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Regulatory Alert

Delivering Clarity

Mandatory dematerialization of shares of unlisted public companies

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Background

In a major initiative to keep track of ownership of securities on real time basis, enhance transparency, protect investors and improve governance in the corporate sector, the Ministry of Corporate Affairs (MCA) issued a draft notification titled Companies (Prospectus and Allotment of Securities) Third Amendment Rules, 2018 (Amendment Rules), on 10 September 2018. The Amendment Rules require unlisted public companies (UPC) to issue securities in dematerialized form only. As per the draft notification, the Amendment Rules will come into force from 2 October 2018.

The term "listed company" is defined in the Companies Act 2013. As a corollary, the term UPC means a public company whose securities are not listed on any recognized stock exchange. The Amendment Rules require dematerialization of "securities", which *inter alia* includes shares, scrips, stocks, bonds, debentures, debentures stocks or other marketable securities of a like nature. Hence, provisions of the Amendment Rules will also be applicable to debentures/ bonds and other securities issued by UPC.

This Alert provides an overview of the provisions of the Amendment Rules dealing with dematerialization of securities of unlisted public companies.

Key highlights of the Amendment Rules

- On and from 2 October 2018, all UPCs shall:
  - issue securities only in dematerialized form; and
  - facilitate dematerialization of all its existing securities;

  in accordance with the provisions of the Depositories Act 1996 and regulations made thereunder.
- UPCs shall ensure that entire holding of securities of promoters, directors, key managerial personnel (KMP) are in dematerialized form, before making an offer for issue or buyback of securities or issue of bonus shares or rights offer.
- Every holder of securities of a UPC who intends to transfer securities or who intends to subscribe to any securities of a UPC shall ensure that existing securities are held in dematerialized form before such transfer or subscription to the securities (whether by way of private placement or bonus shares or rights offer).
- The UPC shall facilitate dematerialization of all its existing securities by making necessary application to a depository and securing International Security Identification Number (ISIN) for each type of security and shall inform all its existing security holders about such a facility.
- Every UPC shall ensure:-
  - timely payment of admission and annual fees to the depository and registrar to an issue and share transfer agent (RTA);
  - security deposit of minimum 2 years' fee with the depository and RTA; and
  - compliance with regulations, directions, guidelines, or circulars issued by SEBI, or the depository w.r.t. dematerialization of shares and matters incidental thereto.

- In case of default of payment of fees, the UPC shall not make offer of any securities until the payment of fees is made to the depository, registrar to an issue and share transfer agent.

- The provisions of Depositories Act, 1996, the SEBI (Depositories and Participants) Regulations, 1996 and the SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 shall apply *mutatis-mutandis* to dematerialization of securities of UPCs.

- Every UPC in accordance with regulation 55A of the SEBI (Depositories and Participants) Regulations, 1996 shall submit an audit report on half-yearly basis to the Registrar of Companies.

- Any grievances of the security holders shall be filed before the Investor Education and Protection Fund Authority (IEPFA) set up under the Companies Act 2013.

Conclusion

With change in the Rules, any issue or transfer of securities of UPCs on or after 2 October 2018 will have to be in dematerialized form only. Given the short window to get the securities dematerialized, the draft notification may pose challenges in rolling out issue / transfer, if securities are not dematerialized by the above date.

Dematerialization of securities by UPCs is aimed at curbing misuse of tax provisions, preventing malpractices such as benami shareholding, creation of an audit trail in securities transactions of UPCs, enhancing credibility of institutional investment in UPCs, easing transfer or creation of pledge of shares of UPCs etc.

Any transfer of shares of the UPC will be entitled to avail benefit of exemption from payment of stamp duty on transfer of shares.

There is a specific provision in the Income-tax Act, 1961 [section 45(2A)] that deems the dematerialized shares that are sold, to be in the order of dematerialization of the physical shares, irrespective of the date of acquisition of the physical shares (i.e. FIFO basis with respect to dematerialization of the physical shares). As a corollary, for the purposes of capital gains tax computation, the date of acquisition (i.e. period of holding) and cost of acquisition of the dematerialized shares that are sold, will also have to be considered in the same order i.e. FIFO basis with respect to dematerialization of the physical shares.

Source: Draft notification issued by MCA on The Companies (Prospectus and Allotment of Securities) Third Amendment Rules, 2018 dated 10 September 2018 and Press Release issued by MCA dated 11 September 2018.

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