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Depository System in Indian Capital Market: A Critical Analysis

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ABSTRACT

The Indian depository system has transformed the capital market by enhancing transparency, security, and efficiency, particularly through the transition from physical shareholding to dematerialization. While this shift has streamlined transactions and reduced fraud, recent regulatory mandates requiring private companies to dematerialize shares have raised new challenges. On one hand, mandatory dematerialization promises efficiency and improved governance but on the other hand, it places significant compliance, cost, and operational burdens on private enterprises. Issues such as overriding Articles of Association (AOA), lack of exemptions for wholly owned subsidiaries, logistical hurdles, and investor reluctance to dematerialize physical shares complicate the transition. Moreover, the effectiveness of share transfer restrictions under private company law is diluted when depositories process transfers without company approval, creating governance risks. Despite SEBI's emphasis on timely compliance and its penal framework for non-adherence, the existing infrastructure and shareholder preparedness may not be sufficient to achieve smooth implementation within the mandated timelines. This paper examines these complexities, highlighting the gap between regulatory objectives and practical challenges. By analyzing case laws, compliance frameworks, and stakeholder perspectives, it emphasizes the need for balanced reforms that safeguard investor interests while ensuring the efficiency and resilience of India's evolving depository system.

Keywords: Capital markets, Dematerialization, Shares, Private Company, Depository System.

I. INTRODUCTION

Change is an undeniable and constant aspect of the universe. For an economy to sustain itself amid the ever-evolving international market dynamics, it must embrace and adapt to change. This holds particularly true for India, a developing nation striving to maintain pace with global developments.² The depository system has significantly reduced the time and cost associated

¹ Author is an Advocate at Patna High Court, India.

² Divisha Sharma, "The Journey of Indian Depository System: A Critique of Hiccups Accompanying Dematerialization", SUPREMO AMICUS, Vol 23, 2020, pp 1.

with trading and has made investing in the Indian markets more efficient and secure.³

The depository system revolutionizes the way securities are held and traded in the financial markets. It provides investors with the convenience of holding their securities in electronic form, eliminating the need for physical certificates. Enabling transactions via depository participants, who serve as intermediaries linking investors and the depository, this system facilitates smooth and effective trading.

Dematerialization, a key aspect of the depository system, involves converting physical certificates of securities into electronic form. This process has significantly contributed to the growth of the Indian capital market, as evidenced by various metrics such as the amount raised from the market, the number of stock exchanges and intermediaries, market capitalization, trading volumes, turnover on stock exchanges, and investor population.

By embracing dematerialization and adopting the depository system, the Indian capital market has experienced exponential growth and enhancement in its infrastructure and functionality. This transformation highlights the importance of technological advancements in driving progress and fostering a vibrant and dynamic financial ecosystem.⁴

One of the key benefits of the Indian depository system is its ability to provide investors with greater accessibility and liquidity in the market. By holding securities in electronic form, investors can easily buy, sell, and transfer their investments without the hassle of dealing with physical certificates. This has led to increased participation in the market, particularly from retail investors who may have been previously deterred by the cumbersome process of paper-based transactions. Additionally, the electronic nature of the system has helped to reduce the risk of fraud and theft, as securities are held in a secure and centralized manner. Overall, the Indian depository system has played a significant role in modernizing the country's capital markets and has paved the way for further growth and development in the future.⁵

However, with the increase in the dematerialisation mandate by the SEBI, even though brought for increasing the transparency and efficiency in the capital market, imposes certain challenges. Earlier only public companies had to compulsorily dematerialise their shares but now private companies have to also compulsorily dematerialise their shares. This was brought by the

³ Hemraj Kumawat, "Financial Market: A Study of Indian Capital Market", INTERNATIONAL JOURNAL OF RESEARCH, Vol-1, No.7, August 2014, pp 961-962.

⁴ Yogesh Garg, "An Exploratory Study On Dematerialization & Depository System In Indi" A, INTERNATIONAL RESEARCH JOURNAL OF COMMERCE ARTS AND SCIENCE, Vol.7, 2016, pp. 36.

⁵ Shree Bhagwat, Ritesh Omre "A Study On Indian Depository System: Growth & Role In Indian Financial Market", JOURNAL OF EMERGING TECHNOLOGIES AND INNOVATIVE RESEARCH Vol. 5 no.7, 2018, pp. 266-280.

amendment to the PAS rules by the Ministry of Corporate affairs. Dematerialisation of shares of private companies is a positive step but the question arises that whether the current structure of the Indian Depository is efficient enough to handle these changes. Thus, the aim of the study is to critically analyse the issues and challenges brought by the mandate and provide suggestions that can be taken to further ease the process of dematerialisation of private companies and ensure transparency and effectiveness in the Indian Depository system.

A. Statement of Problem

The introduction of the depository system in the Indian capital market has led to significant changes, particularly in share ownership and transparency. The recent mandates regarding the dematerialization of shares of private companies offer efficiency and transparency but it poses several challenges for private companies. For instance, it brings compliance and cost challenges associated with dematerialization, as the whole process requires substantial resources from private enterprises to ensure regulatory adherence. Despite mandatory dematerialization, the restrictions on private companies' share transfer restrictions remain, but processing transfer requests without the company's approval in the depository system may dilute their effectiveness. Further, there is reluctance from the investors in dematerialising their physical shares and also the present infrastructure is efficient enough to handle these changes within a specified time raises concerns. Overall, the transition to dematerialization poses significant issues and complexities for private companies.

B. Review of Literature

1. In the article by Pravesh Kumar Mann, "Structure Of The Indian Depository System",⁶ the author provides an understanding of the structure and functions of the depository system in India, specifically NSDL and CDSL. Highlights the benefits of the depository system, such as faster settlement cycles, elimination of risks associated with physical certificates, and reduction in paperwork. The study provided insights into the structure and functions of the depository system in India, including processes like dematerialization, rematerialization, and opening a Demat account. It also highlighted the services offered by the depository system, such as change of address, nomination, mandate, and transfer of securities.

2. In the article, "An Exploratory Study on Dematerialization & Depository System In India",⁷ by Yogesh Garg, the author explores the role of depositories in India's capital market, focusing

⁶ Pravesh Kumar Mann, "Structure Of The Indian Depository System", *Journal of Modern Management & Entrepreneurship*, Vol.9, No.4, October 2019, pp.53-62

⁷ Yogesh Garg, "An Exploratory Study on Dematerialization & Depository System In India", *INTERNATIONAL RESEARCH JOURNAL OF COMMERCE ARTS AND SCIENCE*, Vol 7, 2016, pp. 36-40.

on dematerialization and the transaction process through depository participants. The author highlights the benefits of the depository system, such as improved market efficiency, elimination of physical movement of securities, reduction in paperwork, and enhanced security and convenience for investors. The introduction of depositories in India has led to a significant transformation in the capital market. It has facilitated the transfer of securities in the capital market through a mere book entry, eliminating the need for physical delivery. Indian capital market has witnessed a shift from paper-based settlement to electronic settlement, leading to immediate transfer of securities and elimination of stamp duty and risk of bad delivery. The depository system has established connectivity with leading stock exchanges, further enhancing the efficiency of the capital market.

4. In the article by B.Hari Babu, et al.,*Role of Depositories in Indian Capital Market - A Comparative Study between NSDL and CDSL*",⁸ the authors have aimed to understand the role and growth of NSDL and CDSL in the Indian Capital Market. The article highlights the role of the financial system in promoting faster economic development by providing intermediation between savers and investors. It mentions the importance of the secondary market in providing liquidity to financial instruments through trading and settlement on stock exchanges. It discusses the process of dematerialization and highlights the role of CDSL in the Indian Depository System, including its activities through service providers such as depository participants, issuing companies, registrars, share transfer agents, and clearing corporations. The paper concludes that both NSDL and CDSL have played a significant role in reducing settlement risk by minimizing paperwork involved in trading, settlement, and transfer of securities. NSDL and CDSL have contributed to reducing settlement risk by minimizing paperwork involved in trading, settlement, and transfer of securities.

5. In the article by Bharath Reddy, "Enforcing progressive compliance: Push for digitalization by dematerializing shares of all Companies",⁹ the article offers a thorough examination of the Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023. These rules provide that existing shares must be converted and new shares issued solely in dematerialized form, applicable to both public and private limited companies in India. Tracing the evolution of dematerialization from a progressive option to a compliance requirement, the authors analyze the historical background, regulatory evolution, recent amendments, and

⁸ B.Hari Babu, et al., "*Role of Depositories in Indian Capital Market - A Comparative Study between NSDL and CDSL*", INTERNATIONAL JOURNAL OF SCIENTIFIC AND RESEARCH PUBLICATIONS, Vol. 6, December 2016, pp. 135-141.

⁹ Bharath Reddy, "*Enforcing progressive compliance: Push for digitalisation by dematerialising shares of all Companies*", <https://corporate.cyrilamarchandblogs.com/2023/11/enforcing-progressive-compliance-push-for-digitalisation-by-dematerialising-shares-of-all-companies/>, (visited on March 15, 2024).

stakeholder challenges associated with this transformation. The article highlight the increased threshold of regulation and compliance, stakeholder readiness, challenges in implementation, and the need for harmonization of exemptions across different classes of companies. Emphasis has been made on the importance of harmonizing exemptions and reconciling regulatory goals with the desire for a fully digitalized system.

6. In the article by Primit Chandra Rout, “Depository System Contributions In India Towards The Growth Of The Indian Securities Market”,¹⁰, the author discusses the introduction and growth of the securities demat system in India, with the creation of NSDL as the first depository and the subsequent establishment of CDSL to accelerate the growth of electronic securities in the country. Companies benefit from the Demat system as they receive updated lists of investors from depositories, eliminating the need for printing and dispatching physical certificates. The Demat system reduces paperwork and administrative burden for companies, resulting in cost savings. Companies can easily access the information of their shareholders and maintain accurate records through the electronic system. The Demat system facilitates efficient and faster processing of securities transactions, improving the overall efficiency of the company’s operations.

7. In the article by Divisha Sharma, “The Journey of Indian Depository System: A Critique of Hiccups Accompanying Dematerialization”,¹¹ the author discusses the transition from the traditional trading system to an electronic depository system post the 1992 scam linked to Harshad Mehta. An analysis of the structural advantages and disadvantages of the Indian Depository Framework is presented, along with an identification of the root causes behind the associated scams. These scams predominantly involved fictitious or duplicate shares, enabling market manipulation and investor deception. Additionally, the creation of benami demat accounts facilitated ownership concealment and illegal activities. The author underscores the necessity for an enhanced monitoring mechanism to address forthcoming challenges at the intersection of banking and securities markets. Furthermore, the importance of continually upgrading the domestic financial market to align with global standards in anticipation of future challenges is emphasized.

C. Rationale of the study

The rationale of the study arises from the important role of the depository system in the Indian

¹⁰ Primit Chandra Rout, “*Depository System Contributions In India Towards The Growth Of The Indian Securities Market*”, INDIAN JOURNAL OF LAW AND LEGAL RESEARCH, Vol. 5, pp. 1-15.

¹¹ Divisha Sharma, “*The Journey Of Indian Depository System: A Critique Of Hiccups Accompanying Dematerialization*”, Supremo Amicus, Vol 23, 2020, pp. 1-8.

capital market and the pressing challenges it confronts in the dematerialization of shares of private companies. The challenges include the costs of transitioning to a digital system and adhering to regulatory requirements. It also raises concerns about the effectiveness of share transfer restrictions within the depository system. Furthermore, this shift necessitates technological upgrades, and could influence investor relations and market integrity. Therefore, a comprehensive analysis is essential to understand the full scope of dematerialization's implications, evaluate the regulatory framework's effectiveness, and develop strategies to support stakeholders through this transition.

D. Scope and Limitation

The scope of the research includes the analysis of the dematerialization of shares of private companies under the Indian depository system. The research includes a study of the regulatory framework and an analysis of the problems faced by the system in the dematerialization of shares of private companies. The research also focuses on the rights and obligations of the depository, depository participants, and issuer in the dematerialisation process given in various Acts, regulations, and bye-laws. The limitation of this research is that the research is limited to the analysis of the Indian depository system in the capital market. It covers only the Indian jurisdiction. It focuses only on the dematerialization mandate for shares of private companies.

II. DEPOSITORY SYSTEM IN INDIA

In the present day, initiating the process of opening a demat and trading account has become very easy. It includes visiting a website, inputting necessary details, and clicking the submission button. Within moments, one gains ownership of a new demat and trading account, enabling the seamless buying, selling, and holding of stocks. Another crucial factor is that we can do all these formalities not only from the comfort of our home but also because we are no longer required to be attached to the computer. We can do all the trade and have the needs of the trading account catered by the phone in our pocket. Thus, trading has become easier than before in today's time. But this has not been the case since the start. There has been a whole evolution of the trading system in India. The following discussion provides brief information on the meaning of the depository system, its historical development, dematerialization, and other components of depository system

A. Capital Market

The capital market consists of primary and secondary markets, facilitating the issuance and trading of various financial instruments. In the primary market, new securities are issued by corporations, governments, and other entities to the investing community through prospectuses,

while the secondary market, or stock exchange, enables trading of already issued securities.¹² India's secondary market operates through 22 stock exchanges, supporting liquidity for investors and promoting continuous trading. Key participants in the capital market include merchant bankers, mutual funds, financial institutions, foreign institutional investors, and individual investors, with crucial roles played by intermediaries like stock brokers, registrars, custodians, and depositories to ensure smooth market functioning.¹³

A. Depository System

A depository system enables investors to hold securities in electronic form, akin to a bank holding depositor funds. Sec 2 (e)¹⁴ defines Depository as “*a company formed and registered under the Companies Act, 1956 (1 of 1956) and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992*”. Investors can trade in these securities through Depository Participants (DPs), acting as intermediaries between investors and the depository. Governed by the Depository Act of 1996 in India, depositories and DPs must be registered with SEBI to before offering any services. The depository system represents a modernization in stock trading, transitioning securities into digital form through dematerialization.¹⁵ Functioning as securities banks, depositories streamline the trading and holding of dematerialized securities, offering faster and safer settlement processes. Similar to banks, depositories enable redemption and withdrawal of securities through demat and remat processes, maintain investors' assets electronically, facilitate settlement of securities traded on stock exchanges, and handle off-exchange trade settlements. India's prominent depositories include NSDL and CDSL.¹⁶ No depository shall act as a depository unless it obtains a certificate of commencement of business from SEBI.¹⁷

A. Historical Evolution of the Indian Depository System.

1. Pre-Dematerialization Period

Before the introduction of dematerialization, the Indian stock market operated solely through physical share certificates, which posed numerous challenges. Misplacing these certificates often led to difficulties in recovering them, resulting in frauds, time related issues and trades

¹² Kondaiah Jonnalagadda, SECURITIES LAW, 2015, Lexis Nexis, pp. 6.

¹³ Handbook for NSDL Depository Operations Module, Capital Markets and NSDL-Overview, p 1-2, <https://nsdl.co.in/downloadables/Capital%20Markets%20and%20NSDL%20Overview.pdf>, (visited on March 15, 2024).

¹⁴ Section 2(e) of The Depository Act 1996.

¹⁵ Pravesh Kumar Mann, “*Structure Of The Indian Depository System*”, JOURNAL OF MODERN MANAGEMENT & ENTREPRENEURSHIP, Vol.9, No.4, October 2019, pp.54.

¹⁶ Divisha Sharma, “*The Journey Of Indian Depository System: A Critique Of Hiccups Accompanying Dematerialization*”, SUPREMO AMICUS, Vol 23, 2020, pp. 2.

¹⁷ Section 3 of the Depository Act 1996.

were failed. The traditional settlement system on Indian stock exchanges was inefficient and increased risks due to the time taken to settle trades. Securities were physically transferred, leading to delays and risks. Transferring ownership involved cumbersome processes, with the physical movement of paper securities and endorsement on certificates. This often exceeded the stipulated two-month timeframe, resulting in bad delivery and escalating costs. Instances of theft, forgery, and certificate mutilation were widespread, complicating settlement and investor grievance redressal.¹⁸ Furthermore, the Harshad Mehta Scam that occurred in 1992, shook the Indian stock market, exposing loopholes in regulatory policies and causing a significant market crash. The scam, orchestrated through fictitious practices and forged documents, highlighted the vulnerabilities of the physical trading system. This event triggered a re-evaluation of the settlement system and underscored the need for reforms to enhance market integrity and investor protection. Additionally, there was a growing realization that streamlining the transfer process was essential for the growth of the primary market.¹⁹

2. Post- Dematerialization Period

The journey towards modernizing India's stock market began with the passage of the Depositories Act in 1996, aimed at addressing the challenges plaguing the traditional trading system. This legislation focused on establishing depositories to facilitate the seamless transfer of securities with speed, accuracy, and security. It introduced key provisions such as making securities of public limited companies freely transferable, dematerializing securities, and maintaining ownership records in a book entry form. It also revoked certain discretionary powers of companies regarding securities transfer, simplifying procedures outlined in the Companies Act. The establishment of two depositories, NSDL and CDSL, paved the way for instantaneous electronic transfer of securities, revolutionizing the Indian stock market.²⁰

In alignment with global trends, the Indian government had advocated for a highly technical and automated approach to stock market operations. The enactment of the Depository Act of 1996 marked a significant milestone in the history of dematerialization, streamlining trading and settlement processes that were previously cumbersome and time-consuming. Initiating the dematerialization process, stockbrokers opened DEMAT accounts for investors, facilitating the

¹⁸ Handbook for NSDL Depository Operations Module, Capital Markets and NSDL-Overview, p. 8, <https://nsdl.co.in/downloadables/Capital%20Markets%20and%20NSDL%20Overview.pdf>, (visited on March 15, 2024).

¹⁹ Divisha Sharma, "The Journey of Indian Depository System: A Critique Of Hiccups Accompanying Dematerialization", SUPREMO AMICUS, Vol 23, 2020, pp. 2-3.

²⁰ Handbook for NSDL Depository Operations Module, Capital Markets and NSDL-Overview, p. 9, <https://nsdl.co.in/downloadables/Capital%20Markets%20and%20NSDL%20Overview.pdf>, (visited on March 15, 2024).

conversion of physical certificates into electronic form. This transition made trading more efficient and accessible, akin to the simplicity of managing a bank account.²¹

3. Establishment of NSDL and CDSL

National Securities Depository Limited (NSDL): As India's first and largest depository, NSDL received its certificate of commencement of business on June 7, 1996, and commenced operations on November 8, 1996. The digitization of India's stock market started with the creation of the National Securities Depository Limited (NSDL) in 1996, following the enactment of the Depositories Act. NSDL has played a crucial role in spearheading the dematerialization of share certificates, marking a significant milestone in promoting economic development and ensuring market safety.²² As India's first and largest depository, NSDL established the concept of Demat accounts, allowing investors to hold securities electronically and streamlining trading processes. Its innovative technology solutions enhanced efficiency, reduced risks, and lowered costs associated with transactions, contributing to a more secure and transparent trading environment. It was instrumental in implementing the Depositories Act, 1996, which paved the way for electronic settlement of securities transactions in India. NSDL pioneered the concept of Demat accounts, allowing investors to hold securities in electronic form, thus eliminating the reliance on physical certificates.²³

*“NSDL is supported by the Industrial Development Bank of India (IDBI), Unit Trust of India (UTI), and the National Stock Exchange (NSE). The major stockholders of the NSDL are Axis Bank Limited, Deutsche Bank, HSBC, Citibank, HDFC Bank, Standard Chartered Bank, Dena Bank, Oriental Bank of Commerce, State Bank of India (SBI), Canara Bank”*²⁴

SEBI selects only reputable organizations to serve as depository participants.²⁵ Additionally, NSDL ensures compliance with regulatory authorities such as the SEBI while conducting routine inspections of depository participants and Registrar & Transfer Agents.²⁶

Central Depository Services Ltd (CDSL): In 1999, the Central Depository Services Ltd (CDSL) emerged as the second depository in India, with the Bombay Stock Exchange (BSE) serving as its prime promoter. CDSL was established as a joint venture involving nationalized

²¹ “The Evolution of DEMAT and Trading Account in India”, <https://takhtfinancial.com/the-evolution-of-demat-and-trading-account-in-india/>, (visited on March 10, 2024).

²² Dematerialisation, <https://nsdl.co.in/services/demat.php>, (visited on March 10, 2024).

²³ “Evolution of Demat and Trading Account in India”, <https://www.motilaloswal.com/blog-details/evolution-of-demat-and-trading-account-in-india/20128>, (visited on March 10, 2024).

²⁴ NSDL, “National Securities Depository Limited”, <https://cleartax.in/glossary/nsdl-national-securities-depository-limited/>, (visited on March 10, 2024).

²⁵ Ibid.

²⁶ Sunil Kumar D, National Securities Depository Limited, <https://prepp.in/news/e-492-national-securities-depository-limited-indian-economy-notes>, (visited on March 11, 2024)

banks such as “Bank of Baroda, SBI, and Union Bank of India, along with HDFC and Standard Chartered as participants”. Similar to NSDL, CDSL aimed to provide investors with dependable and cost-effective demat and trading account services, ensuring a worry-free investment experience.²⁷ The primary objectives of CDSL remain focused on offering investors reliable, practical, and secure depository services at competitive prices. CDSL is connected to all major Indian stock exchanges, including the MCX Stock Exchange, NSE, and BSE Ltd., ensuring seamless access for investors across various trading platforms. Depository Participants play a crucial role in the CDSL ecosystem by providing investors with accurate account balances and detailed statements of their assets and transactions, empowering them to make informed investment decisions.

DEMAT accounts offered by CDSL serve as comprehensive repositories for various securities, including stocks, debt instruments, mutual funds, and gold ETFs. This all-in-one solution simplifies investment management and enhances the accessibility and efficiency of trading activities for investors.²⁸

D. Key Features of The Indian Depository System²⁹

Multi-Depository System: In the Indian multi-depository system, each customer benefits from specific advantages tailored to their needs. Depositories, which may operate independently, must adhere to legal and regulatory requirements outlined by the Companies Act, 2013, and must also be registered with the Securities and Exchange Board of India (SEBI).

Depository services through depository participants: Depository services are often provided through intermediary entities known as depository participants, which can include banks offering collateralized debt agreements to borrowers through named debtholders. This arrangement, governed by relevant SEBI regulations, enables various securities transactions.

Dematerialisation: Dematerialization is a key aspect of the Indian corporate landscape, facilitating the transformation of physical share certificates into electronic records credited to the account of the depository participant. This shift reduces reliance on paper-based securities transactions, aligning with the trend towards digitization.³⁰

²⁷ “Evolution of Demat and Trading Account in India”, <https://www.motilaloswal.com/blog-details/evolution-of-demat-and-trading-account-in-india/20128>, (visited on March 10, 2024)

²⁸ “The Evolution of DEMAT and Trading Account in India”, <https://takhtfinancial.com/the-evolution-of-demat-and-trading-account-in-india/>, (visited on March 10, 2024)

²⁹ Prमित Chandra Rout, “Depository System Contributions In India Towards The Growth Of The Indian Securities Market”, INDIAN JOURNAL OF LAW AND LEGAL RESEARCH, Vol. 5, Pp 8-10.

³⁰ B.Hari Babu, et al., “Role of Depositories in Indian Capital Market - A Comparative Study between NSDL and CDSL”, INTERNATIONAL JOURNAL OF SCIENTIFIC AND RESEARCH PUBLICATIONS, Vol. 6, December 2016, pp. 140.

Fungibility: Fungibility is an important concept in dematerialization, as shares lose their individual characteristics upon conversion into electronic form. Once dematerialized, securities become interchangeable, eliminating distinctions based on certificate numbers.

Registered Owner/ Beneficial Owner: In the depository system, ownership of shares is divided between the registered owner and the beneficial owner. While the depository operator (NSDL/CDSL) maintains records of dematerialized shares, the beneficial owner retains ownership rights and obligations. This arrangement ensures that the beneficial owner maintains control over their securities.

Free Transferability of shares: Shares in a depository system are freely transferable, allowing for the easy transfer of ownership reflected in the share registry. This facilitates efficient trading and ensures liquidity in the market.

E. Benefits of Depository System

The depository system offers a multitude of benefits that streamline securities trading and enhance investor confidence. By comprehensively holding all securities listed on a stock exchange, it ensures centralized and efficient management of securities. This fosters trading in genuine shares, increasing activity and trust in the capital market. Moreover, the system's transition to electronic processes reduces paperwork, minimizes delays in registration, and enhances operational efficiency. Security holders enjoy improved liquidity and smoother trading activities. With proper distribution of dividends and interest, seamless conversion of debentures, and collateral security provision, the depository system promotes investor protection and financial flexibility. Its elimination of bad deliveries, expedited settlement cycles, and reduced transaction costs further solidify its role in creating a conducive and investor-friendly trading environment.³¹

F. Disadvantage of Depository System

The depository system, while offering numerous advantages, also presents certain drawbacks that require careful consideration. Discrimination between dematerialized and physical shares could potentially disrupt market transactions, emphasizing the need for measures to ensure fairness in trading. Additionally, the lack of control over certain aspects of the system may pose challenges for regulatory oversight, necessitating enhanced supervision by authorities like SEBI. Effective regulation is crucial to address concerns related to operations such as Clearing and Settlement Corporation management. Moreover, the complexity of the system may prove

³¹ Rajnikant Kumar, "Role And Growth Of Depository System: In Indian Financial Market", INTERNATIONAL JOURNAL FOR INNOVATIVE RESEARCH IN MULTIDISCIPLINARY FIELD, Vol. 6, April 2020, pp.96.

daunting for users, highlighting the importance of user-friendly interfaces and educational initiatives. Instances of malpractice, such as promoters dematerializing shares beyond a company's issued capital or the issuance of duplicate shares, highlight the importance of strong monitoring and enforcement mechanisms to maintain market integrity.³²

G. Dematerialisation and Rematerialisation

Dematerialization, or Demat, involves the conversion process from physical to electronic securities. Consequently, traders utilize Demat accounts to manage securities seamlessly, enabling holding, transferring, and trading without the complications of physical paperwork. This transition has enhanced the safety, speed, and efficiency of trading, eliminating the need for physical securities handling.³³

Rematerialization is essentially the opposite of dematerialization. It involves the conversion of electronic securities and debenture certificates back into physical forms. Investors who previously digitized their securities now have the option to revert them to tangible certificates. Some individuals choose rematerialization to avoid the ongoing maintenance expenses associated with maintaining a Demat account. However, it's important to understand that once securities are rematerialized, all transactions occur solely in physical form. During the rematerialization process, investors are unable to trade their assets on the relevant market.³⁴

1. Parties to the Dematerialization of Shares

Depository Participant: Similar to brokers in the stock market, DP acts as representatives in the depository system. U/s 2(g)³⁵ participant “means a person registered as such under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992”. Depository Participants comprise a diverse range of entities such as brokers, banks, insurance companies, clearing cells of stock exchanges, the Reserve Bank of India, financial institutions, institutional managers, and fund managers. DPs facilitate various services, including maintenance of securities account balances, dematerialization and rematerialization of securities, executing share transactions, and providing periodic updates on holdings.³⁶

Issuer: The issuer refers to the company issuing securities, maintaining a register of owners

³² Shree Bhagwat, Ritesh Omre “A Study on Indian Depository System: Growth & Role In Indian Financial Market”, JOURNAL OF EMERGING TECHNOLOGIES AND INNOVATIVE RESEARCH Vol. 5 no.7, 2018, pp. 26.

³³ What Is Dematerialisation Of Shares?, <https://www.hdfcbank.com/personal/resources/learning-centre/invest/what-is-dematerialisation-of-shares>, (visited on March 10, 2024).

³⁴ “Rematerialisation”, <https://nsdl.co.in/services/remat.php>, (visited on March 20, 2024)

³⁵ Section 2(g) of The Depository Act 1996.

³⁶ FAQ-Dematerialisation, https://www.sebi.gov.in/sebi_data/docfiles/20618_t.html, (visited on March 10, 2024).

and registered depositories and u/s 2 (f)³⁷ issuer “means any person making an issue of securities”.

Beneficial and Registered owner: The beneficial owner is the individual registered with the depository as the effective beneficiary of securities. U/s 2(a)³⁸ beneficial owner “means a person whose name is recorded as such with a depository”. This person engages in buying and selling securities issued by companies, with rights and obligations associated with these investments and u/s 2(j) of the Act, a registered owner is defined as “a depository whose name is entered as such in the register of the Issuer.”

H. Clearing Corporations and Clearing Members

A clearing corporation is an organisation/entity affiliated with a stock exchange whose primary objective is to oversee the handling of confirmation, settlement, and delivery of transactions. They are also referred to as Clearing Firm or Clearing House.³⁹ A clearing corporation has been defined under regulation 2(d)⁴⁰ as

“means an entity that is established to undertake the activity of clearing and settlement of trades in securities or other instruments or products that are dealt with or traded on a recognized stock exchange and includes a clearing house and a limited purpose clearing corporation specified under Chapter IV-A.”

The first role of clearing corporation is clearing, which is a process when the organization acts as intermediary and it also assumes the role of the buyer and seller in order to ease the transactions that occur in the trade. It also includes all the activities that occur from the moment when the trade starts to till the final stage when the trade is settled. Next is settlement, the moment clearing comes to an end, settlement begins. The settlement agency receives securities from the seller who wants to sell his securities and receives cash from buyers who want to buy securities and settles among them.

“Clearing corporations under SEBI include Indian Clearing Corporation, Metropolitan, Clearing Corporation of Indian Limited, Multi Commodity Exchange Clearing Corporation Limited, National Commodity Clearing Corporation Limited, National Securities Clearing Corporation Limited. Clearing corporation under RBI include The Clearing Corporation of India. Clearing corporation under International Financial Services Centres Authority (IFSCA),

³⁷ 2(f) of The Depository Act 1996.

³⁸ 2(a) of The Depository Act 1996.

³⁹ Vishnu, “Clearing Corporation”, <https://cleartax.in/glossary/clearing-corporation/>, (visited on March 20, 2024).

⁴⁰ Regulation 2(d) of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

include India International Clearing Corporation”.⁴¹

A clearing member is defined as under regulation 2(e)⁴² as -

“a person having clearing rights in any recognized clearing corporation and includes a clearing member as defined in clause (ae) of sub-regulation (1) of Regulation 2 of the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992.”

The primary function of a Clearing Member (CM) involves facilitating the transfer of securities to and from Clearing House or Clearing Corporations, either on their own behalf or on behalf of their clients. Securities earmarked for delivery can be transferred directly from the client’s account or via the CM’s account to the account of the Clearing House or Clearing Corporation. Likewise, securities for pay-out can be transferred directly to the client’s account based on information provided to the Clearing House by the CM, or through the CM’s account.⁴³

The trading market in India went through an ups and downs to reach the present state of stability and growth. With the implementation of various reforms and policies, the market has become more regulated and transparent, attracting both domestic and international investors. The introduction of online trading platforms has also made it easier for individuals to participate in the market, further boosting its popularity and liquidity. Overall, the trading market in India has come a long way and is now considered as a key player in the global financial market. Thus, the depository system in India plays a crucial role in facilitating the trading and settlement of securities in a safe and efficient manner. Additionally, the system allows for easy transfer of securities, making it more convenient for investors to buy and sell shares in the stock market. Overall, the depository system has revolutionized the way securities are held and traded in India, leading to increased transparency and investor confidence in the financial markets.

III. REGULATORY FRAMEWORK FOR DEMATERIALISATION IN INDIAN DEPOSITORY SYSTEM

The whole working of the depository system in India is regulated by legal provisions. To have an understanding of the working of the dematerialization process under the depository system, it becomes essential to have an understanding of the legal provisions as well as the regulatory bodies that govern the dematerialization process in the depository system in India in the capital market.

⁴¹ List of Clearing Corporations, <https://www.sebi.gov.in/clearing-corporations.html>, /,(visited on March 20, 2024).

⁴² Regulation 2(e) of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

⁴³ Clearing Member, <https://www.cdslindia.com/CM/How-to-become-cm.html#>,(visited on March 20, 2024)

A. Legal Provisions for Dematerialisation in Depository System

1. **The Depository Act, 1996:** In order to solve problems with the deposit process, such as misaligned certificates and "bad delivery" because of incomplete documentation, the Act was enacted. The legislation sought to address certificate theft, forgery, mutilation, and inconsistencies while also offering a legal basis for electronic record ownership systems.⁴⁴

Certificate of security: Individuals entering agreements under section 5 must return the security certificate they wish to deposit to the issuer according to regulations' specifications.⁴⁵ Every person subscribing to securities offered by an issuer shall have the option either to receive the security certificates or hold securities with a depository.⁴⁶

Rights and obligations of depository: A depository has to enter into agreement with one or more participants as its agent.⁴⁷ The depository's dealings with participants will be regulated by an agreement, wherein the participant acts as an agent of the depository as outlined in Section 4(1) of the Act. A depository is deemed to be the registered owner of the securities, but he doesn't have any voting rights or any other rights in regard to the securities held by it.⁴⁸ If any loss is caused to the beneficial owner due to negligence of the depository or participant, the depository has to indemnify the beneficial owner.⁴⁹ To claim compensation is it essential that there must be negligence on the part of the depository or the depository participant.⁵⁰ All the securities that are held by the depository must be dematerialized and be in fungible form.⁵¹ Rights and obligations of depositories, participants and the issuers whose securities are dealt with by a depository shall be specified by the regulations. Each depository is required to provide the issuer with periodic updates regarding the transfer of securities held by beneficial owners.⁵² Additionally, every depository must maintain a registry of beneficial owners.⁵³

Further under the bye laws of CDSL, the role of depository in relation to dematerialization⁵⁴ and rematerialization⁵⁵, is given which needs to be followed by the depository participant.

⁴⁴ Sneha Mishra,,Role of depository and participants, SEBI 1992, The Times of India, July 14, 2021, <https://timesofindia.indiatimes.com/readersblog/myblogpower/role-of-depository-and-participants-sebi-1992-35190/>,(visited on March 14, 2024).

⁴⁵ Section 5 of The Depository Act, 1996.

⁴⁶ Section 8 of The Depository Act, 1996.

⁴⁷ Section 4 of The Depository Act, 1996.

⁴⁸ Section 10 of The Depository Act 1996.

⁴⁹ Section 16 of The Depository Act 1996.

⁵⁰ An Insight into the Depositories Act, 1996, <https://rna-cs.com/an-insight-into-the-depositories-act-1996/>,(visited on March 20, 2024).

⁵¹ Section 9 of The Depository Act 1996.

⁵² Section 13 of The Depository Act 1996.

⁵³ Section 11 of The Depository Act 1996.

⁵⁴ Bye law 9.2 of National Securities Depository Limited Bye-Laws as amended in 2023.

⁵⁵ Bye law 9.4 of National Securities Depository Limited Bye-Laws as amended in 2023.

Under the same the rights and obligations have been given, some of which are that participant must enter into an agreement with the Depository before conducting business. They act as an agent and are liable to the client for their actions. The bye-laws of CDSL provide for admission of participants⁵⁶ to the depository and the admission criteria⁵⁷ for the same. They also provide for rights and obligations of the participant, beneficial owner, and issuer in regard to account opening,⁵⁸ dematerialization⁵⁹, re-materialization.⁶⁰

Rights of the beneficial owner: He is entitled to all the rights and benefits and is subjected to all the liabilities in respect of the securities held by him.⁶¹

Penalties: Section 19 A to 19G deals with penalties under the Act, includes penalties for failure to furnish information, enter into agreement, redress investors grievances, failure to reconcile records and their penalty amounts to one lakh rupees per day of non-compliance or one crore rupees, whichever is lower. Any issuer, its agent, or registered intermediary failing to dematerialize or issue securities certificates upon opting out of a depository by investors, as required by law, will face a penalty. This penalty amounts to one lakh rupees per day of non-compliance or one crore rupees, whichever is lower.⁶²

2. Securities and Exchange Board of India (Depositories and Participant) Regulations 2018

SEBI introduced these regulations to oversee different aspects of depository laws. These regulations cover the registration process for depositories, issuance of business commencement certificates, participant registration, and specifics regarding the responsibilities and rights of depositories, participants, and issuers etc.⁶³

The regulation stipulates that a depository cannot be established without obtaining registration from the Board as per the Depositories Act and its regulations.⁶⁴ If the Board finds, upon review of the application and qualifications, that the applicant's company is suitable to serve as a depository, it may issue the registration certificate.⁶⁵ The depository must have a net worth of

⁵⁶ Bye law 5.1 of Central Depository Services Limited Bye Laws as amended in 2024.

⁵⁷ Bye law 5.2 of Central Depository Services Limited Bye Laws as amended in 2024.

⁵⁸ Bye law 13.1 of Central Depository Services Limited Bye Laws as amended in 2024.

⁵⁹ Bye law 13.2 of Central Depository Services Limited Bye Laws as amended in 2024.

⁶⁰ Bye laws 13.5 of Central Depository Services Limited Bye Laws as amended in 2024.

⁶¹ Section 10(3) of the Depository Act 1996.

⁶² Section 19 D of the Depository Act 1996.

⁶³ SEBI Act 1992, & SEBI (Depositories and Participants) Regulations, 1996, <https://www.teamleaseregtech.com/resources/acts/article/176/sebi-act-1992-sebi-depositories-and-participants-regulations-1996/>,(visited on March 20, 2024).

⁶⁴ Section 3 of the Depository Act 1996.

⁶⁵ Regulation 6,7 of Securities And Exchange Board of India (Depositories And Participants) Regulations 2018.

not less than rupees 100 crores.⁶⁶ Regulation 42 specifies the securities eligible for dematerialization within the depository, including shares, stocks, bonds, debentures, and Indian Depository Receipts, among others.

Registration of participant

To become a participant, applicants must fill out Form F from the First Schedule and submit it to the depository they intend to work with. The depository then forwards the application, along with its recommendations and certification of eligibility, to the Board within thirty days.⁶⁷ The applicant must also belong to one of the categories mentioned in regulation 35.⁶⁸ If the Board deems the applicant eligible, it grants the certificate of registration.⁶⁹ A participant holding a certificate can operate with another depository with approval from that depository.⁷⁰

Rights and obligations of Depositories

Every depository must ensure efficient coordination with issuers or their agents, as well as participants, to reconcile ownership records of securities on a daily basis⁷¹ and continuous electronic communication channels must be maintained with all of them.⁷² Furthermore, mechanisms must be in place to adequately protect the interests of individuals trading securities within the depository system⁷³. Participants should be allowed to withdraw or transfer their accounts according to stipulated conditions. The integrity of electronic records must be maintained to prevent loss or tampering.⁷⁴ Furthermore, cooperation with relevant entities is required for effective clearance, payment of securities transactions.⁷⁵

Rights and obligations of Depository Participant

Participants must adhere to agreements with beneficial owners, as outlined in the depository's bye-laws.⁷⁶ Participants to open separate accounts for each beneficial owner, ensuring segregation of securities.⁷⁷ Participants must provide statements of account to beneficial owners⁷⁸, and allow withdrawals or transfers as per the agreement.⁷⁹ Continuous electronic

⁶⁶ Regulation 14 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁶⁷ Regulation 32 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁶⁸ Regulation 35 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁶⁹ Regulation 36 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷⁰ Regulation 38 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷¹ Regulation 44 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷² Regulation 45 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷³ Regulation 46 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷⁴ Regulation 53 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷⁵ Regulation 55 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷⁶ Regulation 58 of Securities and Exchange Board of India (Depositories and Participants) Regulation 2018.

⁷⁷ Regulation 59 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷⁸ Regulation 60 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁷⁹ Regulation 61 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

communication with the depository is required⁸⁰, along with internal control reviews⁸¹ and daily reconciliation⁸². Electronic record integrity must be ensured⁸³, and separate records maintained for dealings with multiple depositories.⁸⁴ A depository must guarantee fair and transparent access to everyone, without showing bias to its associates or related entities..⁸⁵

Rights and obligations of Issuer

Every issuer with dematerializable securities must establish an agreement with the depository, except when the depository is the issuer or if government securities are issued by the State or Central Government.⁸⁶ When an issuer or investor chooses to hold securities in dematerialized form, the issuer must establish an agreement with the depository to facilitate this process for the investor.⁸⁷ Beneficial owner grievances must be addressed within thirty days, with issuers or their agents keeping the depository informed.⁸⁸ Continuous electronic communication with the depository is required,⁸⁹ and issuers must provide various information regarding events like book closures, dividend payments, and meetings as per the depository's bye-laws or agreement.⁹⁰

Dematerialisation Process

Beneficial owners must inform the participant about the securities they wish to dematerialize and surrender the physical certificates to the participant or their appointed custodian. Upon receiving this information, the participant forwards the details to the depository and confirms the agreement between them and the beneficial owner. The participant maintains records of the surrendered securities and the names of the beneficial owners. Within seven days, the participant provides details of the surrendered securities to the issuer along with the physical certificates. Upon receipt, the issuer confirms to the depository if the securities are listed on the relevant stock exchanges, mutilates and cancels the physical certificates, and updates the depository's records. The depository records the beneficial owner's details and the participant's information upon receiving confirmation from the issuer and informs the participant accordingly. The issuer maintains a record of dematerialized securities.⁹¹ Reconciliation

⁸⁰ Regulation 62 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸¹ Regulation 63 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸² Regulation 64 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸³ Regulation 67 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸⁴ Regulation 68 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸⁵ Regulation 82 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸⁶ Regulation 70 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸⁷ Regulation 43 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸⁸ Regulation 72 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁸⁹ Regulation 77 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁹⁰ Regulation 78 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁹¹ Regulation 74 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

between dematerialized securities and all issued securities is performed daily by the issuer or its agent, except for Government securities, where the depository handles reconciliation daily.⁹²

If a depository or participant breaches any rules outlined in the Acts, bye-laws, agreements, or regulations, fails to provide required information, doesn't cooperate with the board, they will be subject to actions outlined in the Securities and Exchange Board of India (Intermediaries) Regulations, 2008. Similarly, if an issuer or its agent breaches the laws the Board can take action against them under the Depositories Act.⁹³

3. Securities contract (regulation) (Stock Exchange and Clearing Corporation) regulations 2018.

The purpose of the regulation is to oversee the management, ownership, and operations of stock exchanges and clearing corporations. According to the regulation, recognized stock exchanges and clearing corporations must retain all documents pertaining to securities issuance or transfer for a minimum of eight years. A recognized clearing corporation's capital structure should ensure that at least half of its equity share capital is held by one or more recognized stock exchanges, with none of them holding more than 15%.⁹⁴ Furthermore, admission criteria⁹⁵ is given under bye laws of NSDL. Under the bye laws of CDSL the admission of clearing corporation⁹⁶, admission criteria⁹⁷, and rights and obligations of clearing corporation⁹⁸ have been provided.

To conduct organize or assist in organizing any stock exchange or clearing corporations recognition has to be obtained from the Board.⁹⁹ Application for recognition as a stock exchange and as a clearing corporation has to be submitted in Form A and B respectively.¹⁰⁰ The application must comply with certain conditions like being a company limited by shares, being demutualized, having fit and proper persons¹⁰¹, meeting ownership and governance structure requirements, meeting net worth requirements, and having the necessary capability.¹⁰² Recognized stock exchanges and clearing corporations are required to hold their securities in

⁹² Regulation 75 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁹³ Regulation 92,93 of Securities and Exchange Board of India (Depositories and Participants) Regulations 2018.

⁹⁴ Regulation 18 of Securities Contract (Regulation) (Stock exchange and clearing corporation) regulations 2018.

⁹⁵ Bye law 6.6 of National Securities Depository Limited Bye-Laws as amended in 2023.

⁹⁶ Bye law 8.1 of Central Depository Services Limited Bye Laws as amended in 2024.

⁹⁷ Bye law 8.2 of Central Depository Services Limited Bye Laws as amended in 2024.

⁹⁸ Bye law 8.3 of Central Depository Services Limited Bye Laws as amended in 2024.

⁹⁹ Regulation 3 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

¹⁰⁰ Regulation 4 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

¹⁰¹ Regulation 20 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

¹⁰² Regulation 47 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

digital, dematerialized form.¹⁰³

Rights of clearing corporation

Recognized clearing corporations have priority in recovering dues from their clearing members for fulfilling their clearing and settlement obligations. They can recover these dues the clearing members before any other liabilities or claims are settled.¹⁰⁴

Obligations of Clearing Corporations

One of the obligations of clearing corporation is that every recognized stock exchange must, as determined by the Board, employ the services of recognized clearing corporations for clearing and settling its trades starting from a specified date.¹⁰⁵ A recognized stock exchange may utilize a recognized clearing corporation through a written agreement, detailing their rights, obligations, admission terms, risk management strategies, and fees. If engaging multiple clearing corporations, a multipartite agreement is necessary for interoperability. The exchange must also provide its arbitration mechanism for resolving trade disputes.¹⁰⁶ When a recognized clearing corporation plans to expand its services to a specific stock exchange segment or accepts new securities for clearing and settlement, it must obtain approval from the Board.¹⁰⁷ Clearing corporations must adhere to board-specified norms for profit and investment utilization, requiring prior approval for treasury investments. They can engage in unrelated activities through separate legal entities, further employees cannot work for other companies.¹⁰⁸ Other obligation includes to establish a policy framework to prevent discrimination in clearing and settlement services for trades executed on shareholder and non-shareholder stock exchanges.¹⁰⁹

Companies Act, 2013

Sec 29 provides that every company conducting a public offer and any other class of public companies specified by regulations must issue securities exclusively in dematerialized form, adhering to the requirements of the Depositories Act, 1996, and its regulations. Any company not falling under the categories mentioned in subsection (1) may either convert its securities into dematerialized form or issue them in physical form according to the provisions of this Act, or in dematerialized form as per the regulations outlined in the Depositories Act, 1996.

¹⁰³ Regulation 46 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

¹⁰⁴ Regulation 44 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

¹⁰⁵ Regulation 34 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

¹⁰⁶ Regulation 35 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

¹⁰⁷ Regulation 36 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018

¹⁰⁸ Regulation 38 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018

¹⁰⁹ Regulation 39 of Securities contract (regulation) (Stock exchange and clearing corporation) regulations 2018.

Securities and Exchange Board of India Act, 1992

According to section 12 (1A) No entity involved in the securities market, such as depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies, or other intermediaries specified by the Board, can engage in buying, selling, or dealing in securities without obtaining registration from the Board under regulations established by this Act. However, individuals acting in these capacities before the Securities Laws (Amendment) Act, 1995, and were not previously required to register, can continue their activities until regulations are formulated under clause (d) of sub-section (2) of section 30.

Payment and Settlement Act 2007

Under the Act, any organization or individual looking to establish or manage a payment system must first obtain permission from the Reserve Bank in accordance with the guidelines set forth in the Act.¹¹⁰ Section 5 requires individuals or entities to submit an application to the Reserve Bank, to initiate or continue a payment system. The Reserve Bank has the authority to conduct inquiries to verify information authenticity and applicant capability¹¹¹, and criteria for authorization issuance or refusal, considering factors like system necessity, technical standards, and consumer interests.¹¹² Authorized systems must adhere to terms and conditions outlined by the Reserve Bank, while Section 20 mandates compliance with Act provisions, regulations, and directives. There must be transparent disclosure of terms and charges to participants, along with providing copies of relevant rules.¹¹³ Confidentiality of participant information is a mandated, with disclosure only as required by law or with explicit consent.¹¹⁴ Settlement procedures among participants must follow Reserve Bank-approved guidelines for finality and legal adherence.¹¹⁵

B. Evolution of the regulatory regime governing Dematerialization

The Depository Act mandated that all securities held by these depositories must be in electronic form, a significant departure from the traditional paper-based system. Subsequently, a pivotal amendment to the Companies Act in 2000 stipulated that listed companies making public offers of INR 10 crores or more must issue shares exclusively in dematerialized form. Recognizing the drawbacks of physical share certificates, highlighted in a 2004 SEBI committee report, such as high printing costs and susceptibility to theft, the need for dematerialization became more

¹¹⁰ Section 4 of Payment and Settlement Act 2007.

¹¹¹ Section 6 of Payment and Settlement Act 2007.

¹¹² Section 7 of Payment and Settlement Act 2007.

¹¹³ Section 21 of Payment and Settlement Act 2007.

¹¹⁴ Section 22 of Payment and Settlement Act 2007.

¹¹⁵ Section 23 of Payment and Settlement Act 2007.

apparent. The Companies Act of 2013 further mandated dematerialization for all public offers of securities by listed companies, with subsequent rules expanding this requirement to unlisted public companies in 2018. These regulatory milestones highlight the evolution towards a fully dematerialized securities market in India, aimed at enhancing efficiency and security while reducing costs and risks associated with physical certificates.¹¹⁶ In 2014, the Ministry of Corporate Affairs (MCA) extended the requirement of holding securities in dematerialized form to unlisted public companies in India through the Companies (Prospectus and Allotment of Securities) Rules, 2014 (PAS Rules). This was further reinforced by amendments made on September 10, 2018, which imposed mandatory obligations on unlisted public companies under Rule 9A of the PAS Rules. These rules mandated that securities must be issued and held only in dematerialized form, with exceptions for certain entities such as Nidhi companies, government companies, and wholly owned subsidiaries (WOS). Moreover, amendments in 2019 to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 barred listed companies from accepting requests for the transfer of securities held in physical form after April 1, 2019.

In October 2023, the MCA introduced further amendments to the PAS Rules, known as the PAS 2023-Amendment. These amendments introduced Rule 9B, requiring private companies to issue and facilitate dematerialization of all securities, in line with the Depositories Act, 1996. It also mandated that securities holders of private companies comply with dematerialization requirements, with exceptions for small private companies and government companies. These regulatory changes aim to harmonize the framework governing dematerialization, albeit with certain differential treatments for various types of entities.¹¹⁷

C. Regulatory Body

Securities Exchange Board of India: Established in 1988 under the Securities and Exchange Board of India Act, 1992 the SEBI serves as the regulatory authority overseeing India's stock market. SEBI's primary goal is to safeguard the interests of retail investors and maintain market efficiency. It monitors three key stakeholders: securities issuers, investors, and financial sector intermediaries. For securities issuers, SEBI ensures transparent conduct of initial public offerings (IPOs) and subsequent public offerings. It protects investors by preventing fraud and

¹¹⁶ Dematerialization Mandate for Private Companies: Navigating Transparency & Challenges, <https://indiacorplaw.in/2023/12/dematerialization-mandate-for-private-companies-navigating-transparency-challenges.html>, (visited on March 20, 2024).

¹¹⁷ Bharath Reddy, et al., "Enforcing progressive compliance: Push for digitalisation by dematerialising shares of all Companies," <https://corporate.cyrilamarchandblogs.com/2023/11/enforcing-progressive-compliance-push-for-digitalisation-by-dematerialising-shares-of-all-companies/> (visited on March 20, 2024).

market manipulation, crucial for maintaining investor trust and confidence. SEBI also regulates financial intermediaries facilitating transactions between issuers and investors, ensuring the smooth and safe operation of financial transactions within the stock market. SEBI Notifications, issued by the regulatory body, play a crucial role in regulating the securities market in India, serving various purposes aimed at maintaining market integrity and efficiency. Through these notifications, SEBI implements its policies and laws, ensuring compliance and adherence to established standards.¹¹⁸

D. Judicial Pronouncements

In the case of *Probir Kumar Misra v. Ramani Ramaswamy*¹¹⁹, it was held that following the enactment of the Depositories Act, 1996, depositors holding equity share capital of a company and listed as beneficial owners are also considered members of the company, thereby qualifying them as members under the Act.

*PTC India Financial Services Limited v. Venkateswarlu Kari and Another*¹²⁰, in this case, the court clarified the Depositories Act's impact on share pledging, stating that depositories simply convert securities from physical to digital form, known as DEMAT securities. Under the law, the depository is the registered owner, while the beneficial owner, who surrenders physical shares, holds ownership of the fungible share. Thus, the registered owner and beneficial owner are distinct, with the latter being the entity authorized to make decisions regarding trading, transactions, and transfers of the dematerialized security.

In the case of *K.L.A. Padmanabhasa and Another v. Securities & Exchange Board of India and Another*¹²¹, the issue concerns the dematerialization of shares held by the appellants. Despite their request, the company refused, fearing the appellants would sell their shares post-dematerialization, which they believed was not in the company's best interest. The appellants complained to SEBI, citing a violation of Regulation 31(2) of the LODR Regulations, mandating 100% promoter shareholding in dematerialized form. SEBI closed the case without addressing the alleged violation. The appellants appealed, and the Tribunal ruled in their favor, directing SEBI to order the company to dematerialize the appellants' shares within four weeks.

¹¹⁸ Dasari Rajesh Babu, "The SEBI Role in Indian Stock Market", INTERNATIONAL JOURNAL FOR RESEARCH IN ENGINEERING APPLICATION & MANAGEMENT, 2019, pp. 91-92.

¹¹⁹ *Probir Kumar Misra v. Ramani Ramaswamy*, 104 SCL 174

¹²⁰ *PTC India Financial Services Limited v. Venkateswarlu Kari and Another*. (CA No. 5443 of 2019).

¹²¹ *K.L.A. Padmanabhasa and Another v. Securities & Exchange Board of India and Another* 2023 SCC OnLine SAT 407.

In the case of *National Securities Depository Ltd. v. Kamlesh Shah and Others*¹²², an appeal u/s 10F of the Companies Act was filed on a dispute concerning the ownership and rectification of dematerialized shares. The appellant, NSDL, challenged an order from the Company Law Board directing them to issue notices and make decisions regarding dematerialized shares. The appellant argued that their role is limited to administrative functions related to share transfers and that they lack the authority to adjudicate ownership disputes. The appellate authority quashed the part of the order against NSDL, highlighting their restricted role and emphasizing that ownership disputes should be settled elsewhere, following applicable laws and regulations.

In the case of *Canaan International Infotech Limited v. The Adjudicating Officer, Securities and Exchange Board of India SEBI*¹²³, an appeal was filed to challenge the order, where a monetary penalty of Rs. 5,04,000/- was imposed on the appellant for breaching Regulation 54(5) of the Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996. The regulation mandates timely dematerialization of securities upon receipt of requests, which the appellant failed to comply with, resulting in a considerable backlog of 252 pending requests. Despite the appellant's explanation citing financial difficulties and organizational changes, the adjudicating officer upheld the penalty, considering the seriousness of delays in dematerialization. The appellant's argument for leniency based on financial constraints was rejected, emphasizing the stringent penalties mandated by Section 19D of the Depositories Act. Consequently, the appeal was dismissed, affirming the penalty imposed by the adjudicating officer.

A. Case Studies

Dalmia Scam (2001), in a fraudulent scheme led by Dinesh Dalmia and DSQ Biotech Ltd. promoters, duplicate shares were created, inflating share prices in the secondary market. Dalmia issued extra capital to Mauritius-based companies, further boosting prices. Physical shares with identical numbers were illegally sold. SEBI imposed a penalty of Rs. 630 Crore on Dalmia and banned him and DSQ Biotech promoters from market access for 10 years. Despite SEBI's directives, Dalmia evaded share buyback for 14 years, leading to a Rs. 1 Crore fine in 2019, following an earlier Supreme Court order to deposit Rs. 30 Crore with SEBI in 2016.¹²⁴

¹²² *National Securities Depository Ltd. v. Kamlesh Shah and Others* (2013) 113 CLA 239.

¹²³ *Canaan International Infotech Limited v. The Adjudicating Officer, Securities and Exchange Board of India SEBI*, 2010 SCC OnLine SAT 34.

¹²⁴ "BACKSTORY: The spectacular rise of Dinesh Dalmia and the all-too-familiar fall of a scamster", Cnbctv.18, February 12, 2021 <https://www.cnbctv18.com/business/backstory-the-spectacular-rise-of-dinesh-dalmia-and-the-all-too-familiar-fall-of-a-scamster-8291901.htm>, (visited on March 21, 2024).

The IPO scam, in 2005, The IPO Scam unfolded during Yes Bank's public offering, revealing fictitious bank and Demat accounts operated by Roopalben Panchal and associates. During Yes Bank's IPO, 6,315 applications with identical addresses were submitted under different names, exposing the scam. Karvy Stock Broking, the Depository Participant (DP), failed to detect these irregularities, flagged by SEBI's surveillance system. SEBI uncovered around 45,000 additional benami Demat accounts aimed at IPO shares for small investors in IDFC. SEBI tightened regulatory measures, holding entities like depositories, DPs, registrars, and brokers accountable. Stricter systems at NSDL and CDSL were implemented to eliminate multiple Demat accounts. The Know Your Customer (KYC) process was introduced, and intermediaries were directed to enhance surveillance and investigation capabilities.¹²⁵

Karvy Demat Scam, in the 2019 Karvy Stock Broking Fraud, the Hyderabad-based brokerage firm exploited clients' dematerialised securities by creating unauthorized pledges, leading to a fraudulent scheme totaling approximately Rs. 2000 Crore. The misconduct was uncovered due to delayed payouts and a significant sum transferred to Karvy Realty, a group company. SEBI and NSE investigations revealed Karvy's false claims of client securities as their own, prompting regulatory amendments. Responsibility for legitimate pledges shifted to depositories, requiring investor consent. Both BSE and NSE suspended Karvy's membership, with penalties imposed and securities transferred back to investors' accounts. This incident prompted regulatory changes, including the prohibition of securities pooling and expanded definitions of pledge under SEBI regulations.¹²⁶

In some cases, the SEBI has issued orders against companies for not following the mandate of dematerialisation. Some of them are –

In the case of Alfavision Overseas (India) Limited¹²⁷, the company faced scrutiny over investor grievances and dematerialization delays. SEBI investigated complaints of price manipulation in the company's stock. The investigation uncovered significant price fluctuations and suspicious volumes, with sub-brokers linked to the company. In June 2003, SEBI issued a notice to Alfavision Overseas for various violations, including market manipulation and dematerialization failures. The company's response citing staff shortages was deemed insufficient. Consequently, SEBI imposed a two-year ban on Alfavision Overseas from capital

¹²⁵ N Sundaresha Subramanian, "The scam that changed India's primary market", Business Standard, Aug 02 2016, https://www.business-standard.com/article/markets/the-scam-that-changed-india-sprimary-market-116080101718_1.html, (visited on March 21, 2024).

¹²⁶ Swati Bharadwaj, Partha Sinha, "Karvy demat scam: Here's how the scam played out", Times of India, Aug 20, 2021, <https://timesofindia.indiatimes.com/city/hyderabad/karvy-scam-heres-how-it-unfolded/articleshow/85471866.cms>, (visited on March 21, 2024).

¹²⁷ 2003 SCC OnLine SEBI 235.

market activities to safeguard investor interests and deter fraudulent practices, effective immediately, marking regulatory action against market malpractices.

In the case against Motorola Enterprises Ltd., for Delay in Dematerialisation of Shares¹²⁸, u/s 19 of the Depository Act 1996, the order addresses the delayed dematerialization of shares reported by NSDL and CDSL. Despite regulatory mandates for timely completion, numerous dematerialization requests remained pending for over 30 days, adversely affecting shareholders' ability to trade promptly. MEL attributed the delay to financial disputes with their R&T agents but failed to meet obligations, violating SEBI regulations. In response, SEBI directed MEL to complete all pending dematerialization requests within one month and submit a compliance report. Non-compliance would lead to MEL's restriction from accessing the securities market and dealing in securities for two years, highlighting the importance of timely dematerialization to safeguard shareholder interests.

In the case against Baroda Rayon Corporation Ltd., for Delay in Dematerialisation of Shares¹²⁹, SDL and CDSL informed SEBI that 1778 dematerialization requests were pending for over 30 days as of December 12, 2003. BRCL attributed the delay to financial disputes with their Registrar & Transfer Agent (R&T Agent) and assured SEBI of resolving the pending requests promptly. After a personal hearing, BRCL provided evidence of reducing the dematerialization backlog to zero, which was confirmed by CDSL. Consequently, SEBI decided against issuing adverse directions under Section 19 of the Depositories Act, 1996, against BRCL.

Re: Maharashtra Polybutenes Ltd.¹³⁰, SEBI investigated irregular trading in Maharashtra Polybutenes Ltd. (MPL) shares, suspecting violations of SEBI Act, 1992. Despite previous losses, there was sudden trading surge and price increase over five months. Section 10 of the Depositories Act, 1996 states depository-recorded beneficial owners hold all securities rights and liabilities. Misleading disclosures to BSE misled investors about stable promoter shareholding, recurring over four quarters, which led to the company being held liable.

From the above discussion, it can be seen that various Acts and regulations are there which govern the working of the Indian depository in the capital market. From the analysis of the case laws and case studies the issue of dematerialization is taken very seriously and any depository who doesn't follow it has to face penalties. Though these regulations are there still there exist scams that have shaken the financial market. The issue of dematerialization has slowly grown and the mandate for the same has spread from public companies to private companies. However,

¹²⁸ 2005 SCC OnLine SEBI 62.

¹²⁹ 2005 SCC OnLine, SEBI 24.

¹³⁰ Re : Maharashtra Polybutenes Ltd , SAT Appeal No.:[331/2018].

the mandate of dematerialization for the private introduced for improving efficiency and transparency has brought some issues and challenges with it, which affects the shareholder and needs to be addressed. The following chapter will discuss the issues and challenges.

IV. ISSUES AND CHALLENGES

Dematerialization of shares refers to the conversion of physical shares and securities into digital or electronic formats. Until recently, only public companies were mandated to adhere to this provision under Section 29 of the Companies Act, 2013. However, the incorporation of Rule 9B into the Companies (Prospectus and Allotment of Securities) Rules, 2014 ("PAS Rules 2014") extends this regulatory requirement to private companies as well, thereby discontinuing the issuance of physical share certificates.¹³¹

The Ministry of Corporate Affairs (MCA) has implemented a significant modification in the Company (Prospectus and Allotment of Securities) Rules, 2014, through the second amendment rules dated October 27, 2023. As per the amendment, all private companies, excluding small companies, are obligated to convert their securities into Demat form within 18 months from the closure of the Financial Year ending on March 31, 2023. The PAS 2023-Amendment introduces Rule 9B, which mandates private companies to issue securities exclusively in dematerialized form and facilitate the dematerialization of all securities in accordance with the provisions of the Depositories Act, 1996. Furthermore, private companies involved in various activities subsequent to the compliance date must ensure the dematerialization of securities held by promoters, directors, and key managerial personnel. Furthermore, securities holders of private companies must dematerialize securities before the transfer or ensure dematerialization for subscriptions made post-compliance date, akin to requirements for unlisted public companies.¹³²

A. Rationale behind the Mandate

The government's decision to enforce dematerialization for private companies marks a significant step forward in enhancing the country's financial sector. This move aims to make things efficient, transparent, and safer for both businesses and investors. There are several reasons behind this change. Firstly, it's about tackling issues like shell companies and identity fraud, which have been more common in the private sector compared to public companies. Dematerialization helps by keeping a digital record of all transactions, making it much harder

¹³¹ Diya Parvati, "Dematerialisation of Securities of Private Companies: Ushering a New Era of Transparency", <https://www.ccl.nluo.ac.in/post/dematerialisation-of-securities-of-private-companies-ushering-a-new-era-of-transparency>, (visited on March 21, 2024).

¹³² Ibid.

for people to hide their ownership through fraudulent means.

Furthermore, dematerialization will make it easier for government authorities to identify who truly owns a company's shares. This move allows for seamless integration of personal account numbers and Aadhaar details, making it simpler for regulators to verify genuine ownership and prevent misuse, ultimately making the market more transparent. Another benefit of dematerialization for private companies is how it will simplify the process of foreclosure. Since shares will exist in electronic form, there's no need to deal with physical certificates anymore. This means no more hunting down and retrieving paper certificates, which can be a time-consuming hassle, especially if the shares are pledged by multiple parties..¹³³

B. Issues and challenges:

Following are the issues and challenges faced in the dematerialization of shares of private companies: -

Holding - Subsidiary companies: As per the updated PAS Rules, all private companies, excluding small or government ones, are obligated to comply with dematerialization conditions for their securities. This includes subsidiaries and holding companies, regardless of their turnover or share capital. For foreign corporations operating in India through private company subsidiaries, this poses a practical challenge. They're required to open demat accounts with SEBI-registered DPs to convert their shares into digital form. This process involves providing extensive KYC information to the DP and obtaining a PAN from Indian tax authorities. There are associated fees for opening and maintaining demat accounts, which may lengthen investment timelines, especially for first-time foreign investors in private Indian companies.¹³⁴ The KYC process and dematerialization requirements are anticipated to slow down the transfer process for securities currently held in physical form. This could impact timelines for mergers, acquisitions, and private equity transactions. First-time investors in India may face additional hurdles, as they need to obtain a PAN, complete KYC procedures, and open a demat account.¹³⁵

No exemption granted to WoS of private companies: The 2018 Amendment Rules exempt wholly-owned subsidiaries (WoS) of unlisted public companies from the dematerialization

¹³³ "Dematerialization Mandate for Private Companies: Navigating Transparency & Challenges", <https://indiakorplaw.in/2023/12/dematerialization-mandate-for-private-companies-navigating-transparency-challenges.html>, (visited on March 21, 2024).

¹³⁴ Palomita Sharma, et al., "Mca's Digital Leap: Dematerialization Of Securities By Private companies", <https://nishithdesai.com/SectionCategory/33/Research-and-Articles/12/43/NDAHOTLINE/12823/1.html>, (visited on March 21, 2024).

¹³⁵ "Enforcing progressive compliance: Push for digitalisation by dematerialising shares of all Companies", <https://corporate.cyrilamarchandblogs.com/2023/11/enforcing-progressive-compliance-push-for-digitalisation-by-dematerialising-shares-of-all-companies/>, (visited on March 21, 2024).

requirement. However, this exemption doesn't apply to WoS of private companies under the updated PAS Rules. So, a private company acting as a WoS of another private company still needs to follow dematerialization requirements. On the flip side, if a private company serves as a WoS of a public company and is deemed a public company, it retains the exemption from the 2018 Amendment Rules. This inconsistency in regulations may create confusion and unequal treatment among various types of wholly-owned subsidiaries, depending on their parent company's nature. Educating stakeholders, including shareholders and employees, about the dematerialization process poses a challenge. Moreover, staying compliant with evolving regulatory requirements for dematerialization can be burdensome for WoS, necessitating continuous efforts to ensure adherence. While dematerialization can improve efficiency, its impact on the overall control structure of WoS may be limited, particularly for those wholly owned and controlled by a parent company.¹³⁶ The exception only includes small private companies and government companies but no exemption for Nidhi Companies, Section 8 Companies or for WOS. This creates unnecessary and unjustified differential treatment and the rationale behind this is unclear.¹³⁷

Constraint on share transfer in depository system: A key aspect of private companies, as defined by the Act, is that the transfer of shares or securities within such entities is always governed by the restrictions and procedures outlined in their Articles of Association (AoA). This principle remains unchanged regardless of whether the securities are held in physical or dematerialized form. Although the recent directive for dematerializing securities in private companies, as per the Amended PAS Rules, is now operational, it must not compromise this obligation. In the practical operation of the depository system, the Depository Participant (DP) holds the authority to process dematerialized share transfer requests directly. This can be done based on executed Delivery Instruction Slips (DIS) submitted by the transferor, without necessarily requiring approval from the company, especially in the case of private companies, to ensure compliance with AoA restrictions. This issue creates potential problems because it challenges the traditional control mechanisms established by private companies to govern the transfer of shares or securities. With shares held electronically by depositories, direct transfers are facilitated, potentially overriding company articles of association ("AoA") restrictions. By allowing DPs to process dematerialized share transfers without the need for company approval,

¹³⁶ Gunjan Gupta, "Dematerialization Mandate: A WOS Perspective", <https://singhania.in/blog/dematerialization-mandate-a-wos-perspective>, (visited on March 22, 2024).

¹³⁷ "India – Enforcing Progressive Compliance: Push For Digitalisation By Dematerialising Shares Of All Companies", <https://conventuslaw.com/report/india-enforcing-progressive-compliance-push-for-digitalisation-by-dematerialising-shares-of-all-companies/>, (visited on March 21, 2024).

there is a possibility that transfers could occur in violation of AoA restrictions. Balancing the advantages of dematerialization, such as efficiency and transparency, with the imperative of maintaining control over ownership structure and safeguarding shareholder interests is imperative.¹³⁸

Challenges in Enforcing Restrictive Covenants: The move to mandatory dematerialization means shares are now stored electronically with depositories like NSDL and CDSL, and all transfers take place through depository participants (DPs). While this system ensures speed and efficiency, it also weakens traditional safeguards for enforcing shareholder restrictions such as the Right of First Refusal (ROFR), tag-along, and drag-along rights. Earlier, physical transfer of shares required company oversight, which made monitoring these restrictions easier. In the digital format, however, transfers can happen almost instantly, leaving little room for companies or other shareholders to step in before their contractual rights are affected.¹³⁹

Control over nominee shareholding under depository system: In situations involving wholly-owned subsidiaries (WoS) or similar arrangements, it's common for the registered owner and the beneficial owner of securities to be different. For instance, according to Section 187(1) of the Act, a company can hold shares in its subsidiary through nominee(s) to fulfill the minimum shareholder requirement. Additionally, Section 89 of the Act requires the declaration of beneficial interest in shares with the Registrar of Companies (RoC) when the registered and beneficial owners are not the same. These principles also apply to securities held in dematerialized form.

Under Section 10 of the Depository Act, 1996, the depository acts as the registered owner but without voting rights. On the contrary, the beneficial owner retains all rights and benefits associated with the securities. Furthermore, all shareholders are considered beneficial owners within the depository system, even if they are acting as nominees. This legal framework may pose practical challenges for holding companies aiming to control the actions of nominee shareholders. Therefore, it's essential for beneficial owners and nominees to carefully consider these conceptual and procedural differences before engaging in such arrangements in the future.¹⁴⁰

Transition Challenges: The PAS 2023-Amendment introduces a heightened compliance

¹³⁸ Supra Note 133.

¹³⁹ Makarand Lele, "The Shift to Dematerialization: Challenges in Protecting Shareholder Rights for Private Companies", <https://www.icsi.edu/media/webmodules/CSJ/October-2024/21.pdf>, (visited on August 21, 2025).

¹⁴⁰ Sharad Abhyankar, et al., "Dematerialisation of Shares of Private Companies", <https://www.khaitanco.com/thought-leaderships/Dematerialisation-of-Shares-of-Private-Companies>, (visited on March 21, 2024).

requirement for holding securities within a relatively short 18-month window for compliance.¹⁴¹ This presents a significant challenge, especially given the large number of registered companies in India, totaling 24,61,937. These factors raise concerns about the readiness of NSDL and CDSL systems and IT infrastructure to handle the potential influx of applications for converting physical securities to demat form, while also acknowledging the emotional significance attached to physical certificates.¹⁴²

Furthermore, some families and individuals have a sentimental attachment to physical securities, considering them as cherished legacy assets passed down through generations. Additionally, certain investors are hesitant to embrace dematerialization due to the reluctance to pay annual account maintenance charges, particularly among small long-term shareholders. This hesitation is exacerbated when dividends are minimal or non-existent, leading to the accumulation of charges over time. Moreover, incidents such as brokers defaulting on their obligations, exemplified by the case of Karvy Stock Broking, whose trading license was suspended, have heightened investor apprehensions. In such scenarios, investors bear the consequences of Depository Participant (DP) defaults, as shares become inaccessible once a DP is suspended by the regulator, hindering the transfer process to another DP.¹⁴³

Legal Consequences and Potential Disputes: This shift increases the risk of disputes when restrictive rights are overlooked in the electronic process. For instance, if a shareholder sells shares in violation of an ROFR clause and the depository system does not raise any red flag, the aggrieved party may turn to litigation for breach of contract. Courts may then be required to interpret how such contractual rights interact with the dematerialized framework, potentially setting new legal precedents. Over time, this could reshape how shareholder rights are enforced in private companies, highlighting the tension between modern efficiency and traditional contractual protections.¹⁴⁴

Logistical Challenges: Lastly, the shift to dematerialization might present logistical obstacles for securities holders who have undergone name, address, or residential status changes, or in cases where jointly held securities are now unclaimed due to the demise of holders without proper documentation or nomination. Furthermore, situations where physical certificates are inaccessible would necessitate companies to issue duplicate certificates to facilitate the

¹⁴¹ Diya Parvati, “Dematerialisation of Securities of Private Companies: Ushering a New Era of Transparency”, <https://www.ccl.nluo.ac.in/post/dematerialisation-of-securities-of-private-companies-ushering-a-new-era-of-transparency>, (visited on March 21, 2024).

¹⁴² Supra Note 116.

¹⁴³ Divisha Sharma, “The Journey of Indian Depository System: A Critique Of Hiccups Accompanying Dematerialization”, SUPREMO AMICUS, Vol 23, 2020, pp. 6.

¹⁴⁴ Supra Note 138.

dematerialization process, initiating a one-time clean-up endeavour.¹⁴⁵ Conversely, disputes may arise if multiple investors claim ownership based on physical certificates in their possession.¹⁴⁶

The PAS 2023-Amendment represents a forward-looking transition, although, as mentioned earlier, it may not be entirely favourable to stakeholders. On the positive side, it promises enhanced protection for security holders by mitigating risks such as disputes, litigation, theft, and forgery through the adoption of a digitalized system. Transitioning to a transparent and more efficient format would also assist regulatory bodies in monitoring and safeguarding securities. However, a significant concern arises regarding whether the current infrastructure is equipped to manage such a substantial change.. There are worries that the transition to a digitalised mechanism may be too abrupt for some stakeholders who are not technologically savvy or do not have access to the necessary resources. It will be crucial for regulatory bodies to provide adequate support and guidance to stakeholders during this transition period to ensure a smooth and successful implementation of the PAS 2023-Amendment.

V. CONCLUSION AND SUGGESTIONS

A. Conclusion

The Indian depository system plays a pivotal role in the capital market landscape, offering efficiency, transparency, and security to investors and companies alike. Through a detailed analysis of its structure, laws, and operational dynamics, it can be seen that depository system's ability to streamline the process of buying and selling securities has been a game-changer for market participants, cutting down on paperwork and reducing the risk of fraud. Overall, the Indian depository system is a crucial component of the financial ecosystem, constantly evolving to meet the needs of a rapidly changing market environment.

The depository system has grown a lot over time, it has transitioned from physical shares to mandatory dematerialization. Which has had a positive effect on working, efficiency, and transparency. Concerning the complexities of dematerialization mandates and compliance hurdles, it's necessary to remember the human element at the heart of the capital market. Behind every share certificate and electronic entry lies a shareholder, entrusting their investments to the system with the expectation of protection and prosperity. It is this human element that should drive the continual improvement and innovation of the depository system. By putting the needs and concerns of shareholders at the forefront, it can be ensured that the system remains robust

¹⁴⁵ Supra Note 136.

¹⁴⁶ Supra Note 134.

and reliable. As the SEBI strives to uphold the integrity of the market and protect the interests of investors, it is essential to remember the ultimate goal of fostering growth and prosperity for all stakeholders involved. In doing so, it can lead to building a financial ecosystem that is not only efficient and secure but also transparent and equitable for all.

While challenges such as compliance burdens, cost implications, and logistical hurdles may seem daunting, they also present opportunities for innovation, collaboration, and regulatory refinement. By harnessing the power of technology, stakeholder engagement, and regulatory foresight, it can be easy to overcome these challenges and pave the way for a more resilient, inclusive, and investor-friendly depository system. Through strategic partnerships and continuous dialogue with stakeholders, it can be ensured that the market remains transparent and secure for all participants. By embracing new technologies and streamlining processes, the efficiency of the depository system can be enhanced and reduce costs for investors. Ultimately, by prioritizing the needs and expectations of shareholders, it can build a stronger and more sustainable investment ecosystem for the future. Through the analysis of the case laws and the case studies it can be seen that SEBI has always been in support of the dematerialization of shares and that too within a specified timeline. Those not adhering to had to face penalties, which is harmful for their reputation in the market and causes loss not only to the companies but to their investors too.

The recent mandate to dematerialize shares has brought with it certain issues and challenges that need to be addressed to bring out the effect for which it has been brought. The issues of overriding the AOA, no exemption granted to WOS of private companies, and transition and logistical challenges, without addressing these issues, the reason for which this mandate has been brought cannot be fully achieved. There is a need to solve these issues so that timely dematerialisation of the shares can happen and no harm comes to the companies and their stakeholders. Thus, the hypothesis stands proved that the mandatory dematerialization of shares in private companies in India is likely to face hurdles due to compliance, cost, and operational challenges.

B. Suggestions

After critically analysing the issue the researcher observed that to address the issues and challenges observed in this area, certain suggestions can help in better implementation of the PAS 2014 mandate.

- Offering assistance and guidance to first-time investors through online platforms or dedicated support services to help them navigate the PAN application, KYC procedures,

and demat account opening process smoothly. Provide guidance and support to companies, especially smaller ones, to navigate the compliance process. Establish dedicated support programs or helplines staffed by experts who can assist companies in understanding and fulfilling dematerialization requirements. This can be done through online chat support, dedicated helpline or online guides.

- Provide clear guidelines and explanations regarding dematerialization requirements for WoS of private companies to avoid confusion and ensure consistent treatment.
- To mitigate risks related to share transfer restrictions, private companies are advised to implement effective measures at the depository level, such as freezing ISINs, and to communicate legal limitations outlined in their charter documents to depository participants. This ensures that DPs adhere strictly to AoA restrictions before processing any share transfer requests.
- For nominee shares, creating a joint demat account between actual and nominee shareholders can be beneficial. Additionally, integrating restrictions on share transfer or pledges into the Articles of Association or freezing ISINs for specific purposes can further safeguard against unauthorized transactions.
- Launch comprehensive campaigns to raise awareness about dematerialization requirements, benefits, and risks. Conduct educational workshops, seminars, and advertising campaigns targeted at investors, companies, and other stakeholders to explain the benefits, risks, and procedures of dematerialization. Increased awareness fosters a better understanding and acceptance of dematerialization, encouraging broader participation and smoother transitions in the market.
- To prioritize updating IT infrastructure during the interim period to ensure the successful implementation of the mandatory dematerialization requirement. This can be done by investing in advanced technologies enhances the security, efficiency, and reliability of dematerialization systems, reducing the risk of fraud, hacking, or system failures, thereby increasing investor trust and participation.
- In response to the complications arising from dematerialization, private companies may need to update their shareholder agreements and Articles of Association to ensure restrictive rights remain enforceable in an electronic system. This could mean inserting clauses requiring Depository Participants (DPs) to recognize such covenants, creating electronic approval procedures, and aligning all provisions with laws like the Companies

Act, 2013, and SEBI regulations. Company Secretaries will play a key role in ensuring these changes are legally compliant.

- To safeguard against unauthorized share transfers, companies can formally instruct DPs to restrict debits on specific ISINs and execute tripartite agreements with DPs and Registrars/Transfer Agents (RTAs) to clearly define transfer protocols. Restrictions can also be reflected in each shareholder's Beneficial Owner (BO) account to prevent unapproved activity. Strengthening approval mechanisms is critical as companies may require board or committee consent, issue No Objection Certificates (NOCs), and implement digital signatures or online approval systems. These measures integrate corporate governance with depository processes, helping private firms maintain control and enforce shareholder rights effectively in the dematerialized framework.
- To ensure compliance with transfer restrictions in a dematerialized shareholding system, private companies must adopt a multi-pronged approach. First, regular internal audits and compliance checks with Depository Participants (DPs) help detect and prevent unauthorized transfers, supported by periodic reports from the DP. Shareholder agreements should also explicitly acknowledge these restrictions, with penalty clauses included to discourage violations, though obligations under the Articles of Association already bind shareholders by default.

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