

Dematerialization of securities for private companies – and its implications under other allied laws

1. Background

Earlier in 2018, the Government had mandated unlisted public companies in India to issue securities and facilitate dematerialization of all its existing securities. Similarly, the Ministry of Corporate Affairs ('MCA') vide notification dated 27th October 2023 has now published the Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023 ('Notification'). The Notification has introduced Rule 9B to the Companies (Prospectus and Allotment of Securities) Rules, 2014 requiring private companies to issue securities only in dematerialized form and facilitate dematerialization of all its existing securities in accordance with the Depositories Act, 1996 and regulations made thereunder, within the timelines specified.

In this alert we have captured the applicability, timeline for compliance and few consequential implications of the mandatory dematerialization of securities.

2. Applicability

- The new Rule 9B requires every private company, other than a small company¹ and government company² ('qualified private company'), to comply with the mandatory dematerialization of securities.
- It is to be noted that while the Rule excludes a "small company" from undertaking the aforesaid compliances, the definition of small company excludes a holding company or a subsidiary company. In other words, a holding company or a subsidiary company would not be treated as a small company (even if they satisfy the threshold limits applicable to small companies), and hence such companies would have to undertake mandatory dematerialization of securities.
- It is imperative to note that, Rule 9A of the Companies (Prospectus and Allotment of Securities) Rules, 2014 which introduced the dematerialization for unlisted public companies states that every unlisted public company must issue securities only in dematerialized form and facilitate dematerialization of all its securities. However, there was a specific exclusion provided to unlisted public company which is a **wholly owned subsidiary**.

¹ As per Section 2(85) of Companies Act, 2013 ('Cos Act'), 'Small company' means a company, other than a public company,—

(i) paid-up share capital of which does not exceed rupees four crore; and
(ii) turnover of which as per profit and loss account for the immediately preceding financial year does not exceed rupees forty crore.

Provided that nothing in this clause shall apply to —

(A) a holding company or a subsidiary company;
(B) a company registered under section 8; or
(C) a company or body corporate governed by any special Act

² As per Section 2(45) of Cos Act, 'Government company' means any company in which not less than fifty-one per cent of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

- The below table summarizes the various scenarios where dematerialization is applicable in case of a holding / subsidiary relationship:

| Holding company (Note 1) | Subsidiary company | Demat applicability (for the Holding company) | Demat applicability (for the Subsidiary company) |
|---------------------------------|---------------------------|--|---|
| Private Company | Private Company | Since small company test is failed, shares would have to be dematerialized under Rule 9B. | Since small company test is failed, shares would have to be dematerialized under Rule 9B. |
| Private Company | Unlisted Public Company | Since small company test is failed, shares would have to be dematerialized under Rule 9B. | If the unlisted public company is a subsidiary (and not a WOS), shares would have to be dematerialized under Rule 9A. However, if the unlisted public company is a WOS, it would be exempted from dematerialization by virtue of the specific exclusion for WOS under Rule 9A. |
| Unlisted Public company | Private company | Since it is a unlisted public company, shares would have to be dematerialized under Rule 9A. | A subsidiary of a public company is also deemed to be a public company. If the private company is deemed to be a public company and the private company is a subsidiary (not a WOS), shares would have to be dematerialized under Rule 9A. However, if such private company is a WOS, it would be exempted from dematerialization by virtue of the specific exclusion for WOS under Rule 9A. Even if the subsidiary is not deemed to be a public company for the purpose of Rule 9A, since small company test is failed, shares would have to dematerialized under Rulee 9B. |

Note 1: Demat applicability will be triggered for the Holding Company only if the Holding Company is an Indian company. However, demat applicability is triggered for the subsidiary company regardless of whether Holding company is Indian company or a foreign company, since even a subsidiary of a body corporate is considered as a subsidiary company.

It is interesting to note that a private limited company which is a wholly owned subsidiary of a private company is required to comply with mandatory dematerialization. However, a private company which is a wholly owned subsidiary of unlisted public company is exempted by virtue of the exclusion provided under Rule 9A. The same is depicted in the below diagram.



3. Timeline for dematerialization

A company, which on the last day of a financial year, ending on or after 31st March 2023, is a qualified private company as per audited financial statements for such financial year, shall, within 18 months of closure of such financial year comply with the Notification. The due dates shall be as follows:

| Scenarios | Due date for dematerialization |
|---|--|
| Qualified private company as on 31 st March 2023 | 30 th September 2024 |
| Not a qualified private company as on 31 st March 2023 but a qualified private company as on 31 st March 2024 | 30 th September 2025 |
| Qualified private company during the financial year but not a qualified private company as on the end of the financial year | Rule 9B is not applicable |
| Qualified private company as on 31 st March 2023 but not a qualified private company as on 31 st March 2024 | 30 th September 2024. Currently, there are no provisions for re-materialization provided in this regard. |

4. Compliance requirements

- The qualified private companies shall also be required to submit a return reconciling the shares held in physical and demat form on a half yearly basis within 60 days from the conclusion of each half year with the registrar in **Form PAS-6**.
- Any qualified private company intending to make an offer for issue of securities, buyback of securities, issue of bonus shares or rights issue after the due date for dematerialization, can make such offer only if the qualified private company has **dematerialized its entire securities** held by its promoters, directors, and key managerial personnel.
- Holder of securities shall ensure that all their securities in qualified private company are dematerialized before subscribing to any securities whether by way of private placement, bonus shares or rights offer made after the due date for dematerialization by such qualified private company.
- In case of transfer of security of qualified private company by the holder after the due date for dematerialization, the holder of security shall ensure that all such securities in qualified private company are dematerialized before such transfer.

5. Brief steps for dematerialization of securities

- To facilitate the process of dematerialization, companies shall be required to alter their Articles of Association (AOA), if the existing AOA does not permit issue of shares in dematerialized form
- The companies shall then submit requisite documents, pay the applicable fees and register with the depository (NSDL or CDSL). Post registration, the company shall obtain an International Securities Identification Number (ISIN) for each security.
- The rule refers to 'securities' and thus shall include equity shares, preference shares, debentures, compulsorily convertible preference shares (CCPS), compulsorily convertible debentures (CCDS) etc. Hence each kind of dematerialized security of the company shall be allotted a unique ISIN by the depository.
- Upon obtaining the ISIN, companies shall intimate the same to all its security holders.

- The security holders shall then open a demat account with a depository participant and submit a demat request form along with the physical certificates of the securities that are to be dematerialized.
- The depository participant shall scrutinize the details provided by the security holders and forward the request to the Registrar and Transfer Agents ('R&T agents') appointed by the company (if any) or to the in-house team having connectivity with the depository.
- Upon confirmation received from the R&T agents or the in-house connectivity team of the company, the depository participants credit the respective securities to the demat account of the security holders.

6. Consequential implications

6.1 Ownership of securities held in demat form

- The depository shall be deemed to be the registered owner of the securities held in dematerialized form for the sole purpose of effecting transfer of ownership of security. However, the voting rights and any other rights shall continue to be held by the beneficial owner.
- The depository is considered as a registered owner only for the limited purposes of Depositories Act, 1996 and not for the provisions of Cos Act.
- In the case of wholly owned subsidiaries which are qualified private company, the nominee shareholder is also required to open a demat account.

6.2 Applicability of stamp duty

- There shall be no stamp duty on mere transfer of registered ownership of securities from the securities holder to the depository (i.e., at the time of dematerialization).
- Qualified private company shall be liable to pay stamp duty (at applicable rates) at the time of issue of securities to the depository.
- At the time of transfer of security, stamp duty shall be collected by the depository from the transferor of securities.

Hence, stamp duty continues to be applicable in the similar manner that was prevalent for physical securities. It is only that the requirement to stamp the securities is no longer applicable.

6.3 Miscellaneous

- With mandatory dematerialization of securities, the requirement to issue physical share certificates by the qualified private company and Form SH-4 for transfer of security is no longer applicable.
- Rule 9B is applicable to qualified private company having overseas holding or subsidiary company. Hence, all the Indian companies who have a foreign shareholder (including flip structures) shall require their overseas counterpart to open demat account and to dematerialize their securities held in Indian companies.
- Qualified private company shall no longer be required to maintain register of members. The register and index of beneficial owners maintained by depository shall suffice the requirement under the applicable provisions of Cos Act.
- Non-resident security holders 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 in India.
- For securities held in demat form, the company/ its R&T Agents (if any) shall obtain the details of the beneficiary holders as on the record date and their relevant bank details from the depository and the company shall make the dividend payment to the beneficiary.

- For income tax purposes, the cost of acquisition and period of holding in the case of transfer of securities (including buyback) held in demat form shall be determined on First-In-First-Out basis (FIFO basis), as against shares being transferred in physical form where the shares which are to be transferred can be selected.

7. Concluding remarks

This move for mandatory dematerialization of securities for certain private companies by Government is to bring in transactions of shell companies into their radar. Since the definition of small companies exclude holding and subsidiary companies, the applicability of dematerialization would be widened. Further, mandatory dematerialization does not remove the restriction of free transferability of securities which shall continue to remain as the distinguishing characteristic of a private company. The Buyer would also have to check in the case of transfer of shares whether the shareholder has converted the shares into demat form, prior to undertaking the share transfer. Further, companies and security holders shall have the burden of additional compliances and costs like dematerialization charges, annual account maintenance charges etc.

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