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Phone : +91 73059 14348 – info@iledu.in / Chairman@iledu.in



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DEMATERIALIZATION MANDATE FOR PRIVATE COMPANIES: A STEP TOWARDS TRANSPARENCY OR A BURDEN ON SMES?

AUTHORS – RUDRA VASHISHTH* & MRS. SWARNIM CHOUDHARY**

* STUDENT AT QUANTUM UNIVERSITY, ROORKEE

** ASSISTANT PROFESSOR AT QUANTUM UNIVERSITY, ROORKEE

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Abstract –

The Ministry of Corporate Affairs (MCA), through the Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023, introduced Rule 9B mandating dematerialization of securities for private companies other than small companies. This reform represents a major shift in India's corporate governance framework by extending digital securities compliance beyond listed and unlisted public companies to a substantial segment of private enterprises. The objective of the reform is to improve transparency, reduce fraud, streamline ownership tracking, and strengthen investor confidence. However, the mandate has also generated concerns regarding compliance costs, technological barriers, administrative burdens, and operational difficulties, especially for small and medium enterprises (SMEs) transitioning toward larger corporate status.

This paper critically examines the dematerialisation mandate from legal, economic, and governance perspectives. It evaluates whether the reform advances transparency and accountability or imposes disproportionate burdens on SMEs and closely held private companies. The paper analyses the legislative framework, practical implementation challenges, comparative global practices, stakeholder concerns, and the overall impact on India's corporate ecosystem. The study argues that while the reform promotes digitisation and corporate transparency, its effectiveness depends upon balanced implementation, regulatory flexibility, cost rationalisation, and awareness among private companies. The paper concludes that the dematerialisation mandate is an important step toward modern corporate governance in India, but without adequate infrastructural and procedural support, it may create unintended compliance hardships for SMEs.

Keywords- Dematerialisation, Private Companies, Rule 9B, Corporate Governance, MCA, Securities Regulation, SMEs, Transparency, Digital Securities, Companies Act, 2013, Compliance Burden, Investor Protection, Corporate Transparency, Depositories, Securities Market Reforms.

Introduction

Digitalisation has become an important part of modern corporate governance and regulatory systems. In India, corporate and securities laws have gradually shifted from paper-based mechanisms to electronic systems to improve efficiency, transparency, and accountability.

One of the major developments in this process is the concept of dematerialisation ("demat"), which refers to the conversion of physical share certificates into electronic form maintained through depositories. Initially applicable only to listed companies, the system was later extended to unlisted public companies under Rule 9A of

the Companies (Prospectus and Allotment of Securities) Rules, 2014.

A significant change was introduced by the Ministry of Corporate Affairs through its notification dated 27 October 2023, which inserted Rule 9B into the Companies (Prospectus and Allotment of Securities) Rules, 2014. The amendment made dematerialisation mandatory for private companies other than small companies. The objective of this reform is to promote transparency, ensure proper ownership tracking, prevent fraudulent share transfers and benami holdings, and strengthen corporate governance standards in private companies.

The reform, however, has also raised concerns among small and medium enterprises (SMEs) and closely held family businesses. Many companies argue that compliance with dematerialisation requirements involves additional financial costs, procedural formalities, and technological challenges. Since private companies generally operate with limited shareholders and restricted share transfers, critics question whether such extensive compliance obligations are necessary for all private entities.

In this context, the present paper examines the legal and practical implications of the dematerialisation mandate. It analyses whether the reform serves as an effective step toward transparency and accountability or creates an excessive compliance burden on SMEs and private companies in India.

Meaning and Concept of Dematerialisation

Dematerialisation, commonly referred to as “demat,” is the process through which physical share certificates and other securities are converted into electronic form. Instead of maintaining paper-based certificates, ownership records are stored digitally through depositories such as the National Securities Depository Limited and Central Depository Services Limited. Investors and companies access these electronic records through

authorised intermediaries known as Depository Participants (DPs).

Under the dematerialisation system, securities exist only in electronic format, and all transactions relating to transfer, allotment, or transmission of shares are carried out digitally. This system eliminates the need for physical handling of share certificates and creates a more efficient and secure mechanism for maintaining ownership records.

The introduction of dematerialisation has significantly reduced problems associated with physical securities, such as loss, theft, forgery, damage, delayed transfers, and disputes regarding ownership. Electronic records ensure greater accuracy, faster transactions, and easier verification of shareholding patterns. The system also strengthens regulatory oversight by enabling authorities to track ownership changes more effectively.

In the corporate sector, dematerialisation plays an important role in promoting transparency, accountability, and investor confidence. It supports India’s broader digital governance and corporate reform initiatives aimed at modernising business operations and reducing fraudulent practices within the corporate structure.

Legal Framework Governing Dematerialisation

1. Companies Act, 2013

The statutory foundation for dematerialisation in India is provided under Section 29 of the Companies Act, 2013. This provision authorises the Central Government to prescribe specific classes of companies that must issue and hold their securities in dematerialised form. The purpose of the provision is to modernise the securities system and promote greater transparency and efficiency in corporate transactions.

At the initial stage, the provision primarily focused on listed public companies because such companies deal with a large number of investors and securities transactions. However, Section 29 was intentionally drafted in broad

terms, enabling the government to gradually extend dematerialisation requirements to other categories of companies whenever necessary. This flexibility later allowed the introduction of Rule 9A for unlisted public companies and Rule 9B for certain private companies.

The Companies Act, 2013 strongly emphasises corporate governance, accountability, and protection of stakeholders' interests. Mandatory dematerialisation supports these objectives by ensuring that ownership records are maintained electronically, reducing the possibility of manipulation, fraudulent transfers, and disputes relating to shareholding. Electronic records also make regulatory supervision easier and improve the reliability of corporate data maintained by companies.

2. Depositories Act, 1996

The Depositories Act, 1996 established the legal and institutional framework for holding and transferring securities electronically in India. Prior to this legislation, securities transactions were largely dependent upon physical share certificates, which often created problems such as delays in transfer, loss of certificates, forgery, fake certificates, and lengthy administrative procedures.

The Act introduced the concept of depositories, which function as electronic repositories for securities. Under this framework, securities are maintained digitally through institutions such as the National Securities Depository Limited and Central Depository Services Limited. Companies and investors access these systems through registered intermediaries known as Depository Participants (DPs).

The primary objectives of the Depositories Act include:

- Elimination of paper-based securities and physical certificates
- Faster and more efficient settlement of transactions
- Reduction of fraud, forgery, and risks associated with physical documents

- Increased investor protection and confidence
- Creation of a transparent and technologically advanced securities market

The Act played a transformative role in digitising India's securities market and laid the groundwork for future reforms concerning compulsory dematerialisation across different categories of companies.

3. Rule 9A of the Companies (Prospectus and Allotment of Securities) Rules, 2014

Rule 9A of the Companies (Prospectus and Allotment of Securities) Rules, 2014 marked an important expansion of the dematerialisation regime. Introduced in 2018, the rule made dematerialisation compulsory for unlisted public companies.

Under this provision, unlisted public companies were required to issue securities only in dematerialised form and facilitate the conversion of existing physical securities into electronic form. The companies were also required to obtain an International Securities Identification Number (ISIN), enter into agreements with depositories, and ensure compliance with depository regulations.

Rule 9A was introduced to improve transparency and accountability in unlisted public companies, many of which handled substantial investments and corporate transactions despite not being listed on stock exchanges. The rule also aimed to prevent fraudulent share transfers and strengthen regulatory oversight over shareholding patterns and ownership structures.

Importantly, Rule 9A served as the foundation for the later introduction of Rule 9B applicable to private companies.

4. Rule 9B: Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023

A significant development in India's corporate regulatory framework occurred when the Ministry of Corporate Affairs introduced Rule 9B

through the Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2023 by notification dated 27 October 2023.

Rule 9B extends mandatory dematerialisation requirements to private companies other than small companies. This reform represents a major shift because private companies traditionally operated with comparatively fewer compliance obligations due to their closely held ownership structures.

Under Rule 9B, eligible private companies are required to:

- Issue securities only in dematerialised form
- Facilitate the dematerialisation of all existing securities
- Obtain an International Securities Identification Number (ISIN) for every class of security
- Ensure that shareholders convert their holdings into demat form before any transfer, buyback, bonus issue, rights issue, or fresh allotment of securities

The reform seeks to strengthen transparency, improve traceability of ownership, reduce benami and fraudulent transactions, and ensure better corporate governance standards within the private sector. Electronic maintenance of securities records also enables easier regulatory monitoring and due diligence during investments, mergers, and acquisitions.

However, the rule has also generated concerns among SMEs and family-owned businesses regarding increased compliance costs, procedural requirements, and technological challenges. Considering these practical difficulties, the compliance deadline was later extended to 30 June 2025, allowing companies additional time to transition into the dematerialised system.

Applicability of Rule 9B

Rule 9B applies primarily to private companies that are not classified as small companies under the Companies Act, 2013. The intention behind limiting applicability was to reduce the compliance burden on very small businesses while bringing larger private entities within a transparent digital framework.

The rule generally applies to:

- Private companies that do not qualify as small companies
- Holding and subsidiary private companies
- Section 8 companies that satisfy the prescribed financial thresholds
- Certain foreign subsidiaries operating in India and governed by Indian corporate laws

The rule does not apply to:

- Small companies as defined under Section 2(85) of the Companies Act, 2013
- Government companies
- Certain categories of exempt companies notified by the government

Under Section 2(85) of the Companies Act, a “small company” generally refers to a private company whose paid-up share capital and annual turnover remain within the limits prescribed by law. These thresholds are revised by the government from time to time. The exemption provided to small companies recognises their limited financial and administrative capacity and seeks to prevent excessive regulatory burden on smaller business entities.

The applicability criteria under Rule 9B reflect the government’s attempt to balance transparency with ease of doing business. While larger private companies are expected to maintain higher governance standards due to their financial scale and investor involvement, smaller enterprises have been provided exemptions to avoid disproportionate compliance obligations.

Objectives Behind the Dematerialisation Mandate

1. Enhancing Transparency

One of the central objectives behind mandatory dematerialisation is to create a more transparent corporate ownership system. In traditional paper-based structures, tracking the actual ownership of shares was often difficult due to incomplete records, delayed updates, and manual documentation. Physical certificates also made it easier to conceal changes in ownership or maintain non-transparent shareholding arrangements.

By shifting securities into electronic form, ownership details become digitally recorded and easily traceable through depositories. Regulatory authorities can monitor changes in shareholding patterns more effectively and identify the real beneficiaries behind corporate entities. This transparency is particularly important in private companies where ownership structures are often closely held and less visible to external stakeholders.

A transparent ownership mechanism also improves trust among investors, creditors, regulators, and business partners. It ensures that corporate records remain accurate, updated, and accessible whenever required for regulatory scrutiny or financial transactions.

2. Preventing Fraud and Benami Transactions

Another important objective of the dematerialisation mandate is the prevention of fraud and benami transactions. Physical share certificates have historically been vulnerable to forgery, duplication, theft, destruction, and unauthorised transfers. In many cases, disputes arose because of fake certificates, manipulated transfer records, or multiple claims over the same securities.

The electronic system significantly reduces such risks because securities are maintained through secure digital records under regulated depositories. Every transaction leaves an electronic trail, making manipulation and fraudulent transfers much more difficult.

Dematerialisation also helps authorities identify suspicious transactions and trace ownership more efficiently.

The reform further supports the government's broader efforts to curb benami holdings and undisclosed ownership structures. By requiring shareholders to maintain demat accounts linked with verified identities, the system increases accountability and discourages misuse of corporate entities for illegal or fraudulent activities.

3. Improving Corporate Governance

Mandatory dematerialisation is also aimed at strengthening corporate governance standards within private companies. Good corporate governance requires proper maintenance of records, accountability of management, and transparent decision-making processes. Electronic securities systems contribute to these goals by creating reliable and organised ownership records.

Dematerialised securities generate clear audit trails that help companies maintain accurate shareholder information and comply with legal requirements more efficiently. Regulators and auditors can verify transactions more easily, reducing the chances of hidden or irregular share transfers.

In addition, digital compliance systems encourage companies to adopt more professional management practices and modern governance mechanisms. The reform therefore promotes a culture of accountability and regulatory discipline, especially among larger private companies handling substantial investments and financial transactions.

4. Facilitating Investments and Due Diligence

The dematerialisation mandate also seeks to improve the investment environment for private companies. Investors, financial institutions, and venture capital firms generally prefer companies with transparent and digitally verifiable ownership structures. Electronic securities records reduce uncertainty and make it easier

for investors to assess the authenticity of corporate shareholding patterns.

Demat systems simplify due diligence processes during mergers, acquisitions, private equity investments, and fundraising activities. Since ownership records are maintained electronically, transactions can be completed more quickly and with greater accuracy. This efficiency reduces administrative delays and legal disputes during corporate restructuring or investment negotiations.

For growing private companies, adopting dematerialisation may also enhance credibility and improve access to institutional funding. In the long term, it can help companies integrate more smoothly into formal financial and corporate systems.

5. Alignment with Digital India Initiatives

The dematerialisation reform is closely connected with the government's larger vision of digital governance and economic formalisation under initiatives such as "Digital India." Over the past decade, India has increasingly adopted technology-driven systems in taxation, banking, financial services, and corporate regulation to improve efficiency and transparency.

Mandatory dematerialisation supports this broader policy objective by replacing outdated paper-based processes with secure digital mechanisms. It promotes ease of doing business by simplifying securities management and reducing dependence on physical documentation.

The reform also reflects the government's intention to create a more organised and technology-oriented corporate ecosystem where regulatory supervision becomes easier and business operations become more efficient. By encouraging digitisation within private companies, the mandate contributes to the long-term modernisation of India's corporate governance framework.

Benefits of the Dematerialisation Mandate

1. Increased Transparency

One of the most significant advantages of the dematerialisation mandate is the improvement in transparency within corporate ownership structures. In many private companies, physical share certificates and manually maintained records often made it difficult to identify the actual ownership of shares. Electronic records maintained through depositories create a centralised and reliable system of ownership verification.

This transparency benefits regulators, investors, creditors, and tax authorities by enabling them to access accurate and updated information regarding shareholding patterns. It also helps in identifying beneficial ownership and reduces the possibility of hidden or benami holdings within companies.

2. Reduction in Litigation

Disputes relating to physical share certificates have traditionally been a common issue in private companies. Cases involving loss of certificates, forged signatures, duplicate certificates, or disputed transfers frequently resulted in prolonged litigation and uncertainty regarding ownership rights.

Dematerialisation reduces these problems because ownership records are maintained electronically and every transaction is digitally recorded. Electronic records provide stronger evidentiary value and minimise ambiguity regarding transfer of securities. As a result, companies and shareholders are less likely to face disputes concerning authenticity or ownership of shares.

3. Faster Share Transfers

The dematerialised system significantly improves the speed and efficiency of share transfers. Under the traditional physical system, transfer of shares involved multiple procedural steps such as execution of transfer deeds, payment of stamp duty, physical verification of certificates, and dispatch of documents. These

processes often caused delays and administrative inconvenience.

With dematerialisation, transfers are completed electronically through depository participants, making the process quicker, safer, and more efficient. The elimination of physical paperwork also reduces administrative burden and improves operational convenience for companies and shareholders.

4. Better Regulatory Oversight

Electronic securities systems enable regulatory authorities to monitor corporate transactions more effectively. Since all transactions leave a digital audit trail, authorities can easily identify suspicious activities, unusual share transfers, or irregular ownership patterns.

This improved oversight strengthens regulatory enforcement and helps prevent fraudulent practices within companies. It also assists investigative agencies and tax authorities in tracing transactions whenever corporate misconduct or financial irregularities are suspected.

5. Enhanced Investor Confidence

Investors generally prefer companies that maintain transparent and professionally managed records. Poorly maintained physical documentation often creates doubts regarding governance standards and reliability of ownership information.

Dematerialisation enhances the credibility of private companies by ensuring that securities records are accurate, secure, and digitally verifiable. This increases investor confidence and may encourage greater participation from institutional investors, venture capital firms, and private equity investors. A transparent demat system also improves the overall reputation of companies seeking financial growth and external investment.

Challenges and Burdens on SMEs

Although the dematerialisation mandate offers several long-term advantages, it has also created practical difficulties for small and

medium enterprises (SMEs) and closely held private companies. Many businesses believe that the transition from physical securities to electronic systems is not merely a technical change but a major compliance shift that increases financial and administrative pressure.

1. Compliance Costs

One of the biggest concerns for SMEs is the increase in compliance-related expenses. To comply with Rule 9B, companies are required to obtain ISINs, appoint registrars and transfer agents, coordinate with depositories, and maintain continuous compliance records. In addition, businesses often need professional assistance from company secretaries, chartered accountants, and legal advisors.

Apart from one-time setup expenses, companies must also bear recurring annual maintenance charges and depository fees. For large corporations, these costs may be manageable, but for smaller businesses operating with limited financial resources, the additional expenditure can become a significant burden.

2. Administrative Complexity

The dematerialisation process involves several procedural formalities that many SMEs are not accustomed to handling. Companies must pass board resolutions, update statutory records, communicate with shareholders, complete KYC requirements, and periodically file reconciliation reports such as Form PAS-6.

Many small businesses do not have dedicated compliance departments or trained personnel to manage these obligations. As a result, owners and management often face additional administrative pressure while trying to balance day-to-day business operations.

3. Digital Literacy Challenges

A large number of traditional and family-run businesses in India still operate through conventional record-keeping methods. For such enterprises, shifting to a completely digital securities system can be challenging.

Limited familiarity with online compliance systems, digital documentation, and depository procedures may create confusion and operational difficulties. In smaller towns and semi-urban areas, lack of technical expertise and inadequate digital infrastructure may further complicate the transition process.

4. Shareholder Resistance

Another practical issue arises from resistance among shareholders, especially elderly family members who may not be comfortable using digital platforms or opening demat accounts. In many closely held private companies, shares are held within families across generations, and some shareholders may prefer traditional physical certificates.

This reluctance can delay compliance and create internal difficulties for companies attempting to complete the dematerialisation process within prescribed timelines.

5. Increased Dependency on Intermediaries

Under the demat system, private companies become increasingly dependent on external intermediaries such as depository participants, registrars, transfer agents, and compliance professionals. While these intermediaries facilitate smooth functioning of the system, continuous dependence on external agencies increases operational costs and reduces flexibility for businesses.

For SMEs that previously managed share records internally with minimal formalities, this shift represents a substantial structural change in corporate functioning.

6. Burden on Closely Held Companies

Critics of the reform argue that the compliance framework does not sufficiently differentiate between large private corporations and small closely held entities. Many private companies have only a few shareholders and very limited share transfer activity. In such cases, the risk of large-scale fraud or public investor harm may be comparatively low.

Despite this, Rule 9B imposes obligations similar to those applicable to larger companies. This has raised concerns regarding proportionality, as smaller businesses may be subject to complex compliance requirements without corresponding governance risks

Impact on SMEs

Economic Impact

The dematerialisation mandate has a direct financial impact on SMEs. Compliance expenses increase operational costs and may affect working capital management. For growing businesses, funds that could otherwise be used for expansion, production, or employment generation may instead be diverted toward regulatory compliance requirements.

Operational Impact

The reform requires SMEs to adopt new internal systems and compliance mechanisms. Employees may require training to handle electronic records, coordinate with depositories, and manage regulatory filings. These additional responsibilities increase administrative workload and operational pressure on businesses.

Psychological Impact

Many small business owners perceive the mandate as excessive regulatory intervention into private corporate affairs. Since private companies traditionally enjoyed operational flexibility and fewer procedural obligations, the introduction of mandatory dematerialisation has created concerns regarding over-regulation and increasing compliance culture within the private sector.

Long-Term Impact

Despite short-term difficulties, dematerialisation may provide long-term benefits to SMEs. Transparent ownership structures and digitally maintained records can improve investor confidence and enhance the credibility of businesses. Over time, companies may find it easier to attract investment, raise capital, and participate in corporate restructuring activities.

The reform may also encourage SMEs to adopt stronger governance standards and integrate more effectively into India's evolving digital corporate ecosystem.

Comparative International Perspective

United Kingdom

In the United Kingdom, corporate compliance systems are increasingly digitalised through institutions such as Companies House. However, private companies still enjoy comparatively flexible shareholding structures, and mandatory dematerialisation has evolved gradually rather than through strict universal mandates.

United States

In the United States, many private companies, especially startups and venture-backed enterprises, maintain electronic cap tables and digital ownership records through specialised technology platforms. The transition toward digitisation has largely been market-driven and supported by investor practices rather than rigid statutory mandates.

Singapore

Singapore has developed a highly digitised corporate governance framework through the Accounting and Corporate Regulatory Authority. The system focuses on simplified electronic compliance procedures and user-friendly digital governance mechanisms, making compliance easier for businesses.

Lessons for India

Compared to several international jurisdictions, India's approach appears more compliance-oriented and mandatory in nature. While the objective of transparency is important, a more gradual and phased transition model may have reduced resistance among SMEs and traditional businesses.

Providing incentives, simplified procedures, and stronger digital support systems could help create a smoother balance between regulatory transparency and ease of doing business.

Suggestions and Recommendations

1. Phased Compliance Structure

The government should adopt a graded compliance framework based on factors such as turnover, number of shareholders, and transaction volume. Smaller businesses should receive relaxed compliance requirements compared to larger private companies.

2. Financial Support for SMEs

Reduced depository charges, subsidised professional assistance, or government-backed compliance support programs could help SMEs manage the financial burden associated with dematerialisation.

3. Simplified Procedures

The Ministry of Corporate Affairs should simplify procedures relating to ISIN acquisition, PAS-6 filing, and shareholder onboarding to reduce procedural complexity for businesses.

4. Awareness and Training Programs

Government agencies and professional institutions should conduct awareness campaigns and training sessions to help SMEs understand dematerialisation procedures and digital compliance systems more effectively.

5. Exemptions for Closely Held Family Companies

Closely held private companies with limited shareholders and no public fundraising activities may be provided conditional exemptions or simplified compliance mechanisms to maintain proportionality.

6. Technology Integration

Creating a unified digital platform integrating MCA filings, depository systems, and compliance reporting mechanisms would improve efficiency and reduce duplication of procedures for companies.

Conclusion

The dematerialisation mandate for private companies marks a transformative step in India's corporate regulatory framework. By

extending electronic securities governance to non-small private companies, the government seeks to improve transparency, accountability, and investor protection.

The reform has substantial long-term advantages, including fraud prevention, better corporate governance, easier due diligence, and enhanced regulatory oversight. It reflects India's broader commitment to digitisation and formalisation of economic systems.

However, the mandate also imposes considerable compliance and operational burdens on SMEs, particularly family-owned and closely held businesses lacking digital readiness. The uniform application of stringent compliance requirements may create disproportionate hardships for entities with minimal governance risks.

Therefore, while the dematerialisation mandate is fundamentally a progressive reform, its success depends on balanced implementation. Regulatory flexibility, simplified compliance procedures, and SME-friendly support mechanisms are essential to ensure that the reform promotes transparency without undermining entrepreneurial growth.

In conclusion, the dematerialisation mandate should not merely become another compliance obligation; rather, it should evolve into a practical governance tool that strengthens trust, efficiency, and sustainable corporate development in India.

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NO. 08, ARUL NAGAR, SEERA THOPPU,
MARUDHAANDA KURICHI, SRIRANGAM - 620102,
TAMILNADU, INDIA.

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