



Dematerialization of Shares in Private Limited Companies

Dematerialization is the process of converting physically held shares and securities (in the form of paper certificates) into a digital or electronic form (stored in a 'demat' account). Dematerialization facilitates the smooth process of buying, selling, transferring, and holding securities while making it cost-effective and secure for issuers as well as investors.

The certificates (paper-form securities) are the title documents reflecting ownership of shares and securities. It is often hard to keep track of all paper-based documents. Moreover, the increasing number of papers may lead to missing out on an important document. If the original certificates are somehow misplaced or stolen, it can prove to be a nightmare for an investor.

Having these securities in dematerialized form provides safe custody of title to the ownership.

MCA Notification for Dematerialization of Securities of Private Companies

As per the Companies (Prospectus and Allotment of Securities) Rules, 2014, all unlisted public companies were required to issue and facilitate the dematerialization of all securities in accordance with the provisions of the Depositories Act, 1996 and the regulations made thereunder.

Furthermore, in an endeavor to enhance transparency, protect investor interest by mitigating the risks associated with physical share certificates, and strengthen corporate governance, the Ministry of Corporate Affairs (MCA) issued a notification¹ on 27 October 2023 to dematerialize the securities.

1. The Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023.



This brought in a significant amendment via the Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023 wherein a new Rule 9B has been inserted in the Companies (Prospectus and Allotment of Securities) Rules, 2014, mandating the below-mentioned provisions of dematerialization of the securities for private limited companies:

- Issue securities only in dematerialized form, and
- Facilitate dematerialization of all securities

In accordance with the provisions of the Depositories Act, 1996 and regulations made thereunder.

Applicability, Timeline, and Impact

Applicability

Every private company, as on the last day of a financial year ending on or after 31 March 2023, which is not a small company as per the audited financial statements for such a financial year, shall, within eighteen months of the closure of such financial year, comply with the provisions of this rule. declaration to that effect is reported to the company.

Definition of Small Company

As per Section 2(85) of the Companies Act, 2013,² “small company” means a company, other than a public company, with:

- Paid-up share capital which does not exceed four crore rupees or such higher amount as may be prescribed, which shall not be more than ten crore rupees; and
- Turnover (as per profit and loss account for the immediately preceding financial year) does not exceed forty crore rupees or such higher amount as may be prescribed, which shall not be more than one hundred crore rupees:
 - 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

Exclusion for Dematerialization

Small companies and government-owned companies.

Timeline

Private companies, other than small companies and government companies, are required to facilitate the dematerialization of securities within 18 months from the closure of the financial year ending on 31 March 2023.

Impact on Companies

All eligible private companies must obtain an International Securities Identification Number (ISIN) and appoint a Registrar and Transfer Agent (RTA) comply with the provisions of Rule 9B.

Impact on Security Holder(s)

Every holder of securities of an eligible private company:

- **Who holds shares as on the date of the notification becoming applicable** shall open a demat account and request for dematerialization of the securities held in physical form
- **Who intends to transfer securities** on or after the prescribed time shall get such securities dematerialized before the transfer
- **Who intends to subscribe** to any securities of the concerned private company shall ensure that all their existing securities are held in dematerialized form before such transfer or subscription to the securities



Penalties for Non-compliance

If a company or any officer of a company does not comply with the requirement to dematerialize their securities as per the deadline mentioned in the notification issued on 27 October 2023, the following consequences will apply:

- The company will not be able to issue/allot any type of securities
- The security holder will not be able to transfer or subscribe to any type of security
- The company will not be able to undertake any corporate actions – dividend, takeover, mergers and acquisitions, funding, etc
- Monetary penalties on the company and every officer in default:
 - on the company: INR 10,000 + INR 1,000 for each day that the violation continues subject to a maximum limit of INR 2,00,000
 - every officer of the company who is in default: INR 10,000 + INR 1,000 for each day that the violation continues subject to a maximum limit of INR 50,000

Process of Dematerialization of Shares

For Companies

The Board of Directors shall, in compliance with the provisions of the applicable rules and subject to the provisions of the Articles of Association, **pass a resolution approving the following matters:**

- Seek admission with any **depository** (CDSL/NSDL)
- Appoint an RTA
- Designate an '**Authorized Signatory**'
- **Appointment of an RTA:** An RTA who shall help in managing the record-keeping aspect of securities held in electronic form and ensure smooth process of dematerialization should be appointed

- **Execute tripartite agreement and obtain an ISIN:** Enter into a tripartite agreement with the depository (for example, NSDL or CDSL in India, as the case may be) and the RTA, which shall inter alia govern the relationship among the parties and outline the scope of services to be undertaken by each of them. This agreement shall also outline the terms and conditions of the dematerialization process. After this process, the company shall be issued a security-specific ISIN
- **Inform security holders:** The prescribed companies will inform or intimate its security holders regarding the facility of dematerialization of securities. Furthermore, the company may also provide assistance to its security holders in order to open their demat account and convert their physical share certificates into the dematerialized form

For Securities Holders

- **Select Depository Participant (DP):** The security holder(s) will select a DP for opening a demat account for the purpose of dematerialization of their securities
- **Submit dematerialization request:** The security holder will submit a request to the DP in the Dematerialization Request Form (DRF) for dematerialization, along with the share certificates of the securities to be dematerialized
- **Verification of DRF:** The DP will scrutinize the form and the share certificates submitted to ensure authenticity and regulatory requirements. Once the verification is complete, the DP will forward the dematerialization request to the respective depository
- **Confirmation and updates to records:** Once the depository verifies and approves the dematerialization request, the physical shares are canceled and the equivalent electronic shares are credited to the security holder's demat account



Benefits of Dematerialization

Safety and Security

After the process of dematerialization, the transaction shall be carried out by electronic means, which is completely safe and secure from any kind of theft, damage, and loss of the share certificates. It leads to utmost security and eliminates any type of physical or tangible risk associated with maintaining and recording the transactions and transfers manually or physically.

Ease and Convenience

Dematerialization facilitates carrying out transactions electronically. The owner of the shares can carry out any transaction from any place which makes the whole process easy and convenient, which ultimately increases the efficiency in managing the records of the issued shares of the company. Considering the evolving environment and encouragement of digital transactions, the dematerialization of shares makes the transfer of funds a hassle-free process.

Enhanced Transparency and Corporate Governance

Dematerialization fosters authenticity, transparency, and traceability of shareholding information, making it easier to identify the true owners in complex ownership structures. It helps prevent fraud, promotes sustainability, and assists regulatory bodies in conducting more thorough oversight by having access to comprehensive digital data.

Cost Reduction

Once the company provides the facility of dematerialization of its securities to its security holders, all the records, data, and the transfers or transmissions (as the case may be) will be maintained electronically, which will reduce the cost of maintaining the records manually.

Challenges in the Dematerialization Process

Dematerialization, once implemented, is likely to provide a hassle-free process for holding shares, provided the challenges mentioned below are mitigated:

Lack of Awareness and Acceptance:

- For private companies (which usually are exempt from the majority of compliances considering their status), mandating the conversion process from the paper-form of securities to the dematerialization of shares can be a meticulous task as they lack awareness and are not familiar with technical process and the benefits of the dematerialization
- The security holders of such private companies may find it difficult to understand and opt for the transition of physical shares into demat shares
- This challenge can be tackled with the fact that this is a one-time process and that it will improve the ease of doing business in the long-run
- However, once they are informed that the exercise of the dematerialization process is introduced in order to bring authenticity, transparency, and traceability of shareholding information, they should accept and comply with the same

Technology Adoption and Learning Curve:

- The company and investors transitioning to demat accounts may encounter challenges related to technology adoption and a learning curve associated with electronic systems. The move from traditional paper-based processes to digital platforms can be daunting for both the company as well as the security holders
- The adoption of technology into the conversion process will also help attract foreign investors as they will be assured that their shareholding in Indian companies are aligned with the system in place globally for maintaining securities electronically



Conclusion

Dematerialization ensures transparency and traceability of shareholding information, ensuring clear titles of ownership in complex ownership structures. It also prevents fraud, promotes sustainability, and assists regulatory bodies in conducting more thorough oversight by having access to comprehensive digital data.

In case private companies do not comply with these new regulations within the given timeframe, the companies will not be able to buy/sell/transfer securities and may even face monetary penalties.

The requirement introduced by the MCA through this notification aims to ensure universal implementation, covering a broad spectrum of private companies, irrespective of company size or capital structure.

Source: <https://bit.ly/3RxiYi2>



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