

## Indian regulators direct private companies and AIFs to dematerialize their shares

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### Background

Last month, India's Ministry of Corporate Affairs (the "MCA") notified the Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023 (the "Amendment Rules"), that amended the Companies (Prospectus and Allotment of Securities) Rules, 2014 (the "PAS Rules"). The primary objective of the Amendment Rules is to promote the dematerialization of securities of public and private companies.

In India, the dematerialization of securities was introduced by the Securities and Exchange Board of India (the "SEBI") through the Depositories Act, 1996 (the "Depositories Act") to simplify the process of buying and selling securities. At present, shares can only be traded in a dematerialized form in accordance with regulations framed by the SEBI, and under the PAS Rules even promoters of public companies must hold their shares dematerialized form.

Prior to the Amendment Rules, such dematerialization requirements did not apply to private companies. However, owing to the convenience, accessibility, flexibility and safety offered by dematerialized securities, and to counter the concern of back-dating and manipulation of physical shares, the Amendment Rules make the dematerialization requirement applicable to private companies as well.

In keeping with this theme, as per a recent SEBI press release (the "SEBI Press Release"), after September 30, 2024 (the "Compliance Date"), Alternative Investment Funds ("AIFs") will only be allowed to purchase securities that are in a dematerialized form, except in a few instances.

### Key changes

The Amendment Rules introduce Rule 9B to the PAS Rules which makes the following important prescriptions. Private companies must:

- facilitate the dematerialization of all of their securities within eighteen (18) months of the closure of the financial year ending March 31, 2023, *i.e.*, on or before the Compliance Date;
- issue securities only in dematerialized form subsequent to the Compliance Date;
- ensure that all the shares held by promoters, directors and key managerial personnel have been dematerialized prior to making: (i) any offer for issue of any securities; (ii) any offer for buyback of securities; (iii) an issue of bonus shares; or (iv) a rights offer, if such issues or offers occur after the Compliance Date.
- secure an International Security Identification Number ("ISIN") for each type of security;

- inform all existing shareholders about such facility;
- make timely payment of fees to the depository, Registrar to an Issue and Share Transfer Agent;
- maintain a security deposit of not less than two (2) years of fees with the depository, Registrar to an Issue and Share Transfer Agent;
- bring any discrepancies observed in their issued capital and the capital held in dematerialized form to the notice of the depositories; and
- comply with all other relevant provisions of applicable legislations, including *inter alia*, the Depositories Act, 1996, the Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018 and the Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 and make applicable filings.

It is important to note that in order to ease the compliance burden, these requirements have not been made applicable to “small companies,” meaning companies whose paid-up capital and turnover (topline) does not exceed INR40,000,000 (Rupees Forty Million) and INR 400,000,000 (Rupees Four Hundred Million), respectively.

Similarly, the SEBI Press Release also exempts certain cases from the dematerialized holding requirement. The dematerialization requirement will not be made applicable to any existing investments, unless: (i) dematerialization has been mandated under other applicable laws; or (ii) the AIF has control in the investee company (either on its own or in conjunction with other entities which are mandated to hold their investments in a dematerialized form).

The SEBI Press Release also exempts the requirement of holding future investments in a dematerialized form in cases such as: (i) liquidation schemes of AIFs; (ii) schemes of AIFs whose tenure ends within one (1) year from the date of the SEBI notification; and (iii) schemes of AIFs which are in an extended tenure as on the date of issuance of the SEBI notification.

## Our comments

Dematerialized securities offer various advantages over physical securities, and a move towards dematerialization is a move towards greater transparency and convenience. Further, this requirement has only been made applicable to companies that operate on a significant scale, and small companies have been exempted from this requirement.

Therefore, companies that go beyond the stipulated threshold as per their audited financial statements for the financial year ended March 31, 2023, must comply with the dematerialization requirements. If not already done, companies must revise their Article of Association allowing them to issue shares in electronic form. They must also obtain: (i)

registrations from the depositories, viz., the National Securities Depositories Ltd (NSDL) and the Central Securities Depositories Ltd (CDSL); and (ii) a unique 12-digit ISIN code used to identify different securities such as shares, bonds, etc.

A company may obtain the services of a depository participant to facilitate the dematerialization process in compliance with various applicable laws and regulations.