Demat – A Word of Caution for Issue/Allotment in Securities

Gone are those days when, securities had to be issued physically in the form of certificates, their transfer had to be given effect through physical delivery of certificates resulting in to infinite delay and problems like loss of certificates and fraudulent transfers etc., introduction of dematerialization is a landmark step on the path of ease of doing business. Now with the requirement of dematerialization being applicable to unlisted public and private companies, the economic activity at Indian capital market has touched new heights. Yet, practical difficulties faced by companies while undertaking dematerialization related compliances need the attention of Company Secretaries.

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INTRODUCTION

DEMAT MANDATE FOR PRIVATE COMPANIES

The Ministry of Corporate Affairs ("MCA") on 27th October 2023, mandated private companies to provide demat connectivity for its shareholders and debenture holders by inserting a Rule 9B in the Companies (Prospectus and Allotment of Securities) Rules 2014 ("Allotment Rules"). By the virtue of this Rule, all the private companies other than small companies[1] as on 31st March 2023 and every year thereafter are required to facilitate dematerialization of its securities and to ensure this, a timeline was given of 18 months from the closure of such financial year, as on which they are not small companies and need to comply with this Rule. Hence for all private companies which were not small companies and Section 8 companies as on financial year ended 31st March 2023 had time till 30th September 2024 to ensure the same. Now MCA has vide a notification dated 12th February 2025 extended this timeline till 30th June 2025.

ISSUE OF NEW SECURITIES

As per Section 29 of Companies Act, 2013[2] (the Act) read with Rules 9A and 9B of the said Allotment Rules, all companies other than small companies, and Section 8 companies are not only required to facilitate dematerialization (demat) of securities by obtaining International Securities Identification Number (ISIN) and also issue all its fresh securities after the date of this notification only in demat mode. Further, if the company is desirous of making any fresh issue of securities, then it has to ensure that the security holding of all its promoters, Directors and Key Managerial Personnel (KMP) and also the proposed offeree is held in dematerialized form only.

However, in case of shareholders other than promoters, directors and KMP this is not the case. It is not the responsibility of the company to ensure that these other shareholders convert their securities in demat mode. The company is only required to facilitate the demat process by obtaining ISIN. It is on the shareholder's own wish, whether and when does he want to convert his securities into demat mode. However, rule 9A/9B of Allotment Rules say that whenever a shareholder wants to subscribe to issue of fresh securities made by the company through private placement or bonus issue or rights issue etc., or he wants to transfer securities, he first needs to convert his securities into demat mode and without that he cannot subscribe to fresh issue of securities or transfer his securities.

These provisions relating to mandatory requirement of demat of securities of shareholders other than promoters, Directors and KMP, have given rise to certain practical questions that may be faced by the companies while undertaking fund raising activities. In this article, we shall try to find answers to these questions one by one.

1. **Difficulty in rights issue:** As we know, in rights issue, as per Section 62(1) of the Act, an offer for subscription to

1. *Definition of small companies section 2(85) of Companies Act 2013 (85) "small company" means a company, other than a public company,—*
(i) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than 32[ten crore rupees]; 3[and]
(ii) turnover of which as per profit and loss account for the immediately preceding financial year] does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than 18[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;

2. *Section 29 of Companies Act 2013*
29. (1) Notwithstanding anything contained in any other provisions of this Act,—
(a) every company making public offer; and
(b) such other class or classes of public companies as may be prescribed, shall issue the securities only in dematerialised form by complying with the provisions of the Depositories Act, 1996 and the regulations made thereunder.

securities of company is given to all equity shareholders of the company. In case the entire securities holding of promoters, directors and KMP are in demat form, then company can make a rights issue offer. So, a question arises that whether Company needs to offer the securities only to those equity shareholders who hold their shares in demat form or should it offer to all equity shareholders? As per the provisions of section 62(1) of the Act, it needs to offer to all equity shareholders. Lets consider a situation wherein the company has given an offer to existing shareholders to subscribe to shares of company through rights issue. One of the shareholders holding equity shares in physical form applies for the rights issue. Now the company can neither refrain from giving his entitled shares to him nor can it allot the new shares unless his existing shareholding is converted into demat form. In this situation, the question before the company is what should it do to comply with all applicable provisions?

(a) **Compliance required on the part of company:** As far as the compliances on the part of company are concerned, as discussed above, the company is only required to facilitate demat by obtaining ISIN and ensure that shareholding of promoters, Directors and KMP is in demat mode. The company is not responsible to ensure that all other shareholders have dematerialized their securities before subscribing to rights issue.

However, since the company is under legal obligation as to not to issue shares to such subscribers who have subscribed to fresh issue without dematerializing their existing securities, the company as a caution or as a good practice, can insert a caution in the notice/ letter giving offer to existing shareholders to subscribe to fresh issue that, shareholders who have not dematerialized their existing securities will not be able to subscribe to rights issue that the company will not be able to allot shares to such subscribers.

(b) **Recourse if subscription amount is received from shareholder holding physical securities:** As discussed above, in case of a rights issue as per Section 62(1) of the Act, the company is under obligation to give offer to all existing equity shareholders to subscribe to the rights issue. But as per rule 9A/9B of Allotment Rules, a shareholder holding shares in physical form is not legally allowed to subscribe to rights issue. In such a case, if we consider a situation wherein the company in the notice offering rights issue, has mentioned a caution that a shareholder existing holding physical securities will not be able to subscribe to rights issue and inspite of that, a shareholder having shareholding in physical form has subscribed. Then what is the recourse to the company in such situations?

To find an answer to this question, reference has to be made to rules of interpretation of statutes. One principle that may prove useful in this regard is, "principle of harmonious construction". This rule of construction says that when there are in an enactment two provisions which cannot be reconciled with each other, they should be so interpreted that, if possible, effect should be given to both. Further, the Honorable Supreme Court in its judgment in the matter of *Bengal Immunity Co. Ltd. v. State of Bihar*[3] explained the principle of harmonious construction in following words:

*"It is a cardinal rule of construction that when there are in a Statute **two provisions which are in conflict with each other** such that both of them cannot stand, they should, if possible, **be so interpreted that effect can be given to both**, and that a construction which renders either of them inoperative and useless should not be adopted except in the last resort. This a what is known as the rule of harmonious construction."*

In this case, Section 62(1)(a) appears to be in conflict with rules 9A and 9B of the Allotment Rules. Therefore, principle of harmonious construction can be applied to interpret both provisions in such a manner that effect can be given to both of them.

If reference is made to clause (a) of sub-section (1) of Section 62[4], it can be seen that the sub-section (1) along with clause (a) talks about making offer to all the equity shareholders and not about allotting shares to all equity shareholders. Whereas, Rules 9A(3)[5]/9B(4)[6] do not restrict company from offering shares to any shareholders, instead they restrict the shareholder from subscribing to rights issue without dematerializing existing securities. Therefore, both these sections can be harmoniously read and given effect without contradicting each other.

Now with respect to the allotment of new shares to such equity shareholder securities holding securities in physical form, the company can neither allot shares in physical mode as per rule 9A/9B of Allotment Rules, nor can it deny allotment of shares to any person who has subscribed to the same. In this situation, reference has to be made to one more principle of interpretation of statute, and that is, giving preference

3. *Bengal Immunity Co. Ltd. v. State of Bihar AIR 1955 SC 661. Judgment dated 06/09/1955*
4. *clause (a) of Section 62(1) of Companies Act 2013*

(1) Where at any time, a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered—

(a) to persons who, at the date of the offer, are holders of equity shares of the company in proportion, as nearly as circumstances admit, to the paid-up share capital on those shares by sending a letter of offer subject to the following conditions, namely:—

5. *Rule 9A sub-rule (3) of Companies (Prospectus and Allotment of Securities) rules 2014*

(3) Every holder of securities of an unlisted public company,_

(b) who subscribes to any securities of an unlisted public company (whether by way of private placement or bonus shares or rights offer) on or after 2nd October, 2018 shall ensure that all his existing securities are held in dematerialized form before such subscription.

6. *Rule 9B sub-rule (4) of Companies (Prospectus and Allotment of securities) rules 2014*

(4) Every holder of securities of the private company referred to in sub-rule (2),-

(b) who subscribes to any securities of the concerned private company whether by way of private placement or bonus shares or rights offer on or after the date when the company is required to comply with this rule shall ensure that all his securities are held in dematerialised form before such subscription.

to special provision over general provision. This principle says that, *When there is a* ***conflict between special provision and general provision, the special provision prevails over the general provision;*** *the general provision applies only to such cases which are not covered by the specific provision.*

This principle of interpretation is better explained In *Pretty v. Solly (1859-53 ER 1032)* quoted in Craies on Statute Law at p. 206, 6th Edition) Romilly, M. R., -*"The rule is that whenever there is a particular enactment and a general enactment in the same statute and the latter, taken in its most comprehensive sense, would overrule the former, the particular enactment must be operative, and the general enactment must be taken to affect only the other parts of the statute to which it may properly apply."*

In this case, Section 62 is the general provision talking about the further issue of share capital. Whereas, rule 9A and 9B of the Allotment Rules is a special provision requiring demat of securities as a pre-condition for allotment. Therefore, as per above mentioned principle, preference has to be given to a special provision, that is to non-allotment of securities if the existing holding of securities is not in demat mode. Hence, even if the equity shareholder holding shares in physical mode has subscribed to rights issue in violation of rule 9A/9B of the Allotment Rules, the company cannot allot new shares to him as such allotment would be in non-compliance of the special provision i.e., Rule 9A/9B of the Allotment Rules.

As per SEBI circular dated 25th January 2022, in case of stock split and duplicate share certificate request, listed entities need to honor Investor Service Requests by crediting the shares in demat mode only.

(c) **Finding a mid-way:** If there is a situation wherein, after receipt of notice/letter offering shares pursuant to rights issue, the shareholder initiates the process for demat of his existing securities and in the meantime, intimates the company that has initiated the demat process and is desirous of subscribing to rights issue once the same is completed. Considering this as a genuine situation, can the company help the shareholder get his entitled new shares without violating the provisions of law?

If we refer to sub-clause (i) of Section 62(1)(a)[7], it says that if the shareholder does not subscribe to the offer in specified time, then the offer shall be deemed to have been declined by him. Under general parlance, "to subscribe" means to give consent or approval to something written by signing. Whereas, as per Merium Webster dictionary, "to subscribe" means *"to pledge (a gift or contribution) by writing one's name with the amount."* Reading this definition in the context of Section 62(1)(a)(i) of the Act, "to subscribe to securities" means to agree to buy securities of company by paying the subscription amount. Since in this given situation, if the shareholder does not pay the subscription amount within the offer period, but only expressed his interest to do so, it cannot be said that he has subscribed to the rights issue and therefore, the offer will be deemed to be declined.

As per Merriam Webster dictionary, "To decline" means: *"to withhold consent"*. Therefore, "to decline" or "deemed to decline an offer" implies that the shareholder has denied to subscribe to rights issue. In such a situation, sub-clause (iii) of Section 62(1)(a)[8] comes in to play. This sub-clause gives power to Board of directors to dispose off the shares not accepted/declined by shareholders in a manner not disadvantageous to the company and shareholders.

In this case, if the shareholder has not subscribed to the issue by paying subscription money, he is deemed to have declined the offered shares and now the Board has the authority to decide to whom to allot the shares which have already been issued once (offered once). Since the said shareholder had already expressed both, his interest and disability to subscribe, the Board may later on, after ensuring that the shareholder has dematerialized his existing securities, allot the shares to him even after the expiry of offer period by exercising its power under sub-clause (iii) of clause (a) of Section 62(1). However, in such a case, the responsibility to prove that such allotment was not disadvantageous to company and shareholders is on the Board of directors.

2. **Difficulty in filing Return of Allotment for Rights Issue:** As per Section 39(4)[9] and rule 2(1)(c)(vii)[10] and its explanation of Companies (Acceptance of Deposits) Rules 2014, once the subscription money is received, the company is under obligation to allot securities

7. *sub-clause (I) of section 62(1)(a) of Companies Act, 2013*

(i) the offer shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days or such lesser number of days as may be prescribed and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;

8. *Clause (a) sub-clause (iii) of section 62(1) of Companies Act 2013*

(iii) after the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not dis-advantageous to the shareholders and the company;

9. *Section 39 sub-section (4) of Companies Act 2013*

(4) Whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in such manner as may be prescribed.

10. *rule 2(1)(c)(vii) of Companies Acceptance of Deposit rules 2014*

(vii) any amount received and held pursuant to an offer made in accordance with the provisions of the Act towards subscription to any securities, including share application money or advance towards allotment of securities pending allotment, so long as such amount is appropriated only against the amount due on allotment of the securities applied for;

Explanation.- For the purposes of this sub-clause, it is hereby clarified that -

(a) Without prejudice to any other liability or action, if the securities for which application money or advance for such securities was received cannot be allotted within sixty days from the date of receipt of the application money or advance for such securities and such application money or advance is not refunded to the subscribers within fifteen days from the date of completion of sixty days, such amount shall be treated as a deposit under these rules.

within 60 days from the date of receipt of subscription money and thereafter file return of allotment in form PAS-3 within 30 days from date of allotment. In this situation, if some issued shares remain unsubscribed and they are disposed off subsequently after the date of first allotment, then it will have to be considered as a separate allotment. In the form PAS-3, the Company needs to give a declaration that *no return of allotment is pending to be filed for securities allotted prior to the date of this allotment.* This means company will have to file 2 separate forms PAS-3 in such case because earlier when PAS-3 was in V2 version of MCA, multiple dates of allotment could be entered, but now in V3 version of MCA, the form PAS-3 allows to enter only 1 date of allotment, and the said declaration means that the return of allotment for the securities allotted on a previous date has already been filed separately. In short, if this process of disposal of shares after the offer period takes more than 60 days time from the date of first receipt of subscription money, then company will need to make 2 separate allotments and file 2 separate form PAS-3.

In alternative, it may be considered that the shareholder(s) having shares in physical form and participated in right issue, the shares so allotted in proportionate basis may be kept in abeyance and the said shares may be credited in that particular shareholder's demat account only (once he complies with Rule 9A/9B), the company may write his name in list of allotees along with a comment that the shares are held in abeyance for the purpose of dematerialization of existing securities. For more precautionary measure the RTA or the company should call for the original physical share certificate and within 30 days should issue a letter of confirmation to the shareholder. Thereafter, the shareholder within 120 days from receipt of such letter, should get his securities dematerialized and thereafter, the credit share shall be given to his demat account. If securities are not dematerialized within the specified time, then may be kept in suspense escrow demat account of the company till the compliance is pending.

3. **Difficulty in private placement:** In case of private placement as well, this question may arise that can a person who might be holding some securities of the company in physical mode subscribe to the private placement offer? However, in case of private placement the question is not as complicated as in case of rights issue. During private placement, as per sub-section (2) of Section 42[11], the Board has right to select the allotee. Therefore, the Board can verify the compliance with rule 9A/9B of Allotment Rule before issuing private placement offer letter in PAS-4 format and if the proposed offeree holds some securities of company and has not dematerialized his existing securities, then the Board may not offer fresh securities to him before he ensures dematerialization of existing securities.

   Even if for any reason, the offer is made to such an offeree, the offer period under Section 42 can be kept open for a longer period (maximum 1 year from the date of passing special resolution[12]) as would be sufficient for getting the existing securities of the offeree converted into demat mode before subscribing to the private placement offer. However, in such a case, the Board has to be extra cautious with respect to the reasons as to why it has selected such an offeree who holds some securities of the company in physical mode as an 'offeree' for private placement offers.

4. **Difficulties in Bonus issues:** On reading the provisions of rule 9A/9B of the Allotment Rules, it is evident that shareholders cannot subscribe even to bonus issue without converting their existing securities into demat mode. Also, the company cannot issue/allot shares in physical mode even in case of bonus issue. But if we refer to Section 63 which talks about bonus issue, it does not require the shareholders to subscribe to bonus issue[13] The bonus shares are issued by the company and automatically credited to the demat account of the shareholders holding demat accounts. Now if the shareholder does not have a demat account then will he not get the bonus shares?

   As mentioned, in bonus issue the shareholders are not required to subscribe to offer, instead the shares are directly to be credited to demat account of shareholders. Now if a shareholder does not have a demat account, then the company may allot the shares in the name of such shareholder and then keep it in abeyance till the time, that shareholder opens a demat account and converts his existing securities into demat form. Once this is done, the company may release the shares into the shareholder's demat account. Therefore, as far as bonus issue is concerned, there are not much complications, other than that relating to filing of return of allotment.

   - **Difficulty in filing return of allotment for bonus issue:** As per section 39(4)[14] read with rule 12(2)[15] of Allotment Rules, when the company

11. *sub-section (2) of Section 42 of Companies Act 2013*

    (2) A private placement shall be made only to a select group of persons who have been identified by the Board (herein referred to as "identified persons"), whose number shall not exceed fifty or such higher number as may be prescribed [excluding the qualified institutional buyers and employees of the company being offered securities under a scheme of employees stock option in terms of provisions of clause (b) of sub-section (1) of section 62], in a financial year subject to such conditions as may be prescribed.

12. *Rule 13 sub-rule (2) clause (e) of Companies Share Capital and Debentures rules 2014.*

    (e) the allotment of securities on a preferential basis made pursuant to the special resolution passed pursuant to sub-rule (2)(b) shall be completed within a period of twelve months from the date of passing of the special resolution

13. *Section 63(1) of Companies Act 2013 63. (1) A company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—*

14. *Section 39 sub-section (4) of Companies Act 2013 - (4) Whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in such manner as may be prescribed*

15 *Rule 12 (2) There shall be attached to the Form PAS-3 a list of allottees stating their names, of Companies Prospectus and Allotment of securities rules 2014 address, occupation, if any, and number of securities allotted to each of the allottees and the list shall be certified by the signatory of the Form PAS-3 as being complete and correct as per the records of the company.*

files return of allotment in form PAS-3 for any fresh issue of securities, it has to provide therein, the list of allotees including the details of securities allotted to such allotees. Now if the shares are allotted but kept in abeyance, then there arises a question that, whose name is to be written in list of allotees to be attached to form PAS-3? Since the company would be aware about the name of shareholder(s) whose shares are kept in abeyance and also knows that the said shares are going to be credited in that particular shareholder's demat account only (once he complies with Rule 9A/9B), the company may write his name in list of allotees along with a comment that the shares are held in abeyance for the purpose of dematerialization of existing securities.

5. **Difficulty in case of Consolidation / Sub-division of Shares & issue of duplicate Share Certificate:** Post Rules 9A/9B of the Allotment Rules becoming applicable, a company cannot issue fresh securities in physical mode. The shareholders, however, are not restricted from holding already existing securities in physical mode unless they are intending to subscribe to fresh issue of securities or intending to transfer their securities. In case of consolidation/sub-division of shares, the already existing shares of the shareholders are split into multiple shares OR multiple existing shares are consolidated into lesser number of shares. In these cases, only the number of shares is increased and its face value is decreased or vice versa, but no new shares are issued/ allotted. Same is the case with issue of duplicate share certificate. No fresh shares are issued/ allotted, just a new copy of original physical share certificate is to be issued, that too on the request of shareholder.

   However, Section 29(1A) of the Act says *"In case of such class or classes of unlisted companies as may be prescribed, the securities shall be* ***held*** *or transferred only in dematerialised form in the manner laid down in the Depositories Act, 1996 and the regulations made thereunder."* So a question arises that how to interpret this word "held" in Section 29(1A)? Should it be read in the context of Rule 9A/9B which speak only about issue of new shares or should the restriction in Rule 9A/ 9B be extended to issue of new share certificates also? Since in both these cases, there is no issue/ allotment of fresh shares, and the Rules 9A and 9B specifically talk about issue/ allotment of fresh shares (and not about share certificates), it may be said that companies can issue physical share certificate in the above exceptional cases. However, it is worthwhile to wait for any clarification or precedent from the Ministry of Corporate Affairs (MCA) as to how to deal in such cases where **only share certificate is to be issued and new shares are not issued.**

   - **Precedent from listed entities:** In case of listed companies, there is a circular dated 25th January 2022 issued by SEBI[16] which says that even in case of stock split and duplicate share certificate request, listed entities need to honour these Investor Service Requests by crediting the shares in demat mode only. This circular states that when a stock split is done or request for issue of duplicate share certificate is received, the RTA or the company should call for the original physical share certificate and within 30 days should issue a letter of confirmation to the shareholder. Thereafter, the shareholder within 120 days from receipt of such letter, should get his securities dematerialized and thereafter, the credit of stock split or duplicate share certificate shall be given to his demat account. If securities are not dematerialized within the specified time, then they shall be kept in suspense escrow demat account of the company.

CONCLUSION

Now since this provision comes from SEBI circular, it is applicable to listed entities only and not to unlisted public or private companies. Going forward, as and when the law relating to unlisted public and private companies develops further, various practical and interpretation related difficulties may get addressed appropriately. ❐

16. *https://www.sebi.gov.in/legal/circulars/jan-2022/issuance-of-securities-in-dematerialized-form-in-case-of-investor-service-requests_55542.html*