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DEMATERIALIZATION MANDATORY FOR ISSUE AND TRANSFER OF SECURITIES OF UNLISTED PUBLIC COMPANIES

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Introduction

While answering a question on dematerialisation of shares of unlisted companies during the Question Hour session of the Lok Sabha on 29 December 2017, the Ministry of Corporate Affairs (MCA) had expressed its intention of making it mandatory for unlisted public companies to issue shares in dematerialised form only. The MCA also mentioned that it has carried out consultations with the Securities and Exchange Board of India (SEBI), depositories and other stake holders, to determine the feasibility of this move in a phased manner. The rationale behind the proposed move was to provide greater transparency in shareholding and share transactions, better acceptance of such shares as collateral, and mitigation of disputes and risks associated with securities issued in physical form.

Furtherance to the intentions expressed above, the MCA has, on 10 September 2018, issued the Companies (Prospectus and Allotment of Securities) Third Amendment Rules, 2018 (Amendment Rules). The Amendment Rules *inter alia* make it mandatory for every unlisted public company to (i) issue the securities only in dematerialised form, and (ii) facilitate the dematerialisation of all its existing securities. The Amendment Rules will be effective from 2 October 2018.

Rationale for Amendment Rules

The MCA issued a press release dated 11 September 2018 to clarify that the Amendment Rules are being introduced to enhance transparency, investor protection, and governance in the corporate sector. The MCA envisages the benefits to include:

- Elimination of risks associated with physical certificates such as loss, theft, mutilation, fraud, etc.
- Improving the corporate governance system by increasing transparency and preventing mal-practices, such as benami shareholding, and the back dated issuance of securities.
- Exemption from payment of stamp duty on transfer.
- Ease in transfer, and pledge, etc. of securities.

Overview of the Amendment Rules

Applicability. Pursuant to the Amendment Rules, the onus is on both unlisted public companies, as well as every holder of securities of such companies, to dematerialise their securities.

Obligations of unlisted public company. The Amendment Rules impose the following key obligations on unlisted public companies:

- securities are to be issued only in dematerialised form;
- facilitate the dematerialisation of all outstanding securities;
- ensure that the entire holdings of promoters, directors, and key managerial personnel are dematerialised prior to making an offer for issue or buyback of securities, or for issue of bonus shares or shares on a rights basis; and
- comply with regulations and guidelines issued by the SEBI and depositories with respect to the dematerialisation of shares.

Consequences of payment defaults. In addition to the above obligations, the Amendment Rules require unlisted companies to make timely payments to depositories, registrars to issue, and share transfer agents, including the requirement to maintain a security deposit of at least two years' fee. If an unlisted public company fails to comply with the above payment obligations, then the unlisted public company cannot offer or buyback securities, or issue bonus shares or shares on a rights basis until it makes all outstanding payments to applicable agencies.

Reporting requirements. The Amendment Rules require unlisted companies to submit audit reports on half-yearly basis with the jurisdictional registrar of companies. The requirement for such audit reports has been linked to the requirements set out in Regulation 55A of the SEBI (Depositories and Participants) Regulations, 1996. The aforesaid regulations *inter alia* require listed companies to submit reports, audited by a qualified chartered accountant or practicing company secretary, on a quarterly basis to concerned stock exchanges for purposes of reconciliation of the total issued capital, listed capital and capital held by depositories in dematerialised form, details of changes in share capital during the quarter, in-principle approval obtained by companies from all concerned stock exchanges in respect of further issued capital and updated status of register of members.

Duties of holders of securities of unlisted public company. Every holder of securities of an unlisted public company who intends to: (a) transfer any securities on or after 2 October 2018, can do so only if the securities are dematerialised; and (b) subscribe for securities of an unlisted public company on or after 2 October 2018, can do so only if all such holder's existing securities are in dematerialised form.

Application of SEBI Regulations. The SEBI (Depositories and Participants) Regulations, 1996 and the SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 will apply *mutatis mutandis* to the dematerialisation of securities of unlisted public companies.

Comments

The MCA has exercised its powers to make rules under Section 29(1)(b) of the Companies Act, 2013, to issue the Amendment Rules. The SEBI has reportedly stated that its depository regulatory framework enables such prescription by the MCA. While the introduction of the Amendment Rules appears to be a welcome move by the MCA, we believe that the Amendment Rules could have certain unintended consequences on unlisted public companies. Some key concerns could be as follows:

1. Unlisted public companies have been given less than a month to dematerialise their securities. Unlisted public companies will have to undertake corporate actions, such as passing resolutions for dematerialisation of shares and ensuring that their articles of association are amended to permit the issuance of dematerialised shares. In addition, unlisted public companies will also have to undertake the process of obtaining an International Security Identification Number (ISIN), facilitate the opening of demat accounts for their shareholders and the subsequent conversion of all their securities into dematerialised form. The above actions would require coordination with and the participation of third parties, including appropriate agencies and authorities, to ensure compliance with the Amendment Rules within the prescribed deadline.
 2. Non-resident shareholders of unlisted public companies, who do not hold a Permanent Account Number (PAN) with Indian income tax authorities, will be required to apply for a PAN solely for purposes of opening a demat account.
 3. Not all information required to be disclosed under Regulation 55A of the SEBI (Depositories and Participants) Regulations, 1996, would apply to unlisted public companies. For instance, the requirement of in principle approval from stock exchanges is redundant. The MCA will likely have to amend the audit reporting requirements in the Amendment Rules to specify the requirements under Regulation 55A with which unlisted public companies would have to comply.
 4. Unlisted public companies and their shareholders will now have to incur a number of additional expenses pursuant to the requirements of the Amendment Rules.
 5. While the transfer of dematerialised shares does not require parties to pay stamp duty, the requirement to stamp duty at present continues to apply to the issuance of dematerialised securities. In the absence of specific amendments to applicable stamp duty legislations, there also exists confusion with regard to the instrument on which stamp duty is payable in case of an issue of dematerialised securities. State and central stamp authorities would have to coordinate with each other and depositories to either eliminate the requirement to pay stamp duty on the issuance of dematerialised securities or clarify manner of payment.
 6. The Amendment Rules do not provide any clarity on whether they apply to deemed public companies (private companies which are subsidiaries of public companies). In the absence of such clarity, it appears that deemed public companies may also have to comply with the Amendment Rules.
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