

A Move to Unveil the Opaque Shares Transfer Prior To an IPO: Dematerialization

Himani Singh

New Law College, Bharati Vidyapeeth Deemed University
Pune, Maharashtra, India

ABSTRACT: This Research paper throws light on the dematerialization of shares prior to an IPO and its purpose is to eliminate the benami system, tax evasion, black money transfer and etc. from the market by bringing more transparency in the transaction of shares. When we say prior to an IPO or pre IPO that means it is about the companies which are not available to the public on the stock exchange market i.e Unlisted Companies. Decision to implement dematerialization system in listed companies was enacted in the year 2011 itself so as to make the stock exchange transaction transparent whereas on the other hand unlisted companies were exempted from the implemented act concerning dematerialization, in the year 2011. However, on March 2017, it was observed that India consists of 1.17 million active companies in which about 80,000 to 90,000 such companies are recognised as unlisted companies and on noticing such large number of active companies falling in the category of unlisted companies, government (MCA and SEBI) in the month of June, 2018, decided to make it compulsory for all the unlisted public and private companies to convert their physical shares into dematerialized form before 5th December 2018 with the purpose of eliminating benami holding, tax evasion, black money transfer and etc.

Keywords: Dematerialization of shares, Demat Account, Unlisted Company, Pre-IPO.

I. INTRODUCTION

In this topic, one can get enlightened about the dematerialized holdings prior to an IPO (Initial Public Office). In this topic, one can get greater aspects of learning and equip knowledge about demat shares and dematerialized securities in unlisted public/private companies. When we say prior to an IPO that means we are talking about the company which is yet not registered in the stock market and the shares of that particular company are yet not available to the public i.e Unlisted company. Pre-IPO basically deals with the offering of shares to only a limited number of investors and this is done prior to or in an advance to an IPO. Companies which go for an IPO are those companies which are listed and is available to the public in the stock market, where the public can buy and sell the shares of the company. At the end of March 2017, it was found that India consists of 1.17 million active companies in which about 80,000 to 90,000 such companies are recognized as unlisted companies.¹ An unlisted company is the one which is not listed on any of the stock exchange and hence, can have an unlimited number of shareholders to increase capital for any commercial venture.

According to the Indian law, an unlisted public company comprises of more than 50 shareholders, a higher

¹Dezan Shira & Associates, India to Make Demat Shares Mandatory, Introduce New Disclosure Rules for Companies, India Briefing (May 30, 2018), <https://www.india-briefing.com/news/india-demat-shares-mandatory-beneficial-ownership-rule-16966.htm>,

minimum capital requirement of Rs 500,000 (US\$7,404), and should comply with statutory requirements which are holding shareholder meetings and a cap on director remuneration.

II. WHAT IS PRE-IPO

Pre-IPO offerings of company's share are granted or availed to only a limited number of individuals (investors) and this takes place prior to an IPO. Investing prior to an IPO could turn out to be risky because it could happen that IPO will never take place. Shares in pre-IPO are unregistered shares and so it is hard to sell until the public offering takes place.

III. DIFFERENCE BETWEEN PRE-IPO AND IPO

- Company's shares in pre-IPO are granted to only a limited number of investors and this occurs prior to an IPO. It could be risky to invest in pre-IPO because it could happen that IPO may never take place, shares in pre-IPO are unregistered shares and hence its a hard task to sell until the public offering takes place whereas in IPO or Initial Public Offering is the first time when the stock of a private company is offered to the public, it is often issued by younger and smaller companies but it could be issued by large private companies as well seeking to become public. Risks are involved in both because nobody can provide assurance for the return on equity.
- A company needs to be listed in case of IPO whereas in case of pre-IPO no such requirements are essential just that there should be 100 stakeholders present to carry out the process.
- In IPO, company shares are traded on stock market whereas in pre- IPO, shares are traded among the existing stakeholder or private investors.

IV. WHAT IS DEMATERIALIZATION

Dematerialization is a procedure of converting the physical securities of an investor into an equal number of securities in electronic form which is maintained in a demat² account with a depository participant who is basically an agent between the depository and the company.

As per the current statistics at BSE (Bombay Stock Exchange) and NSE (National Stock Exchange), 99.9% transactions occur in dematerialized form since it is declared compulsory by SEBI. Therefore, according to the convenience of trading in dematerialized mode, it is important to have a Beneficial Owner (B.O.) account for trading at the exchanges. However, to facilitate trading by small investors (maximum 500 shares) in the physical mode, the stock exchanges provide an additional trading window which gives one-time facility for

² Demat - It means the conversion of physical shares into an electronic form for the purpose of share transaction.

small investors to sell physical shares which are in the compulsory demat list. The buyers of these shares will have to demat the shares before selling it further.

V. HISTORY OF DEMATERIALIZATION OF SHARES

- **Commencement of Dematerialization**

The sanctioning of Depositories Act in August 1996 made way for the foundation of NSDL, advanced by local institutions. The center group at NSDL had the alternative of going for either immobilization or dematerialization. In immobilization, the physical shares certificate stays with the depository in its vault. The depository would recognize the shares and make an electronic section. NSDL decided to follow the case of Japan which had settled on dematerialization, than the US, which had picked immobilization.³

- **Overcoming challenge**

The difficulties looked by NSDL as it went about on its central goal which was threefold. First was to induce organizations to permit investors the option to hold shares in electronic form. The second was to have a wide system of depository by getting banks and financiers or brokerage to be its operators, and thirdly to persuade investors to hold shares in the demat form. NSDL felt that the third part would be the most troublesome since traditional investors would not be convinced withholding their investment in an electronic passage. Be that as it may, shockingly, the reaction to demat was greatly improved than had anticipated.

NSDL authorities got together with numerous organizations to offer them the concept of demat. Numerous organizations joined in the initial stage, however, later the number stagnated. Reason behind it was that numerous different organizations were doubtful about the idea, and needed to see with their own eyes how investors reacted to it, before going along with it. The next step was more troublesome: persuading banks to join with NSDL as depository. In the mid-90s, broking firms experienced an absence of credibility. So while representatives were quick to join with NSDL, that did not help NSDL's motivation since retail investors did not confide in the intermediaries/brokers enough to open a demat account along with them.

So NSDL needed to get banks on its side to promote the idea of demat. This was a sluggish procedure. It was hard to explain capital markets to the banks. For reasons unknown, they were loath to having anything to do with the capital markets. NSDL authorities had a go at revealing to them that similarly as they held assets, it (NSDL) held shares. On putting forth that point of view at last banks saw the point. That was a key defining moment for the idea of demat.

³ Santosh Nair, 20 years of demat: A move that transformed share trading in India, Moneycontrol (Jan 23, 2017 08:54 AM) <https://www.moneycontrol.com/news/business/markets/20-years-demata-move-that-transformed-share-trading-india-943891.html>

Having a big system of depository members was vital to the accomplishment of dematerialization. It would have been not possible for the NSDL to without any help cope up with the huge volume of physical shares that was supposed be dematerialized. Investors would submit physical shares to the depository member, which would send those to the organization's exchange specialist in the wake of telling NSDL.

It was amid the procedure of dematerialisation that numerous examples of phony shares came to light, which otherwise would have gone unnoticed. Numerous organizations had a larger number of shares available for use than were really issued by them.

At long last came the investors. At first, there were two fragments on the stock trades: the physical portion and the demat section. In the first place, liquidity in the physical section was better, and that in the demat portion was an issue.

This prompted an endless loop wherein low liquidity debilitated investors from exchanging demat shares, which additionally diminished liquidity. And while retail investors were snappier to grasp the possibility of electronic shares, the promoters of a portion of the reputed organizations would require goading from SEBI.

It was just as late as June 2011 that SEBI made it compulsory for promoters of every listed organization to hold shares in the demat form. Information accessible with the controller demonstrated that promoters of about 50 percent listed organizations, still held shares in physical shape. Also, these included many blue-chip organizations and open division giants. As of December 31, 2016, the NSDL brags of a little more than 1.5 crore demat accounts. A low figure for a nation like India, which is endeavoring to financial instruments over the traditional form like gold and land.

This year, in the mid of June 2018 government felt the need to introduce dematerialization for unlisted companies as well. In India when it comes to comparison in the number of unlisted and listed companies then one will find that there are more number of unlisted companies than that of listed companies and after making it mandatory for the listed companies shares only to be available in demat form, this year they decided to implement the same for the unlisted companies.

This step of government is taken so as to bring transparency to the share transaction and eradicate the benami. SEBI has announced the date of 5th December 2018 to be the last date for all the unlisted companies to get their shares in demat form and companies which will not get shares in dematerialized form till 5th December will not be able to transfer shares.⁴

⁴ Santosh Nair, 20 years of demat: A move that transformed share trading in India, Moneycontrol (Jan 23, 2017 08:54 AM) <https://www.moneycontrol.com/news/business/markets/20-years-demata-move-that-transformed-share-trading-india-943891.html>

VI. PROCEDURE FOR DEMATERIALIZATION OF SHARES IN UNLISTED COMPANY

- The company shall bring changes in its articles by passing a resolution at the general meeting to add the articles concerning demat of shares.
- The company shall sign agreements with the NSDL (National securities depository limited), Depositories, and CDSL(Central depositories services limited) after getting it approved by the board of Directors in the Board meeting. SEBI has made it compulsory that if an organisation has decided to provide demat facility to its investors it must have signed an agreement with both the depositories.⁵
- To dematerialize the shares, a company need to have electronic connectivity with the depositories.⁶ Electronic connectivity can be established either through a Registrar which has got the required infrastructure or in-house by the medium of computer hardware, software, and other equipment. If the company has decided to go for an outside Registrar then the agreement stated above will be an agreement among three parties.
- The moment company gets admitted into the depository system, an International Securities Identification Number(ISIN) is appointed by the depository to the company. This number varies for each security of the company which gets admitted to the depository.
- Once electronic connectivity gets established then depositories give information to the participant about the name and ISIN of the company, which has joined the Depository System.
- The company must give information about the dematerialization. The shareholders must be informed about the company's shares that can be held in dematerialized form. This could be done by getting an ad in newspapers or mentioning it in the Annual Report of the Company

Following procedures are guided by *SEBI* which are required to be followed by the company in order to establish the demat account and get dematerialized shares:

STEP1: It is necessary for BO (Beneficiary Owner) to open the Demat account with the depository and to get an account number of the demat account.

STEP2: DRF (Demat Request Form) is required to be filled by BO and the further requirement is to submit it along with the physical certificates to the depository participants. A separate DRF has to be used for each ISIN,

⁵ CA Adarsh Agrawal,PROCEDURE FOR DEMATERIALISATION OF SHARES OF COMPANY, lawyersclubindia(2011),lawyersclubindia
<http://www.lawyersclubindia.com/forum/PROCEDURE-FOR-DEMATERIALISATION-OF-SHARES-OF-COMPANY-17771.asp>

⁶ CA Adarsh Agrawal,Procedure For Dematerialization Of Shares Of Company, lawyersclubindia(2011),
<http://www.lawyersclubindia.com/forum/PROCEDURE-FOR-DEMATERIALISATION-OF-SHARES-OF-COMPANY-17771.asp>

in case, BO has both free as well as lock-in shares of the same ISIN(The international security identification number) then separate demat request has to be made.

STEP3: DP (Depository Participant) would cross-check that the DRF is correct or not.

STEP4: DP will make a demat request on the NSDL or CDSL system and send the same to the Company, the Registrar and Transfer Agent (RTA).

STEP5: The genuineness of the certificates will be verified and tested by Registrar and Transfer Agent (RTA) and after that procedure RTA confirms the request.

STEP6: Once the request gets successfully set up, DP will remove the physical certificates and will generate a Demat Request Number and send an electronic communication to the depository and send the DRF and the share certificate to the company by courier.

STEP7: On getting confirmation, depository can credit an equivalent number of securities in the demat account of the BO kept up with CDSL or NSDL.

STEP8: The depository can download the details of the demat request and convey the same to the electronic registry maintained by the Registrar of Companies.⁷

VII. TRANSFER OF SHARES IN DEMATERIALIZED FORM

- A shareholder needs to open a demat account with Depository Participant (DP) and submit physical shares in order to convert it into dematerialized form.
- Shareholders who want to transfer(transferor) the shares in dematerialized form can transfer the shares in the demat account of the other individual or company(transferee), for that purpose of transferring, shareholders need to issue appropriate instructions to the concerned DP through Delivery Instruction Slip (DIS). The delivery instruction slip is a book similar to a chequebook and an investor is supposed to handle it with the same care as a chequebook.
 - The seller is supposed to mention investor`s demat account number in the DIS.
 - It is vital to be acknowledged of that RTA will have to confirm from the company before approving any kind of the transfer. Its necessary to have company approval and only then RTA will register a transfer in the demat mode.

Rules and regulation introduced by Indian Government for dematerialization

⁷ Amartya Bag, Dematerialization of shares and complete procedure,ipleaders (November 18, 2014) , <https://blog.ipleaders.in/procedure-dematerialization-of-shares/> , Step1- Step8 is reffered from ipleades.

- The amendment is an outcome of the meeting held on March 28, 2018, but the plan was being thought of long back since 2014. In an article of Business Standard 30 July 2014, TS Reddy, the Managing Director and CEO of CDSL, said, “It will be good transition for the market. I doubt if any section of the market will be opposed to the idea. In my opinion, the transition will be smooth; the only hurdle will be in the case of companies that no longer function or have no trading activity holding pre-IPO.

- While the **Companies Act, 2013**⁸ already has a provision (Section 29) that mandates the issuance of securities in demat form for companies making public offers, the **Depositories Act, 1996**⁹ states that an investor can hold shares either in physical or in demat form. This legal ambiguity has allowed many investors in unlisted public companies to retain their shares in physical form, evading tax and financial scrutiny. Further, any move by the government mandating the conversion of shares will be an ambitious task, impacting over 55 million shareholders.

- The latest move anticipated by the **Ministry of Corporate Affairs**¹⁰ has made it obligatory for unlisted public companies to dematerialize (demat) their shares.

- Companies in India will need to maintain a record of “beneficial owners”. This was introduced in the **Companies (Amendment) Act, 2017**¹¹ early this year to improve corporate governance and follow the norms set by the Paris-based Financial Action Task Force (FATF-GAFI) to combat money laundering

- The amendment to **Regulation 40 of Securities and Exchange Board of India** (Listing Obligations and Disclosure Requirements) Regulations, 2015 vide Gazette notification dated June 8, 2018, has mandated that transfer of securities would be carried out in dematerialized form only.

- The Securities and Exchange Board of India (SEBI) declared that while it is still possible for investors to hold shares in physical however, form after December 5, 2018, they may not be able to transfer shares after that deadline. This is to curb fraud by share-transfer agents.

- In case of failure to reveal about beneficial ownership may lead to penalties of up to Rs 500,000 for a company, including all the officers of the company who is a part of default and up to Rs 100,000 for an individual. In addition, continuing failure to comply will trigger a daily fine of Rs 1,000.

- The Companies Act also empowers the government to investigate cases of beneficial ownership.¹²

⁸ Ministry of commerce and affairs, Companies Act 2013, <http://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf>

⁹ SEBI, Depository Act 1996, <https://www.sebi.gov.in/acts/act03a.pdf>

¹⁰ Ministry of Commerce and Affairs, <http://www.mca.gov.in/>

¹¹ Ministry of Law and Justice, Companies (Amendment) Act 2017, http://www.mca.gov.in/Ministry/pdf/CAAct2017_05012018.pdf

VIII. OBJECTIVE OF DEMATERIALIZING THE SHARES IN UNLISTED COMPANY

- India's regulatory agencies, consisting of the SEBI and the MCA, have repeatedly announced the conversion of physical share certificates into demat form to unveil opaque ownership of organisations or benami ownership in shell companies.
- This step will reduce the number of frauds relating to equity shares and dividend payouts. If there is an absence of 100% demat of shares of unlisted or listed public/private companies then fundamentally fragile companies can always manage to issue duplicate shares to individuals/promoters, which can be guaranteed with different financiers to receive funding.
- The ministry of corporate affairs (MCA) has announced the plan for dematerialisation of securities/shares in past few weeks as it wants to make sure that the real ownership is revealed through the exercise, besides making it an easy task to track the shareholders.
- Since the demat account of the company will be linked with the aadhar and pan of the shareholder so it will become an easy task for the government authorities to spot the chain of benami transactions which are in existence.
- As it will be able to detect the chain of benami transaction so it will become easy for income tax authority to catch the tax evasion committed by unlisted companies.

IX. ADVANTAGES OF HAVING DEMATERIALIZED HOLDINGS PRIOR TO AN IPO

- Transfer of shares will be very easily done it will consume minimal time and no stamp obligations shall be levied.
- Easy track record of all the transactions can be maintained.
- Sometimes the share certificates get lost, destroyed due to fire, decay, etc which is not the case in case of dematerialisation of shares
- Dematerialization not only avails shareholders with a hassle-free way of dealing in shares but also reduces all the associated tensions.
- Minimization in bad deliveries
- Prevent loss of shares and postal delay

¹²Dezan Shira & Associates, India to Make Demat Shares Mandatory, Introduce New Disclosure Rules for Companies, India Briefing (May 30, 2018), <https://www.india-briefing.com/news/india-demat-shares-mandatory-beneficial-ownership-rule-16966.htm>,

- Immediate shares transfer
- Minimization in paperwork.
- No delay in settlement cycles and payouts.
- The dematerialization completely mitigates the associated heartburns generating from shares theft, mutilation, forgery, counterfeit shares and loss of shares amid a natural calamity.¹³

X. DISADVANTAGES OF HAVING DEMATERIALIZED HOLDING PRE-IPO

The disadvantages of the dematerialization of securities can be summarised as follows:

- Trading of shares will become uncontrollable in case of dematerialization of shares
- It is obligatory on the capital market regulator to oversee the trading in dematerialized shares and to keep note of it that share transfer does not damage the interest of investors. The role of main market players such as shares-brokers is imperative to be under the supervision as they have the potential of manipulating the market or investors¹⁴
 - Several regulatory frameworks have to be confirmed too, including the Depositories Act, Regulations. Additionally, On various different levels, the agreement has to be entered in the process of dematerialization. These following things may cause disquietude to the investor who desires of simplicity when it comes to transfer in the dematerialized way.¹⁵
 - It cannot be ignored that there are numerous security holders who prefer to have their securities/shares in physical form and who are again of holding their securities in demat mode. The amendment related to dematerialization of shares will destitute the shareholder of their fundamental right of choosing to have their shares in their desired form. This is another instance of reactive lawmaking. Certain instance of fraudulent transfers that came to fore in case of Sharepro will lead to doing away with the option of holding securities in physical form.
 - Though the amendment claims to remove the difficulty and promotes easiness, convenience, and safety in transactions for investors, the same come along with the various level of difficulties to the shareholders for whom the demat system and the electronic form does not seem to be user-friendly. The bonafide shareholder, vesting shares in physical form, will be largely affected by such compulsion and will be left with only two

¹³ Trinath Tadakamalla, Dematerialized Securities (2013),http://www.legalserviceindia.com/articles/dematerialized_securities.htm

¹⁴ Abey Francis, Advantage and Disadvantage of Depository System, MBA Knowledge Base, <https://www.mbaknol.com/investment-management/advantages-and-disadvantages-of-the-depository-system/>

¹⁵ Trinath Tadakamalla, Dematerialized Securities (2013),http://www.legalserviceindia.com/articles/dematerialized_securities.htm

options i.e., either to convert their securities in demat form, which shall be against their will or to refrain from transferring their securities ever, in both the circumstances, it is the interest of the securities holder which shall get suppressed by the lawmaker.

XI. CONCLUSION

After the guidelines provided by SEBI and MCA, it became mandatory for every unlisted company to have dematerialized shares to trade. When companies have to trade their shares in the stock market at the public level than companies generally go for IPO but when the company is young then it usually opts for pre-IPO to trade its dematerialized share among its existing shareholders only. The reason behind government making it compulsory for all the companies to have shares in dematerialized form is to unveil the non-transparent share transfer and to combat the benami system, black money transfer, tax evasion by companies and etc illegal means. Everything which gets introduced come with some kind of advantage or disadvantage together but the advantages of dematerialization overshadows its disadvantages and the changes ushered in by SEBI and the Central Government in terms of compulsory dematerialization of securities is important for developing the securities market to a degree of advancement. Freely traded securities are an essential component of such an advanced market and dematerialization addresses such issues and is a step towards the advancement of the market.