Lecture 4
Depository System: Features, Advantages and Disadvantages

It is a system whereby the transfer and settlement of scrips take place not through the traditional method of transfer deeds and physical delivery of scrips but through the modern system of effecting transfer of ownership of securities by means of book entry on the ledgers or the depository without the physical movement of scrips.

The new system, thus, eliminates paper work, facilitates automatic and transparent trading in scrips, shortens the settlement period and ultimately contributes to the liquidity of investment in securities. This system is also known as 'scripless trading system'.

There are essentially four players in the depository system:

(i) The Depository

(ii) The Participant

(iii) The Beneficial Owner, and

(iv) The Issuer.

(i) The Depository:

A depository is a firm wherein the securities of an investor are held in electronic form and who carries out the transactions of securities by means of book entry. The depository acts as a defecto owner of the securities lodged with it for the limited purpose of transfer of ownership. It functions as a custodian of securities of its clients.

The name of the depository appears in the records the issuer as the registered owner of securities.

At present there are two depositories in India:

(a) National Securities Depository Ltd. (NSDL), and

(b) Central Depository Services (India) Ltd. (CDSL).

National Securities Depository Limited which commenced operations during November 1996 was promoted by IDBI, UTI and National Stock Exchange (NSE). Central Depository Services (India) Limited commenced operations during February 1999. It was promoted by Mumbai Stock Exchange in association with Bank of Baroda, Bank of India, State Bank of India and HDFC Bank.

(ii) The Participant:

A participant is an agent of the depository. He functions as a bridge between the depository and the beneficial owners. He maintains the ownership records of every beneficial owner in book entry form. Both the depository and the participant have to be registered with the Securities and Exchange Board of India.

SEBI grants necessary approval for the same only on the satisfaction of the condition that adequate systems and safeguards are available in such companies in order to ensure against manipulation of records and transactions.

(iii) The Beneficial Owner:

Beneficial owner means a person whose name is recorded as such with a depository. A beneficial owner is the real owner of the securities who has lodged his securities with the depository in the form of book entry. He has all the rights and liabilities associated with the securities.

(iv) The Issuer:

The issuer is the company which issues the security. It maintains a register for recording the names of the registered owners of securities, the depositories. These issuers send a list of shareholders, who opt for the depository system, to the depositories.

Features of Depository System:

A depository system has the following features:
(a) Day-to-day basis of reconciliation is made by NSDL;

(b) Securities are divisible and, as such, can be transacted by any quantity;

(c) Securities are allotted International Security Identification Number (ISIN) by SEBI;

(d) The benefit of depository system is enjoyed by the investor/owner of securities; and

(e) CDSL and NSDL are the Depository Participants to act as agent.

Advantages of Depository System:

- **Enjoyed by Investors:**

i. It eliminates bad deliveries;

ii. It computes the settlement cycle very fast;

iii. It makes immediate transfer and registration of securities;

iv. It eliminates all risks associated with physical certificate;

v. It also provides nomination facility to the investors;

vi. It reduces trading cost;

vii. Since it is paperless trading, no share certificate and deed etc. are required.

- **Enjoyed by the Capital Market:**

(i) Dues are settled in a very short time;

(ii) It also eliminates bad delivering;

(iii) It also eliminates the problems arising from odd lots of securities;

(iv) It eliminates the physical handling of paperwork's;

(v) It reduces errors;

(vi) Questions of loss, mutilation of securities does not arise.

(vii) Huge number of transactions can be settled at a very short time.

- **Enjoyed by the Company:**

(a) It reduces the risk of loss of securities and, at the same time, reduces the fraudulent activities;

(b) It avoids the checking of shares, deeds and various papers,

(e) No share certificate is issued as the securities are divisible;

(d) It reduces the various costs which require secretarial help;

(e) It supplies better communication facilities

(f) Easy availability of data and information (i.e. issue of bonus share, right share, dividend declaration, etc.) are available which helps the shareholder to take decisions.

It is likely to bring about the following benefits to various investors, issuing companies as well as the nation:

a. Reduction in paper work.

b. Elimination of risks associated with physical scrips such as theft, forgery, multilation, loss of share certificates etc.

c. Elimination of bad delivers.

d. Increased liquidity of scrips through speedy settlement and reduction in delays in registration.

e. Low transaction costs for purchase and sale of securities compared to physical mode.

f. No stamp duty on transfer of securities.

g. Facilities the issuer companies to update the information regarding shareholders and to communicate with them in better ways.

h. Attract foreign investors and promoting foreign investment.

i. Emergence of healthy and efficient capital market.

j. Greater opportunity for the development of sophisticated custodial services etc.

Disadvantages of Depository System:

The Depository System is not free from snags. Some of them are:

(a) Number of frauds may be increased as there is no physical checking;

(b) Practically, to set up a single depository is not possible;

(c) MDS (Multiple Depository System) invites the problems of coordination.

A **rolling settlement** is the process of settling security trades on successive dates based upon the specific date when the original trade was made so that trades executed today will have a **settlement** date one business day later than trades executed yesterday. In a **rolling settlement** , each trading day is considered as a trading period and trades executed during the day are **settled** based on net obligations for the day. In India, trades in **rolling settlement** are **settled** on a **T+2** basis i.e. on the 2nd working day after a trade.

Meaning of Book Building:

Book Building may be defined as a process used by companies raising capital through Public Offerings-both Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional investors as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process.

Book Building in India:

The introduction of book-building in India was done in 1995 following the recommendations of an expert committee appointed by SEBI under Y.H. Malegam. The committee recommended and SEBI accepted in November 1995 that the book-building route should be open to issuer companies, subject to certain terms and conditions. In January 2000, SEBI came out with a compendium of guidelines, circulars and instructions to merchant bankers relating to issue of capital, including those on the book-building mechanism.

Book Building Process:

The following are the important points in book building process:

1. The Issuer who is planning an offer nominates lead merchant banker(s) as 'book runners'.

2. The Issuer specifies the number of securities to be issued and the price band for the bids.

3. The Issuer also appoints syndicate members with whom orders are to be placed by the investors.

4. The syndicate members put the orders into an 'electronic book'. This process is called 'bidding' and is similar to open auction.

5. The book normally remains open for a period of 5 days.

6. Bids have to be entered within the specified price band.

7. Bids can be revised by the bidders before the book closes.

8. On the close of the book building period, the book runners evaluate the bids on the basis of the demand at various price levels.

9. The book runners and the Issuer decide the final price at which the securities shall be issued.

10. Generally, the number of shares is fixed; the issue size gets frozen based on the final price per share.

11. Allocation of securities is made to the successful bidders. The rest bidders get refund orders.

Example:
In this method, the company doesn't fix up a particular price for the shares, but instead gives a price range, e.g., Rs. 80 to 100. When bidding for the shares, investors have to decide at which price they would like to bid for the shares, e.g., Rs. 80, Rs. 90 or Rs. 100. They can bid for the shares at any price within this range. Based on the demand and supply of the shares, the final price is fixed.

The lowest price (Rs. 80) is known as the floor price and the highest price (Rs. 100) is known as cap price. The price at which the shares are allotted is known as cut off price. The entire process begins with the selection of the lead manager, an investment banker whose job is to bring the issue to the public.

Both the lead manager and the issuing company fix the price range and the issue size. Next, syndicate members are hired to obtain bids from the investors. Normally, the issue is kept open for 5 days. Once the offer period is over, the lead manager and issuing company fix the price at which the shares are sold to the investors.

If the issue price is less than the cap price, the investors who bid at the cap price will get a refund and those who bid at the floor price will end up paying the additional money. For example, if the cut off in the above example is fixed at Rs. 90, those who bid at Rs. 80, will have to pay Rs. 10 per share and those who bid at Rs. 100, will end up getting the refund of Rs. 10 per share. Once each investor pays the actual issue price, the share are allotted.

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