

SEBI'S VISION FOR A DIGITAL SECURITIES MARKET: KEY AMENDMENTS TO BOOST DEMATERIALIZATION

Hardeep Sachdeva & Ayushi Mukherjee*

ABSTRACT

Digitalization is being hailed as the future driver of the Indian regulatory regime. The Securities and Exchange Board of India (“SEBI”) was one of the first regulators to jump on this bandwagon and to foresee the significance of digitalization in the securities market. In this regard, one of the key areas of focus for SEBI, in recent years, has been to promote the dematerialization of securities for listed companies. SEBI has taken various policy measures on an ongoing basis, for completely digitalizing the security holding structure of listed companies in India. This note seeks to analyze the latest amendments introduced by SEBI to streamline the process for mandatory dematerialization of shares, and their legal ramifications on the investors and the public limited companies in India.

Keywords: Dematerialization, Transparency, Digital Securities, Efficiency Investor Protection, Ease of Doing Business.

TABLE OF CONTENTS

I. INTRODUCTION.....	23
II. LEGISLATIVE HISTORY.....	25
III. RECENT DEVELOPMENTS.....	29
IV. CONCLUSION.....	30

I. INTRODUCTION

The lacunas relating to the physical aspect of the trading system of securities

* The authors are Senior Partner and Associate, respectively, at AZB & Partners.

market came to the forefront in the mid-1990s.¹ SEBI in its report titled '*Report of the Group on Reduction of Demat Charges*', dated January 27, 2004, observed that some of the issues involved in dealing with physical shares through public issue allotment and secondary market transactions included the following:²

1. Loss and damage of certificate.

Physical share certificates are vulnerable to loss, theft, or damage. If the share certificate is lost or destroyed, the process of getting a duplicate share certificate is cumbersome, and time-consuming for the investors, and often requires several formalities, including filing of police reports or providing indemnity bonds, causing the investors to incur additional costs. Further, the investors are restricted from effectuating a share transfer for their shares till the time a duplicate share certificate is issued, which may lead to loss of opportunity to sell shares during the interim period.

2. Transfer and transmission delays.

The process of transferring shares through physical certificates is time consuming given the formal requirements and administrative compliance required to be undertaken by the transferor, transferee and the company. Shareholders are required to physically submit transfer forms to the company's registrar, which can be delayed due to postal issues, administrative bottlenecks, or incorrect documentation.

3. Risk of fraud.

Physical certificates are more susceptible to fraudulent activities, such as counterfeit certificates or forged signatures. Without the digital safeguards present in demat accounts, physical shares can also be tampered with more easily.

4. Additional cost to company.

¹ Divisha Sharma, 'The journey of Indian depository system: a critique of hiccups accompanying dematerialization', 23 *Supremo Amicus* 6.2.42 (2021).

² Report of the Group on Reduction of Demat Charges (Jan. 27, 2004), https://www.sebi.gov.in/sebi_data/commndocs/dematrep_p.pdf.

Significant additional cost is incurred by public companies having a large number of shareholders, in printing and distributing the share certificates to the investors.

In light of the above challenges, and with major financial scams uprooting the faith of the investors in the Indian securities market, a need for a substantial overhaul was felt by SEBI. In order to tackle the challenges related to holding of securities in physical form, and to bring the Indian securities market at par with the global standards, in the year 1996, SEBI introduced the 'depository system' of trading with the passing of the Depositories Act, 1996 ("**Depositories Act, 1996**") and formation of the National Securities Depository Limited ("**NSDL**") and the Central Depositories Services Limited ("**CSDL**").

The existing system of physical trading of securities in the stock exchanges was thereafter replaced by the Depositories Act which mandated all securities held by a depository (being NSDL and CDSL) to be in dematerialized form. As a result, trading of securities started taking place in dematerialized form.

II. LEGISLATIVE HISTORY

Pursuant to revamping the trading system, SEBI along with the Ministry of Corporate Affairs has introduced certain key amendments to move towards mandatory dematerialization of shares of the public companies with the objective of: (i) enhancing security and reduced fraud risk; (ii) increasing market efficiency and making the settlement process faster and more seamless; (iii) increasing liquidity with completion of transfer processes in real-time; (iv) ensuring significant cost reductions for both investors and issuers in relation to handling and transfer of physical share certificates; and (v) providing greater transparency and investor confidence with free flow of information.

The key amendments in this regard are enumerated herein below:

1. Public issuances to be in dematerialized form.

Section 29 of the Companies Act, 2013 as amended ("**CA, 2013**") stipulates

that any company making a 'public offer'³ is mandatorily required to issue shares in dematerialized form. The aforesaid provision was notified with effect from September 12, 2013. Further, in the year 2014 and 2018 *vide* subsequent amendments to Rule 9 and Rule 9A of the Companies (Prospectus and Allotment of Securities) Rules, 2014 as amended ("**PAS Rules**"), every public unlisted company was mandated to issue shares in dematerialized form.⁴

Prior to notification of the aforesaid provisions, Section 68B of the Companies Act, 1956 ("**CA, 1956**") provided the stipulations related to the form of shares for public issuances. The aforesaid provision required all listed public companies, making an initial public offer of any security for a sum of INR 10,00,00,000/- (Indian Rupees Ten Crores Only) or more, to mandatorily issue shares in dematerialized form.

While the applicability of Section 68B of CA, 1956 was limited to public listed companies making an initial public issue, Section 29 of CA, 2013 read with Rule 9A of the PAS Rules has expanded the regulatory mandate to include public unlisted companies within its ambit. The aforesaid change was introduced with the objective of promoting transparency and efficiency in operations of public companies (listed and unlisted), which generally have a large number of shareholders and consequently, face the challenge of maintaining physical records for shareholding.

2. Transfer of listed securities permitted only in dematerialized form.

SEBI amended Regulation 40 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**SEBI LODR**") wherein, the dematerialization of shares was made a pre-requisite for transfer of shares of a listed company with

³ Companies Act, 2013, § 23(4) (India) ("Explanation— For the purposes of this Chapter, "public offer" includes initial public offer or further public offer of securities to the public by a company, or an offer for sale of securities to the public by an existing shareholder, through issue of a prospectus.").

⁴ Companies (Prospectus and Allotment of Securities) Rules, 2014, Gazette of India, pt. II sec.3(i), r. 9A(11) (March 31, 2014) (exempting Nidhi companies, government companies and wholly owned subsidiaries that are public companies from complying with the mandatory dematerialization requirements).

effect from April 01, 2019. The aforesaid amendment did not prohibit the investor from holding the shares in physical form however, a restriction on transfer of such shares was imposed till the time the shares were dematerialized. Initially, the amendment was not applicable to transmission (i.e. transfer of title of shares by way of inheritance / succession) and transposition (i.e. re-arrangement / interchanging of the order of name of shareholders) of shares. However, *vide* SEBI (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2022, the aforesaid restriction was made applicable to all share transfers of a listed company, including transmission and transposition of shares.

SEBI introduced the aforesaid amendment with the objective of promoting dematerialization of shares for listed companies. The aforesaid amendment also enabled better monitoring of share transfers by the regulator thereby, increasing transparency in the share transfer process of the listed companies.

3. Allotment of securities for a rights issue permitted only in the dematerialised form.

SEBI introduced a new provision in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018) as amended ("**SEBI ICDR**") in the form of regulation 77A *vide* SEBI (Issue of Capital and Disclosure Requirements) (Sixth Amendment) Regulations, which mandated right entitlements issued pursuant to a rights issue to be mandatorily issued in dematerialized form.

Prior to the introduction of Regulation 77A of the SEBI ICDR, right entitlements were intimated to shareholders through composite application form ("**CAF**"). The process of printing and dispatch of CAF to shareholders was time consuming for the companies. Further, although right entitlements were permitted to be traded on the exchanges, however the settlement was required to be in physical form. In order to address these issues, SEBI revamped the rights issue process including introduction of the provision for issue of right entitlements in dematerialized form. Consequent to the aforesaid change, electronic credit and trading of rights renunciation enabled transparency and

efficiency in the process of renunciation.⁵

4. Promoter shareholding to be in dematerialized form.

Regulation 31(2) of the SEBI LODR mandates 100% (one hundred percent) of the promoter shareholding in a listed company to be in dematerialized form. Pursuant to an amendment in 2018 to Rule 9 of the PAS Rules, a similar mandate was imposed on public unlisted companies issuing convertible securities. The aforementioned provision mandated the promoters of every public company (listed and unlisted) making a public offer of any convertible securities to hold such securities only in dematerialised form. The provision further required the entire promoter holding of convertible securities in held in physical form up to the date of the initial public to be converted into dematerialised form before the offer is made and thereafter such promoter shareholding is required to be held in dematerialized form only. The aforementioned amendment facilitated better scrutiny over the promoter shareholding by the regulator therefore, enhancing transparency and investor protection norms.

5. Issuance of securities in demat form in case of investor service requests.

As an on-going measure to enhance ease of dealing in securities markets by investors, SEBI *vide* a circular dated January 25, 2022 and bearing the reference number as:

SEBI/HO/MIRSD/MIRSD_RTAMB/P/CIR/2022/8 read with Gazette Notification no. SEBI/LADNRO/GN/2022/66 dated January 24, 2022, clarified that with effect from January 25, 2022, listed companies are required to issue the securities in dematerialized form only while processing the following investor requests:

- (i) issue of duplicate securities certificate;
- (ii) claim from unclaimed suspense account;

⁵ Discussion Paper on Rights Issue, Securities and Exchange Board of India (May 21, 2019), (https://www.sebi.gov.in/reports/reports/may-2019/discussion-paper-on-review-of-rights-issue-process_43049.html).

- (iii) renewal / exchange of securities certificate;
- (iv) endorsement;
- (v) sub-division / splitting of securities certificate;
- (vi) consolidation of securities certificates/folios;
- (vii) transmission; and
- (viii) transposition.

Issuance of shares in dematerialized form pursuant to service requests was intended to gradually make security holders move towards dematerialization of the securities.

III. RECENT DEVELOPMENTS

On January 14, 2025, SEBI issued a consultation paper titled 'Certain amendments to SEBI (Listing Obligations and Disclosure Requirement) Regulations, 2015 with the objective of encouraging dematerialization of securities and streamlining certain processes in view of current regulatory landscape'. The objective of the consultation paper is to seek comments / views / suggestions from the public and other stakeholders on the proposal for amending SEBI LODR to mandate issuance of new securities pursuant to (i) consolidation/split of face value of securities and (ii) scheme of arrangements, only in dematerialised form. The last date for providing comments/suggestions on the consultation paper is February 04, 2025.⁶

Presently, the SEBI LODR does not specifically provide for issuance of new securities mandatorily in dematerialised form in case of stock-split, consolidation of face value of shares or merger/demerger. However, presently, if desired by the listed companies, it can be included in the shareholders' resolution approving such corporate action. Similarly, issuance of shares in demat form pursuant to merger/demerger can also be covered in the scheme of arrangement.

⁶ Certain amendments to SEBI (Listing Obligations and Disclosure Requirement) Regulations, 2015 with the objective of encouraging dematerialization of securities and streamlining certain processes in view of current regulatory landscape (Jan. 14, 2025), https://www.sebi.gov.in/reports-and-statistics/reports/jan-2025/consultation-paper-on-certain-amendments-to-sebi-lodr-regulations-2015-with-the-objective-of-encouraging-dematerialization-of-securities-and-streamlining-certain-processes-in-view-of-current-regulato-_90753.html.

In light of the above, the listed companies are still permitted to issue securities in physical mode by virtue of (i) consolidation of face value of securities; (ii) sub-division or split of face value of securities; and (iii) issuance of securities pursuant to a scheme of arrangement viz. merger, demerger and reconstruction etc. In this latest move, SEBI now seeks to restrict the aforementioned avenues for issuance of shares in physical form by listed companies.

The proposed amendment is aligned with SEBI's objective of progressing further towards greater dematerialisation of securities and to prevent fresh creation of physical securities by listed entities. It is also pertinent to note that the consultation paper further proposes that in case an investor does not have a demat account then the issuer companies will be required to open a separate demat account with a suitable ledger of ownership for dealing with such securities. The aforesaid proposed change allows some flexibility to investors who do not have a demat account on the date of implementation of the corporate actions related to consolidation / split / restructuring.

IV. CONCLUSION

Since 1996, SEBI has followed a methodical approach to implement requirements for dematerialization in a phased manner. As a result of SEBI's consistent efforts, the Indian securities market is on the precipice of completely digitalizing the security holding structure. Further, with the introduction of the requirement for mandatory conversion of shares of private limited companies into dematerialized form, the regulators have green-lighted an era of paperless security holding for private companies as well.

The move towards mandatory dematerialization comes with several significant benefits. For retail investors, mandatory dematerialization brings greater convenience and accessibility. Investors no longer have to deal with the physical paperwork, such as storage or transfer of share certificates. They can manage their investments online, track their holdings in real-time, and receive notifications for corporate actions. Demat accounts also provide a secure method of owning securities without worrying about the risks associated with physical certificates.

For issuers, the move to dematerialization reduces the complexity and

administrative burden of managing shareholder records. Companies no longer need to manage vast numbers of physical certificates, perform manual transfers, or handle lost certificate claims. Additionally, electronic systems facilitate faster and more accurate corporate action processing, allowing for quicker dividend distribution and more transparent communication with shareholders.

Stock exchanges, brokers, and other market participants stand to benefit from the increased efficiency and liquidity brought by mandatory dematerialisation. As securities are transferred electronically, the settlement process is streamlined, reducing operational costs and the risk of errors. With the introduction of the T+1 settlement cycle, exchanges are expected to see faster turnover and more efficient clearing and settlement of trades.

Depositories like NSDL and CDSL benefit from the increased volume of demat accounts and transactions, contributing to higher revenues. The shift also positions India's capital markets in line with international standards, making them more attractive to foreign investors. Lenders, who are lending on the basis of share pledges, will have far greater flexibilities in foreclosure of the securities and selling the dematerialized shares.

Accordingly, mandatory dematerialization of shares is beneficial for all stakeholders. Making it easier for SEBI, and also other regulators, to monitor, have better surveillance of trading activities and enforce compliances and faster identification of irregularities or fraudulent practices. Securities ownership and trading patterns can be checked in real-time, leading to better control on shares and more effective market regulation.