

IN BRIEF

MANDATORY DEMATERIALISATION OF SHARES FOR PRIVATE LIMITED COMPANIES



A. Introduction

Previously, only 'listed companies' were required to dematerialize (DEMAT) their existing securities and issue new securities in DEMAT form. Starting October 2, 2018, however, the Ministry of Corporate Affairs (MCA) had mandated that all 'unlisted public companies' must also DEMAT their existing securities and issue new ones in DEMAT form.

Recently, private companies, not classified as small companies based on their audited financial statements for the financial year ending on or after March 31, 2023, were given 18 (eighteen) months to DEMAT their existing securities and issue new ones only in DEMAT form.

To enhance transparency and disclosures among both foreign and domestic investors, the MCA introduced mandatory DEMAT of securities for private limited companies through the Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023 (Amendment) on October 27, 2023. This Amendment introduced Rule 9B, which mandates the issuance of securities in DEMAT form and to facilitate the DEMAT of securities by private limited companies.

B. Benefits of Dematerialization

Despite the challenges, the DEMAT of securities offers several advantages:

- **Enhanced transparency:** The move is expected to bring greater transparency to ownership structures.
- **Improved security:** The DEMAT of securities reduces the risk of loss, theft, or damage, which share certificates were otherwise subject to, enhancing investment security.
- **Efficient transactions:** Electronic shares facilitate faster transaction processes, leading to quicker settlement and transfer times.
- **Real-time monitoring:** Investors can easily track their shareholdings.
- **Simplified share management:** The DEMAT of securities streamlines the storage and administration of financial securities, offering ease of use and accessibility to investors.

The transition to DEMAT shares would make the Indian financial securities market easier, safer, and more efficient. While the process presents initial hurdles, it promises long-term benefits for both foreign investors and startups in the evolving corporate landscape.

C. Compliance Requirements

Under Rule 9B of the Amendment, every private company, that is not a small company under the Companies Act, 2013 (Act), as of March 31, 2023, must facilitate the DEMAT of their shares by September 30, 2024, or within 18 (eighteen) months from the end of the financial year in which they no longer qualify as a small company (De-Mat Last Date).

The Amendment specifies that after the De-Mat Last Date, any new issuance of securities by private companies must be solely in DEMAT form. Private companies planning to buy back shares, issue bonus shares, or undertake a rights issue must ensure that their promoters, directors, and key managerial personnel hold securities in DEMAT form.

While the Amendment does not prohibit holding shares of a private company in physical form, any person holding such shares must convert them into DEMAT form to transfer them after the De-Mat Last Date. Therefore, any transfer of shares after this date necessitates a DEMAT of the shares.

D. Steps for Private Companies to Dematerialize Securities

To comply with these regulations, private companies must follow a series of steps to DEMAT their securities, as follows:

i. *Private companies to obtain ISIN*

The first step in the DEMAT process is to obtain an International Securities Identification Number (ISIN) for each type of security issued by the company through a registrar and transfer agent. An ISIN is a unique 12-character alphanumeric code that serves as a standardized identifier for securities in the global financial markets.

ii. *Private companies to engage with depository*

Private companies must engage with depositories to facilitate the DEMAT process. In India, there are 2 (two) registered depositories: the National Securities Depository Limited (NSDL) and the Central Depository Services (India) Limited (CDSL).

iii. *Private Companies to inform their shareholders requesting them to tender the DRF*

Once a private company has obtained an ISIN, it must notify its shareholders of the same and request them to tender their physical share certificates along with a DEMAT request form (DRF), such that the DEMAT of their shares could be completed.

iv. *Shareholders to tender the DRF seeking DEMAT*

The final step involves converting physical share certificates into electronic form. This process requires every shareholder to open a DEMAT account with a Depository Participant and tender their physical share certificates to the Depository Participant with the DRF.

E. Non-Compliance

There are no specific penalties that are stipulated for non-compliance with this new DEMAT requirement. The Act, however, specifies that where no specific penalty or punishment is provided, a penalty under Section 450 of the Act will be levied on the company and every officer of the company who is in default, amounting to a penalty of Rs. 10,000/- (Rupees ten thousand), and in case of a continuing contravention, with a further penalty of Rs. 1,000/- (Rupees one thousand) for each day after the first during which the contravention continues, subject to a maximum of Rs. 2,00,000/- (Rupees two lakh) in case of a company and Rs. 50,000/- (Rupees fifty thousand) in case of an officer who is in default. There is an in-built restriction set out in this new requirement that serves as a quasi-penalty, whereby on one hand, a private company will not be able to either issue or transfer or buy back its shares without complying with the DEMAT obligations, and on the other hand, a shareholder will not be able to transfer/ sell its/ their shares without complying with the DEMAT requirement.

Therefore, it is imperative that private companies adhere to the Amendment, to avoid potential penalties and legal consequences.

F. Conclusion

The present Amendment aligns with a broader movement towards digitalization and modernization in the financial sector, strengthening securities management, improving transparency, and aligning with prevailing trends. DEMAT and digitization of the entire share capital and shareholder data on a pan-India basis will facilitate weeding out benami shareholders, expedite transactions, and enhance ownership tracking mechanisms. The MCA's latest Amendment aims to institutionalize transparency and corporate accountability on a national scale.

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