



The Ministry of Corporate Affairs notifies the provisions relating to the restriction on the 'layers of subsidiaries' under the Companies Act, 2013

Background

The Ministry of Corporate Affairs (MCA) has recently appointed¹ 20 September 2017 as the date on which the proviso to clause (87) of section 2 of the Companies Act, 2013 (the Act) shall come into force. The said provision, along with layering restriction on investment subsidiaries under Section 186(1) of the Act is in consonance with recommendations of the Hon'ble Standing Committee on Finance on the Companies Bill, 2009.

Proviso to Section 2(87) of the Act prescribes that certain class/classes of holding companies that shall not have layers of subsidiaries beyond a prescribed number. Further, Section 186(1) provides that a company, unless otherwise prescribed, shall not make any investment through more than two layers of investment companies.

Though the proviso to Section 2(87) along with explanation (d) was proposed to be omitted in Companies (Amendment) Bill, 2016, however, keeping in view the misuse of multiple layers of companies, where shell companies are created for diversion of funds or money laundering, the MCA has decided to retain the provisions.

The MCA has also notified the Companies (Restriction on number of layers) Rules, 2017 (hereinafter referred to as the 'New Rules') *vide* its Notification² dated 20 September 2017.

Overview of Companies (Restriction on number of layers) Rules, 2017

Restriction on number of layers of holding companies

- No company, other than the exempted companies, shall have more than two layers of **subsidiaries**
- The restriction shall not affect a company from acquiring a company incorporated outside India with subsidiaries beyond two layers as per the laws of such country
- For computing the number of layers, one layer which consists of one or more wholly-owned subsidiary ('WOS') or subsidiaries shall not be taken into account.

Exempted companies

- Banking company
- Non-banking financial company
- Insurance company
- Government company.

Compliances in case of number of layers exceed the prescribed limit

Every company, other than exempted companies, existing on or before the commencement of the rules i.e. 20 September 2017:

- Shall file Form CRL-1 with the Registrar of Companies (the ROC), within 150 days from date of notification

¹ Notification No. S.O.3086(E) dated 20 September 2017

² Notification No. G.S.R. 1176(E) dated 20 September 2017

- Shall not, after the date of commencement of these rules, have any additional layer of subsidiaries over and above the layers existing on such date
- Shall not, in case one or more layers are reduced by it subsequent to the commencement of these rules, have the number of layers beyond the number of layers it has after such reduction or maximum layers allowed.

With a view to remove any hardships to existing companies, the Rules have been provided a prospective application. Hence, existing holding companies need not reduce the existing layers of subsidiaries in excess of two, however, they cannot add any additional layer of subsidiaries provided they file a return with the ROC in the prescribed form (i.e. Form CRL-1).

Penalty

- Company and every officer of the company who is in default shall be punishable with fine up to INR10,000/- and further fine up to INR1,000/- per day after the first, during which such contravention continues.

The New Rules further provides that the provisions shall not be in derogation of the proviso to Section 186(1) of the Act.

Current restriction on the layers of Investment company as per Section 186(1)

The provisions of Section 186(1) provides that a company shall make investment through not more than two layers of '*investment companies*'.

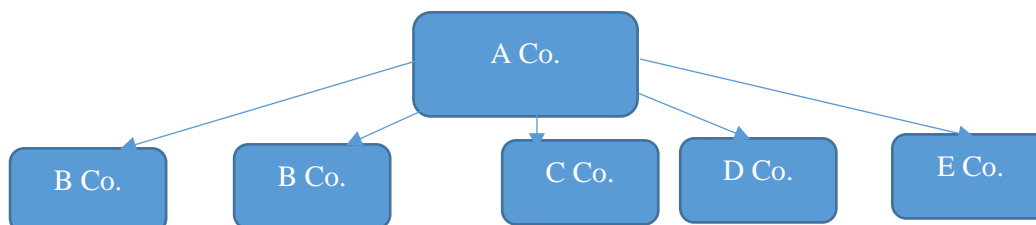
The term 'Investment company' has been defined as "a company whose *principal business* is the acquisition of shares, debentures or other securities". The term 'principal business' has not been defined and is open to judicial interpretation.

Proviso to Section 186(1) provides the following exceptions:

- Company acquiring any other company incorporated in a country outside India, if such other company has investment subsidiaries beyond two layers as per the laws of such country
- Subsidiary company from having any investment subsidiary for the purpose of meeting the requirements under any law/rule/regulations for the time being in force.

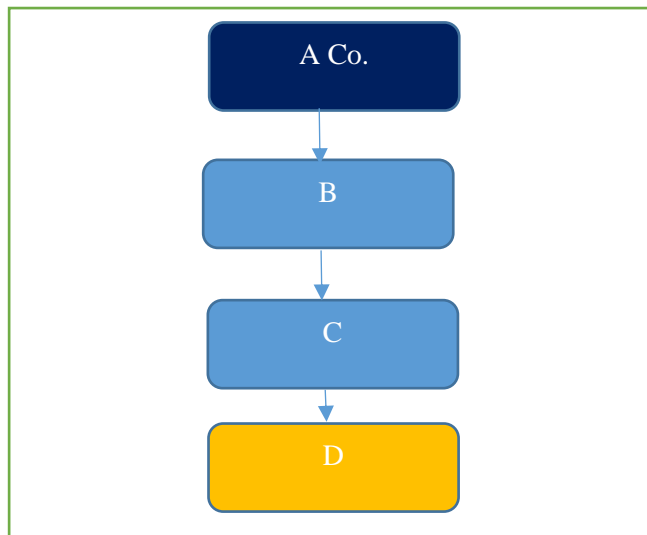
Illustrations:

The New Rules provide no restriction on Horizontal structure as depicted below:



This, in the above example, A Co. can have 'B', 'C', 'D', 'E', 'F' as its subsidiaries as all of them fall under the first layer, vis-à-vis multiple layers, as envisaged by the New Rules.

Possible Structures of Holdings and Subsidiaries



Case 1 – A holding company ‘A’ has multiple layers of subsidiaries i.e. B, C and D

In the aforesaid structure, an existing holding company ‘A’ has three layers of ‘subsidiaries’ and hence will not be able to float ‘D’ unless any exemptions/relaxations become applicable.

Case 2 – ‘B’ is a WOS of ‘A’

The New Rules provide that one layer of WOS shall not be counted for the purpose of computing the number of layers.

In case, if B is a WOS of A, the structure is permissible, as there exists only two layers excluding one WOS.

Case 3 – ‘B’/‘C’ is a subsidiary incorporated outside India

The New Rules provide the exemption to a company from ‘acquiring a company incorporated outside India’.

In the absence of any clarification for exemption available to subsidiaries ‘incorporated’ outside India, the restriction may apply to subsidiaries incorporated outside India.

Case 4 – ‘A’/‘B’/‘C’ fall under exempted companies

In that case, the restriction shall not apply.

Case 5 – ‘D’ is a LLP

The New Rules provide that the restriction would apply to any company, other than exempted companies, having more than two layers of **subsidiaries**.

As per the definition of ‘subsidiary company’ under Section 2(87) of the Act, a ‘company’ includes body corporate i.e., LLP. Therefore the above structure consisting of three layers would be prohibited.

Issues requiring additional consideration

- It may be noted that Section 186(1) of the Act refers to ‘investment companies’ and not to ‘**bodies corporate**’. However, the Rules provide that the restriction would apply to any company, other than exempted companies, having more than two layers of **subsidiaries**. As per the definition of ‘subsidiary company’ under Section 2(87) of the Act, a ‘company’ includes body corporate i.e., LLP.

Thus, the New Rules have made an attempt to broaden the application of the restriction to all subsidiaries including LLPs.

Further, while the restriction under Section 186(1) applies only to Investment Company, the New Rules provides restriction on all subsidiaries including operating subsidiaries.

- The provisions of New Rules shall not affect a company from **acquiring** a company incorporated outside India with subsidiaries beyond two layers as per the laws of such country.

Whether the exemption provided under the New Rules would apply to a company **incorporating** a company outside India with subsidiaries beyond two layers is not clear. However, given the intention is to provide the exemption to subsidiaries outside India which are allowed as per the laws of such country, the benefit of exemption may be provided to such subsidiaries. A clarification from the MCA in this regard would give rest to the ambiguity.

- The New Rules provide that the reporting in CRL – 1 to be done by all existing companies, other than exempted companies. Whether such reporting is also to be done by all existing companies having multiple layers of subsidiaries outside India which is allowed as per the laws of the foreign country, is not clear and needs clarification to the effect.

Our comments

The MCA's recent moves from disqualifying a myriad number of directors to striking off a number of dormant companies followed by placing a restriction on the layers a holding company can hold, are steps to clampdown on illicit fund flows.

The new norms on the restriction on layers of subsidiaries could trigger restructuring/mergers of business entities by retaining only the relevant subsidiaries and winding up entities that may have outlived their purposes.

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