

## ERGO

*Analysing developments impacting business*

### DEMATERIALIZATION OF SHARES OF PRIVATE COMPANIES

6 November 2023      Recently, by way of a notification dated 27 October 2023 (Amendment), the Ministry of Corporate Affairs (MCA) amended the Companies (Prospectus and Allotment of Securities) Rules, 2014 (PAS Rules), inserting a new rule<sup>1</sup>, to require every private company (other than small company and government company) (Private Company) to dematerialise all its securities, issue securities only in dematerialised form and permit transactions in securities only in a dematerialised form. Until now, only public companies were required to do this.

Notified more than a decade ago, Section 29 of the Companies Act, 2013 (Companies Act) (successor of Section 68B of the Companies Act, 1956) brought in the requirement for a public offer of securities by listed public companies and other companies, as prescribed, to be in a dematerialised form. Section 29 of the Companies Act was notified on 12 September 2013 and the PAS Rules were promulgated on 1 April 2014. With effect from 2 October 2018, all unlisted public companies were brought within the ambit of Section 29 of the Companies Act. Now with the Amendment, all private companies (other than small companies and government companies) have also been brought within the purview of Section 29 of the Companies Act, with the introduction of Rule 9B of the PAS Rules. Section 29 of the Companies Act now appears to be fully implemented.

#### OVERVIEW OF THE AMENDMENT

Applicability of the Amendment:

The Amendment is applicable to a Private Company as defined under the Companies Act except for: (a) small company, i.e., a private company with a paid-up share capital of INR 4 crores or below, and turnover of INR 40 crores or below; and (b) government company. In this context, it is relevant to note that there is no exemption for companies incorporated under section 8 of the Companies Act.

Timeline for compliance:

Every private company, which is not a small company as on or after 31 March 2023, shall be required to comply with the new requirements within 18 months of closure of such financial year (Compliance Date). Accordingly, the Compliance Date for every private company (other than a small company) as on 31 March 2023 would be 30 September 2024.

---

<sup>1</sup> Rule 9B of PAS Rules (*issue of securities in dematerialised form by private companies*)

Compliance requirements:

With effect from the respective Compliance Date for a Private Company, the Private Company will be required to (a) issue 'securities' only in dematerialised form; and (b) facilitate dematerialization of all its securities.

*Issue and buyback of securities:* Further, every Private Company while making any offer for issue of any securities or buyback of securities or issue of bonus shares or rights offer, shall ensure that before such offer is made, the securities of the Private Company held by its promoters, directors, key managerial personnel have been dematerialised. Accordingly, as a prerequisite to a Private Company proposing to invite new investments, the securities of the promoter, director and key managerial personnel of such Private Company will have to be dematerialised.

*Transfer of securities:* In the event any person holding any securities in a Private Company intends to transfer them, such person will have to dematerialize such securities before undertaking the transaction. This would require the buyer to also receive the securities in dematerialized form.

*Private placement, bonus shares or rights offer:* In case any individual holding security in a Private Company, subscribes to any securities of such Private Company, whether by way of private placement, bonus shares or rights offer, then such individual is required to dematerialize all the securities held, prior to such subscription.

*Relevant laws to comply with for dematerialisation:* Every Private Company will be required to ensure compliance with the Depositories Act, 1996 (Depositories Act), the Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018 (SEBI D&P Regulations) and the Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993. Further, every Private Company shall submit Form PAS-6 (*Half yearly return for reporting of shares held in Demat form*) to the Registrar of Companies (ROC), along with the relevant fee, within 60 days from the conclusion of each half-year, duly certified by a company secretary in practice or chartered accountant in practice.

*Interaction with depository(ies):* Every Private Company shall ensure the following with respect to interaction with depository:

- (a) Timely payment of fees (admission as well as annual) to the depository and registrar to an issue and share transfer agent in accordance with the agreement executed between the parties.
- (b) At all times, maintenance of security deposit (deposit not being less than 2 years' fees) with the depository and registrar to an issue and share transfer agent, in such form as may be agreed between the parties.
- (c) Compliance with the regulations or directions or guidelines or circulars, if any, issued by the Securities and Exchange Board of India (SEBI) or the depository from time to time with respect to dematerialisation of shares of Private Companies and matters incidental or related thereto.

If a Private Company, fails to comply with the above, then such company shall be restricted from making any offer of any securities, buyback of securities, issue any bonus or right shares, until all the outstanding payments have been duly made to the depositories or registrar to an issue and share transfer agent.

Further, in case the Private Company observes any difference in its issued capital and the capital held in dematerialised form, it is the responsibility of the Private Company to immediately bring such discrepancy to the notice of the depository(ies).

*Mechanism for dealing with grievance(s) of security holder:* Any grievance(s) with respect to dematerialization of securities or transactions in dematerialized form will be adjudicated by the Investor Education and Protection Fund Authority (IEPFA). IEPFA shall have the right to initiate any action against a depository, depository participant, registrar to an issue or the share transfer agent, after prior consultation with the SEBI.

## COMMENT

There are more than 14.45 lakh active private companies in India and account for about 95% of the total companies incorporated in India. This Amendment does not impact ongoing subscription and share sale transactions, as this Amendment will require compliance by 30 September 2024. This will create further complexity for foreign companies as opening a dematerialized shares' account in India requires significant Know Your Customer (KYC) information, and also obtaining a permanent account number with Indian tax authorities. This will therefore increase the lead time for first time foreign investors to invest in Indian companies.

To enable such large number of private companies to undertake the dematerialization process, depositories, depository participants and share transfer agents would be required to garner resources and undertake capacity building measures. This will also increase compliance costs for private companies. Further, to ensure compliance with Rule 9B of PAS Rules, the MCA and corporate governance professionals such as company secretaries, chartered accountants and lawyers will have to undertake awareness programs across the length and breadth of the country. In view of this, the timeline of 30 September 2024 to comply with Rule 9B of the PAS Rules appears to be fair and adequate time.

Dematerialization and digitization of the entire share capital and shareholders' data on a pan-India basis will facilitate weeding out benami shareholders, expeditious transactions, and ownership tracking mechanism. MCA, with the latest Amendment, seems to be taking a leap towards institutionalizing transparency and corporate accountability for the nation at large.

While dematerialization of securities is being mandated under the Amendment, it does not foreclose the option of a security holder to continue to hold such securities in a physical form. However, as and when the person decides to transact in such securities after 30 September 2024, dematerialization would be mandatory prior to initiating the transaction.

Depositories and depository participants form the backbone of the robust infrastructure of the vibrant securities market in India. The Depositories Act imposes significant responsibilities on depositories including registration of security transfer on intimation from a depository participant, and protection of the integrity of the security issues and security holders. Regulation 55 of SEBI D&P Regulations obligates a depository to cooperate with participating entities for the effective, prompt and accurate clearance and settlement of securities transactions and conduct of business. The Depositories Act also holds a depository accountable for any errors in transactions in securities and provides that without prejudice to the provisions of any other law for the time being in force, any loss caused to the beneficial owner due to the negligence of the depository or the participant, the depository shall indemnify such beneficial owner.

Under Companies Act, private companies are recognized by certain basic features and attributes which distinguish them from public companies, viz.: (a) restriction on transfer of shares / securities in a manner prescribed by articles of association, (b) prohibition to invite members of the public to subscribe to any securities of the company, and (c)

number of members of the company shall not exceed 200 except in certain exceptional circumstances. The Amendment is not intended to amend the basic structure of a Private Company.

Operationally, at the time of applying for dematerialization, private companies should inform the depositories about the restrictions in its charter documents and request both depository and depository participant to act in such manner so as to preserve, protect and effectively enforce and implement the inherent restrictive characteristics of such Private Company. The Depositories and Depository Participants will have to evolve uniform practices to ensure that dematerialization does not enable any rogue security holder to bypass the restrictive covenants in the charter documents of a Private Company. However, this is not a new issue as various private companies in the past have had their shares dematerialized.

In terms of action items, pursuant to the Amendment, every Private Company is required to:

1. Obtain the International Securities Identification Number (ISIN) for all existing securities issued by it;
  2. Promote, propagate and facilitate dematerialization of all its existing securities by the holders of such securities;
  3. Once the share capital of the Private Company is dematerialised, the Private Company must issue securities only in dematerialized form;
  4. Ensure that prior to any issue of securities, all the securities held by its promoters, directors and key managerial personnel are held in dematerialised form; and
  5. File form PAS-6 with ROC in the manner and within the time, as prescribed.
- *Sharad Abhyankar (Partner), Sameer Sah (Partner), Saranya Mishra (Senior Associate) and Priyal Sanghvi (Associate)*

For any queries please contact: [editors@khaitanco.com](mailto:editors@khaitanco.com)

*We have updated our [Privacy Policy](#), which provides details of how we process your personal data and apply security measures. We will continue to communicate with you based on the information available with us. You may choose to unsubscribe from our communications at any time by clicking [here](#).*