquiry or inspection all information or such records and other documents in his custody having a bearing on the subject matter of such enquiry or inspection.

If after making or causing to be made an enquiry or inspection, SEBI is satisfied that it is necessary in the interest of investors, or orderly

development of securities market; or to prevent the affairs of any depository or participant being conducted in the manner detrimental to the interests of investors or securities market, SEBI may issue such directions to any depository or participant or any person associated with the securities market; or to any issuer as may be appropriate in the interest of investors or the securities market.

Power of Board to give Directions

Section 19 provides that SEBI after making an enquiry or inspection and if satisfied may issue appropriate directions

- a. to any depository or participant or any person associated with the securities market; or
- b. to any issuer

in the interest of investors or the securities market or to prevent the affairs of any depository or participant being conducted in the manner detrimental to the interests of investors or the securities market.

Penalty for failure to furnish information/return etc.

Section 19A provides that any person, who is required under Depositories Act or any rules or regulations or bye-laws made there under—

- a. to furnish any information, document, books, returns or report to the Board, fails to furnish the same within the time specified therefor fails to furnish the same within specified time;
 - b. to file any return or furnish any information, books or other documents within the time specified therefor in the regulations or bye-laws, fails to file return or furnish the same within the time specified therefor, fails to file such return or furnish the required information within the specified time;
 - c. to maintain books of account or records, fails to maintain the same;
- he shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less.

Penalty for failure to enter into agreement

Section 19B provides that if a depository or participant or any issuer or its agent or any person, who is a registered intermediary and is required under this Act or any rules or regulations made there under, to enter into an agreement, fails to enter into such agreement, such intermediary shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less for every such failure.

Penalty for failure to redress investors' grievances

Section 19C provides that if any depository or participant or any issuer or its agent or any person, who is registered as a registered intermediary, after having been called upon by the SEBI in writing, to redress the grievances of the investors, fails to redress such grievances within the time specified, such depository or participant or issuer or its agents or intermediary shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less.

Penalty for delay in dematerialisation or issue of certificate of securities

Section 19D provides that if any issuer or its agent or any person, who is a registered intermediary, fails to dematerialise or issue the certificate of securities on opting out of a depository by the investors, within the time specified under this Act or regulations or bye-laws made there under or abets

in delaying the process of dematerialisation or issue the certificate of securities on opting out of a depository of securities, such intermediary shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less.

Penalty for failure to reconcile records

Section 19E provides that if a depository or participant or any issuer or its agent or any person, who is a registered intermediary, fails to reconcile the records of dematerialised securities with all the securities issued by the issuer as specified in the regulations, such intermediary shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less.

Penalty for failure to comply with directions issued by Board under section 19 of the Act

Section 19F requires that if any person fails to comply with the directions issued by SEBI under section 19, within the time specified by it, he shall be liable to a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less.

Penalty for contravention where no separate penalty has been provided

Section 19G provides that whoever fails to comply with any provision of this Act, the rules or the regulations or bye-laws made or directions issued by the Board thereunder for which no separate penalty has been provided, shall be liable to a penalty which may extend to one crore rupees.

Power to adjudicate

Section 19H provides that for the purpose of adjudging under sections 19A, 19B, 19C, 19D, 19E, 19F and 19G, the Board shall appoint any officer not below the rank of a Division Chief of the Securities and Exchange Board of India to be an adjudicating officer for holding an inquiry in the prescribed manner after giving any person concerned a reasonable opportunity of being heard for the purpose of imposing any penalty. While holding an inquiry, the adjudicating officer shall have power to summon and enforce the attendance of any person acquainted with the facts and circumstances of the case to give evidence or to produce any document, which in the opinion of the adjudicating officer, may be useful for or relevant to the subject matter of the inquiry and if, on such inquiry, he is satisfied that the person has failed to comply with the provisions of any of the sections specified in sub-section (1), he may impose such penalty as he thinks fit in accordance with the provisions of any of those sections.

Factors to be taken into account by adjudicating officer

Section 19I requires that while adjudging the quantum of penalty under section 19H, the adjudicating officer shall have due regard to the following factors, namely—(a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default; (b) the amount of loss caused to an investor or group of investors as a result of the default; (c) the repetitive nature of the default.

Crediting sums realized by way of penalties to Consolidated Fund of India

Section 19J provides that all sums realised by way of penalties under this Act shall be credited to the Consolidated Fund of India.

Offences

Section 20 provides that without prejudice to any award of penalty by the adjudicating officer under this Act, if any person contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any rules or regulations or bye-laws made there under, he shall be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees, or with both. If any person fails to pay the penalty imposed by the adjudicating officer or fails to comply with any of his directions or orders, he shall be punishable with imprisonment for a term which shall not be less than one month but which may extend to ten years, or with fine, which may extend to twenty-five crore rupees, or with both.

Offences by companies

Section 21 provides that where an offence under this Act has been committed by a company, every person who at the time the offence was committed was in charge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly. The proviso to the section also provides that nothing contained in this sub-section shall render any such person liable to any punishment provided in this Act, if he proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence. Further Sub-section (2) of the section provides that notwithstanding anything contained in Sub-section (1), where an offence under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly.

Cognizance of offences by courts

Section 22 provides that no court shall take cognizance of any offence punishable under this Act or any rules or regulations or bye-laws made there under except on a complaint made by the Central Government or State Government or the Securities and Exchange Board of India or by any person. No court inferior to that of a Court of Session shall try any offence punishable under this Act.

Composition of certain offences

Section 22A provides that notwithstanding anything contained in the Code of Criminal Procedure, 1973, any offence punishable under this Act, not being an offence punishable with imprisonment only, or with imprisonment and also with fine, may either before or after the institution of any proceeding, be compounded by a Securities Appellate Tribunal or a court before which such proceedings are pending.

Power to grant immunity

Section 22B empowers the Central Government to grant immunity, on recommendation by the Board, if the Central Government is satisfied, that any person, who is alleged to have violated any of the provisions of this Act or

the rules or the regulations made there under, has made a full and true disclosure in respect of alleged violation, grant to such person, subject to such conditions as it may think fit to impose, immunity from prosecution for any offence under this Act, or the rules or the regulations made there under or also from the imposition of any penalty under this Act with respect to the alleged violation. No such immunity shall be granted by the Central Government in cases where the proceedings for the prosecution for any such offence have been instituted before the date of receipt of application for grant of such immunity. Recommendation of the Board under this sub-section is not binding upon the Central Government.

Sub-section (2) provides that an immunity granted to a person under Sub-section (1) may, at any time, be withdrawn by the Central Government, if it is satisfied that such person had, in the course of the proceedings, not complied with the condition on which the immunity was granted or had given false evidence, and thereupon such person may be tried for the offence with respect to which the immunity was granted or for any other offence of which he appears to have been guilty in connection with the contravention and shall also become liable to the imposition of any penalty under this Act to which such person would have been liable, had not such immunity been granted.

Appeal to Securities Appellate Tribunal

Section 23A provides that, any person aggrieved by an order of the Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, under this Act, or the regulations made there under or by an order made by an adjudicating officer under this Act may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter. However, no appeal shall lie to the Securities Appellate Tribunal from an order made by the Board with the consent of the parties. Every appeal under sub-section (1) shall be filed within a period of forty-five days from the date on which a copy of the order made by the Board is received by the person referred to in sub-section (1) and it shall be in such form and be accompanied by such fee as may be prescribed:

Provided that the Securities Appellate Tribunal may entertain an appeal after the expiry of the said period of forty-five days if it is satisfied that there was sufficient cause for not filing it within that period.

Sub-section (4) provides that on receipt of an appeal under sub-section (1), the Securities Appellate Tribunal may, after giving the parties to the appeal an opportunity of being heard, pass such orders thereon as it thinks fit, confirming, modifying or setting aside the order appealed against.

Sub-section (5) provides that the Securities Appellate Tribunal shall send a copy of every order made by it to the Board and parties to the appeal.

Sub-section (6) further provides that the appeal filed before the Securities Appellate Tribunal under sub-section (1) shall be dealt with by it as expeditiously as possible and endeavour shall be made by it to dispose of the appeal finally within six months from the date of receipt of the appeal.

Procedure and powers of Securities Appellate Tribunal

Section 23B provides that the Securities Appellate Tribunal shall not be bound by the procedure laid down by the Code of Civil Procedure, 1908, but shall be guided by the principles of natural justice and, subject to the other

provisions of this Act and of any rules, the Securities Appellate Tribunal shall have powers to regulate their own procedure including the places at which they shall have their sittings. The Securities Appellate Tribunal shall have, for the purpose of discharging their functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying a suit, in respect of the following matters, namely—

- a. summoning and enforcing the attendance of any person and examining him on oath;
- b. requiring the discovery and production of documents;
- c. receiving evidence on affidavits;
- d. issuing commissions for the examination of witnesses or documents;
- e. reviewing its decisions;
- f. dismissing an application for default or deciding it *ex parte*;
- g. setting aside any order of dismissal of any application for default or any order passed by it *ex parte*; and
- h. any other matter which may be prescribed.

Sub-Section (3) provides that every proceeding before the Securities Appellate Tribunal shall be deemed to be a judicial proceeding within the meaning of sections 193 and 228, and for the purposes of section 196 of the Indian Penal Code and the Securities Appellate Tribunal shall be deemed to be a civil court for all the purposes of section 195 and Chapter XXVI of the Code of Criminal Procedure, 1973.

Appeal to Supreme Court

Section 23F provides that any person aggrieved by any decision or order of the Securities Appellate Tribunal may file an appeal to the Supreme Court within sixty days from the date of communication of the decision or order of the Securities Appellate Tribunal to him on any question of law arising out of such order. Provided that the Supreme Court may, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.

Right to Legal Representation

Section 23C provides that the appellant may either appear in person or authorise one or more Chartered Accountants or Company Secretaries or Cost Accountants, in practice or Legal Practitioners or any of its officers to present his/its case before the Securities Appellate Tribunal.

Areas on which Rules may be Framed by the Central Government

The Central Government under Section 24, may frame Rules to provide, *inter alia*, for:

- the manner of inquiry under Section 19H(1).
- the time within which an appeal may be preferred from the orders of SEBI under Section 23(1).
- the form in which an appeal may be preferred and the fees payable in respect of such appeal.
- the procedure for disposing of an appeal.
- the form in which an appeal may be filed before the Securities Appellate Tribunal under Section 23A and the fees payable in respect of such appeal.

Power of SEBI to Make Regulations

Section 25 of the Depositories Act, 1996 read with Section 30 of SEBI Act, 1992 empowers SEBI to make regulations for carrying out the purposes of the Act, by notification in the Official Gazette. The regulations may, *inter alia*, provide for:

- The requirements to be complied with by a person for seeking registration as a Depository with SEBI under SEBI Act, 1992.
- The requirements for registration of a person as a participant under SEBI Act.
- Determination of any form in which records may be maintained by a Depository. As per Section 2(1)(i) of the Act, 'record' includes the records maintained in the form of books or stored in a computer or in such other form as may be determined by regulations.
- The requirements for grant of certificate of commencement of business by depositories and the form in which the certificate of commencement of business has to be issued.
- The manner in which the certificate of security shall be surrendered to the issuer by any investor who is desirous of availing depository services.
- The manner in which the issuer has to cancel the certificates of securities received by it for cancellation and its intimation to the depository.
- The manner in which the depository has to register transfer of security in the name of the transferee on receipt of the intimation from a participant and where the beneficial owner or a transferee seeks to have custody of security, the manner in which the depository shall inform the issuer.
- Where a person opts to hold a security with a depository in the event of a public issue, the manner in which the issuer is required to intimate the depository the details of allotment of the security.
- The requirements to be complied with by a beneficial owner for creating with the previous approval of depository, pledge or hypothecation in respect of a security owned by him through depository.
- The conditions and the fees payable with respect to the issue of certificate of securities to the beneficial owner where the beneficial owner seeks to opt out of the depository.
- The rights and obligations of the depositories, participants, and the issuers whose securities are dealt with by a depository.
- The eligibility criteria for admission of securities into the depository.

V. BYE-LAWS OF A DEPOSITORY

Depository is required to frame its bye-laws with the prior approval of SEBI, consistent with the provisions of the Act and the regulations made by SEBI thereunder. SEBI has, however, the power to direct the depository to amend or revoke any bye-laws already made, wherever it considers expedient to do so. If the depository fails or neglects to comply with the directions of SEBI, SEBI may make the bye-laws or amend or revoke the bye-laws on its own.

Contents of the bye-laws

As per Sub-section 2 of Section 26 of the Act, the bye-laws of a depository would include:

- the eligibility criteria for admission and removal of securities in the

depository.

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

Applicability of Section 372A of Companies Act on a Depository

The name of the depository is entered in the records of an issuer as a registered owner in respect of securities held by it on behalf of the beneficial owners. It is possible that a registered owner (Depository) can hold 100% of the securities of a company. This will, however, not contravene Section 372A of the Companies Act, 1956, as the registered owner does not have any economic or voting right in respect of these securities.

Membership Rights in Respect of Securities held by a Depository

The depository as a registered owner shall not have any voting rights or any other rights in respect of securities held by it on behalf of the beneficial owners. The beneficial owner shall be entitled to all the rights and benefits (including the right to vote) and be subjected to all the liabilities in respect of securities held by a depository.

Evidentiary Value of the Records of the Depository

Section 15 of the Act treats depository as a bank for the purposes of the Bankers' Books Evidence Act, 1891. The ownership records of securities maintained by depositories, whether maintained in the form of books or machine readable forms, shall be accepted as *prima facie* evidence in all

legal proceedings.

Cognizance of Offences by Courts

As per Section 22 of the Act, no court inferior to that of a Metropolitan Magistrate or a Judicial Magistrate of first class shall try any offence punishable under this Act. Only SEBI can make a complaint to the Court.

Penalty for Offences under the Act

As per Section 20 of the Act, a maximum penalty of imprisonment for a term which may extend to five years or fine or both can be imposed for offences committed under the Act.

VI. SEBI (DEPOSITORIES AND PARTICIPANTS) REGULATIONS, 1996

The Depositories Act requires that the registration of the depository, depository participant and the custodian, is mandatory with the Securities and Exchange Board of India. These market intermediaries can function or commence business only after registration from SEBI has been obtained and requisite fee paid to SEBI. The requirement of registration is a continuing one and the moment the registration is cancelled or revoked or surrendered, the person shall cease to act as such.

SEBI had issued SEBI (Depositories and Participants) Regulations, 1996 on 16th May, 1996 which apply to depositories and its participants.

These regulations also contain provisions for operations and functioning of depositories, form for application and certificates used and schedule of fees for participants, etc. It also contains provisions for registration of depository and depository participants, rights and obligations of various users and constituents, inspection and procedure for action in case of default.

Entities desiring to become depository participants must apply to the depository and are required to be recommended to SEBI by the depository. If approved and registered by SEBI, the depository participant can be admitted on the depository. The depository has to formulate its own set of criteria for selection of participants. Every participant holding a certificate is required at all times to abide by the specified Code of Conduct.

The regulations require the depository to list out, through its Bye-laws, the securities which are eligible to be admitted to the depository for dematerialisation. Equity shares, debentures, warrants, bonds, units of mutual funds, etc. are part of the list of eligible securities. The depository is empowered to set its own criteria for selection of securities and make securities eligible to be maintained in the form of electronic holdings on the depository.

Further, the regulations stipulate that agreements should be entered into by the following entities:

- depository and every participant
- participant and every client
- depository, issuer company and the Registrar

The draft of these agreements are to be included in the Bye-laws and to be approved by SEBI.

The depository is required to ensure that sufficient safeguards are in place to protect the data available with it and with the participants. To reduce risk in operations, the regulations stipulate that adequate insurance cover be provided by the depository and by the depository participants as well.

The regulations also require for reconciliation to be carried out on a daily basis. Further, the depository and the registrar will also reconcile balances on a daily and a periodic basis.

Rights and Obligations of Depositories and its Constituents

Regulations deal with rights and obligations of depositories and every depository has to state in its bye-laws the eligible securities for dematerialisation which include shares, scrips, stock, bonds, debentures stock, etc., and include units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificate of deposit, securitised debt, money market instruments and even unlisted securities.

Every depository is required to enter into an agreement with the issuer in respect of securities disclosed as eligible to be held in demat form. No agreement is required to be entered into where the depository itself is an issuer of securities.

The depository is also required to enter into a tripartite agreement with the issuer, its transfer agent and itself where company has appointed a transfer agent. Every depository is required to maintain continuous connectivity with issuers, registrars and transfer agents, participants and clearing house or clearing corporations. Depositories should take adequate measures including insurance to protect the interest of the beneficial owners.

Every depository is required to maintain the following records and documents namely:

- records of securities dematerialised and rematerialised;
- the names of the transferor, transferee, and the dates of transfer of securities;
- a register and an index of beneficial owners;
- details of holding of the securities of the beneficial owners as at the end of the each day;
- records of instruction(s) received from and sent to participants, issuers' agents and beneficial owners;
- records of approval, notice, entry and cancellation of pledge or hypothecation, as the case may be;
- details of participants;
- details of securities declared to be eligible for dematerialisation in the depository; and
- such other records as may be specified by SEBI for carrying on the activities as a depository.

Every depository has to intimate the Board the place where the records and documents are maintained.

Subject to the provisions of any other law, the depository shall preserve records and documents for a minimum period of five years.

Participants are required to enter into an agreement with beneficial owners. It is required that separate accounts are to be opened by every participant in the name of each of the beneficial owner and the securities of each beneficial owners are to be segregated and shall not be mixed up with the securities of other beneficial owners or with the participant's own securities. The participants are obliged to reconcile the records with every depository on a

daily basis. Participants are required to maintain the following records for a period of five years—

- records of all the transactions entered into with a depository and with a beneficial owner;
- details of security dematerialised, rematerialised on behalf of beneficial owners with whom it has entered into an agreement;
- records of instructions received from beneficial owners and statements of account provided to beneficial owners; and
- records of approval, notice, entry and cancellation of pledge or hypothecation as the case may be.

VII. AUDIT UNDER SEBI (DEPOSITORIES AND PARTICIPANTS) REGULATIONS, 1996

Regulation 55A of SEBI (Depositories and Participants) Regulations, 1996 provides that every issuer shall submit audit report on a quarterly basis to the concerned stock exchanges audited by a practicing Company Secretary or a qualified Chartered Accountant, for the purposes of reconciliation of the total issued capital, listed capital and capital held by depositories in dematerialized form, the details of changes in share capital during the quarter and the in-principle approval obtained by the issuer from all the stock exchanges where it is listed in respect of such further issued capital.

The audit report is required to give the updated status of the register of members of the issuer and confirm that securities have been dematerialized as per requests within 21 days from the date of receipt of requests by the issuer and where the dematerialization has not been effected within the said stipulated period, the report would disclose the reasons for such delay.

The issuer is under an obligation to immediately bring to the notice of the depositories and the stock exchanges, any difference observed in its issued, listed, and the capital held by depositories in dematerialized form.

VIII. INTERNAL AUDIT OF OPERATIONS OF DEPOSITORY PARTICIPANTS

The two Depository service providers in India, viz., National Securities Depository Ltd. (NSDL) and Central Depository Services (India) Limited (CDS) have allowed Company Secretaries in Whole-time Practice to undertake internal audit of the operations of Depository Participants (DPs). NSDL has vide its circular No. NSDL/SG/II/010/99 dated 26th March 1999 notified amendment of its Bye Law 10.3.1 of Chapter 10 as follows:

10.3.1 “Every Participant shall ensure that an internal audit in respect of the operations of the Depository is conducted at intervals of not more than three months by a qualified Chartered Accountant or a Company Secretary holding a certificate of Practice and a copy of the internal audit report shall be furnished to the Depository.”

CDSL has vide its letter dated September 28, 1999 notified amendment of its Bye Laws 16.3.1 as follows:

16.3.1 “Every Participant shall ensure that an internal audit shall be conducted in respect of the participant’s operations relating to CDS by a qualified Chartered Accountant in accordance with the provisions of the Chartered Accountants Act, 1949 or by a Company Secretary in practice in accordance with the provisions of the Company Secretaries Act, 1980, at such intervals as may be specified by CDS from time to time. A copy of

Internal Audit report shall be furnished to CDS.”

IX. CONCURRENT AUDIT

National Securities Depository Limited vide its Circular No. NSDL/POLICY/2006/0021 dated June 24, 2006 provides for concurrent audit of the Depository Participants. The Circular provides that w.e.f. August 1, 2006, the process of demat account opening, control and verification of Delivery Instruction Slips (DIS) is subject to Concurrent Audit. Depository Participants have been advised to appoint a firm of qualified Chartered Accountant(s) or Company Secretary(ies) holding a certificate of practice for conducting the concurrent audit. However, the participants in case they so desire, may entrust the concurrent audit to their Internal Auditors.

In respect of account opening, the auditor should verify all the documents including KYC documents furnished by the Clients and verified by the officials of the Participants. The scope of concurrent audit with respect to control and verification of DIS cover the areas given below:

I. Issuance of DIS

The procedure followed by the Participants with respect to:

- a. Issuance of DIS booklets including loose slips.
- b. Existence of controls on DIS issued to Clients including pre-stamping of Client ID and unique pre-printed serial numbers.
- c. Record maintenance for issuance of DIS booklets (including loose slips) in the back office.

II. Verification of DIS

The procedure followed by the Participants with respect to:

- a. Date and time stamping (including late stamping) on instruction slips.
- b. Blocking of used/reported lost/stolen instruction slips in back office system/ manual record.
- c. Blocking of slips in the back office system/manual record which are executed in DPM directly.
- d. Two step verification for a transaction for more than Rs. 5 lakh, especially in case of off-market transactions.
- e. Instructions received from dormant accounts.

The Concurrent Auditor should conduct the audit in respect of all accounts opened, DIS issued and controls on DIS as mentioned above, during the day, by the next working day. In case the audit could not be completed within the next working day due to large volume, the auditor should ensure that the audit is completed within a week's time.

Any deviation and/or non-compliance observed in the aforesaid areas should be mentioned in the audit report of the Concurrent Auditor. The Management of the Participant should comment on the observations made by the Concurrent Auditor.

The Concurrent Audit Report should be submitted to NSDL, on a quarterly basis, in a hard copy form.

If the Auditor for Internal and Concurrent Audit is the same, consolidated report may be submitted.

X. ESTABLISHMENT OF CONNECTIVITY WITH NSDL AND CDSL

The stock exchanges may consider shifting the trading of securities of the Companies who have established connectivity with both the depositories to

rolling settlement subject to the following:

- a. At least 50% of non-promoter holdings as per clause 35 of Listing Agreement are in demat mode before shifting the trading in the securities of the company from Trade for Trade Segment (TFTS) to Rolling settlement.

For this purpose, the listed companies are required to obtain a certificate from its Registrar and Transfer Agent (RTA) and submit the same to the stock exchange/s. However, if an issuer-company does not have a separate RTA, it may obtain a certificate in this regard from a practicing Company Secretary/Chartered Accountant and submit the same to the stock exchange/s.

- b. There are no other grounds/reasons for continuation of the trading in TFTS.

The Stock Exchanges are also required to report to SEBI, the action taken in this regard in their Monthly/Quarterly Development Report.

XI. APPOINTMENT OF COMMON AGENCY FOR SHARE REGISTRY WORK

In many cases the issuer companies are having an internal department or a division (by whatever name called) for handling of physical share work and an out side agency for handling the work of electronic connectivity. This kind of arrangement is leading to delay in dematerialisation, non-reconciliation of share holding due to lack of proper co-ordination among the concerned agencies or departments, which is adversely affecting the interest of the investors.

SEBI therefore vide its circular D&CC/FITTC/CIR-15/2002 dated December 27, 2002 decided that all the work related to share registry in terms of both physical and electronic should be maintained at a single point i.e. either in-house by the company or by a SEBI registered R & T Agent.

Further SEBI vide its circular D&CC/FITTC/CIR – 17/2002 dated December 31, 2002 directed all the registrars and share transfer agents (RSTA) that:

1. They shall maintain records of all the shares dematerialised, rematerialised and details of all securities declared to be eligible for dematerialisation in the depositories and ensure that dematerialisation of shares shall be confirmed/created only after an in-principle approval of the stock exchange/s where the shares are listed and the admission of the said share with the depositories have been granted.
2. They shall have proper systems and procedures in place to verify that the securities tendered for dematerialisation have not been dematerialised earlier.
3. They shall ascertain, reconcile daily and confirm to the depositories that the total number of shares held in NSDL, CDSL and in the physical form tallies with the admitted, issued and listed capital of the issuer company; and
4. They shall confirm that the dematerialisation requests have been processed within 21 days and shall also state the reasons for shares pending confirmation for more than 21 days from the date of request.

LESSON ROUND UP

- The legal framework for depository system as envisaged in the

Depositories Act, 1996 provides for the establishment of single or multiple depositories.

- There are two Depositories functioning in India, namely the National Securities Depository Limited (NSDL) and the Central Depository Services (India) Limited (CDSL).
- All the securities held by a depository are dematerialized and are in a fungible form.
- In the depository system, the ownership and transfer of securities takes place by means of electronic book entries.
- Dematerialisation is a process by which the physical share certificates of an investor are taken back by the Company and an equivalent number of securities are credited his account in electronic form at the request of the investor.
- A Depository Participant (DP) is the representative (agent) of the investor in the depository system providing the link between the Company and investor through the Depository.
- SEBI (Depositories and Participants) Regulations, 1996 regulates the function of Depositories and participants.
- Regulation 55A of SEBI (Depositories and Participants) Regulations, 1996 provides that every issuer shall submit audit report on a quarterly basis to the concerned stock exchanges audited by a practicing Company Secretary or a qualified Chartered Accountant, for the purposes of reconciliation of the total issued capital, listed capital and capital held by depositories in dematerialized form, the details of changes in share capital during the quarter and the in-principle approval obtained by the issuer from all the stock exchanges where it is listed in respect of such further issued capital.
- Both the Depositories in India have allowed Company Secretaries in Whole-time Practice to undertake internal audit of the operations of Depository Participants (DPs).
- Concurrent Audit – Depository Participants are subject to concurrent audit by a Practising Company Secretary or qualified Chartered Accountant. Concurrent Audit includes audit of process of demat account opening, control and verification of delivery instruction slips.